Guidance Note on Audit of Banks (2018 Edition)

Attention

Members' attention is invited to relevant directions/circulars issued by the Reserve Bank of India up to February, 2018 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, 2018.

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Foreword

Independent audit of financial statement of banks is essential for a healthy, safe and sound banking system. Audit of banks involves number of peculiarities e.g. huge volumes and complexity of transactions in banks, wide geographical spread of banks' network, large range of products and services offered by banks, extensive use of technology in banks, oversight by the banking regulator etc. All these factors make the task of the bank auditors quite challenging in doing the audits.

The *Guidance Note on Audit of Banks* brought out by the Auditing and Assurance Standards Board of ICAI every year is an important resource which provides detailed guidance to the members on various aspects of statutory bank audits. I am happy that the Auditing and Assurance Standards Board has brought out the revised 2018 edition of the *Guidance Note on Audit of Banks* for the benefit of the members. The revised Guidance Note was initially developed by an expert group constituted by the Board and thereafter it was finalised with the contribution of the Board members. The Guidance Note is comprehensive and self-contained reference document for the members.

At this juncture, I wish to place my appreciation for CA. Shyam Lal Agarwal, Chairman, CA. Sanjay Vasudeva, Vice-Chairman and other members of the Auditing and Assurance Standards Board & the expert group for their efforts in bringing out this Guidance Note to help the members in maintaining quality in bank audits in a timely manner.

I am confident that the members would find the Guidance Note very useful in their professional assignments.

New Delhi **CA. Naveen N.D. Gupta**
March 09, 2018 President, ICAI

Preface

Banking sector is the backbone of any economy as it provides finances to various segments of economy and helps in sustainable socio-economic growth of the economy. Like other economic activities, the banking sector is also exposed to various risks in its operations. For financial stability in the economy, it is essential that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits. By conducting audits of financial statements of banks, the auditors play an important role in building a resilient banking sector.

The Auditing and Assurance Standards Board of ICAI has been helping the members in maintaining quality in bank audits by bringing out the publication "Guidance Note on Audit of Banks" every year. Since the issuance of the last edition of the Guidance Note in 2017, apart from the Master Directions and Circulars issued by RBI, certain important developments have also taken place in the banking sector. It is, therefore, essential that the members undertaking statutory audit of banks and bank branches keep themselves abreast with the latest developments in the banking sector.

I am happy to place in hands of the members, this revised 2018 edition of the Guidance Note on Audit of Banks. The Guidance Note discusses in depth the various important items on the financial statements of banks, its peculiarities, manner of disclosure in the financial statements, the RBI prudential directions thereon, audit procedures, reporting on Long Form Audit Reports both at central and branch level, Ghosh and Jilani Committee recommendations, special purpose reports and certificates, etc. The Guidance Note, *inter alia*, has been updated for the impact of the Master Directions, Master Circulars and other relevant circulars issued by RBI, the relevant pronouncements of the ICAI, GST provisions. The Guidance Note also includes a new Chapter on Scrutiny of Advance Accounts presented in Ind AS by Borrowers. For the benefit of the members, the CD accompanying the Guidance Note contains Illustrative formats of engagement letter, auditor's report, written representation letter, Features of the Gold Monetization Scheme, Abbreviations used in the Banking Industry, Basis of Selection of Advances Accounts in case of bank branch audit, updated bank branch audit programme for the year 2017-18, Verification of the aspects of the Treasury/ Investments of the Bank in Statutory Audit, Flow Charts for Use of Core Banking Solution software in case of Bank Branch Audit, the text of Master Directions, Master Circulars and other relevant Circulars issued by RBI.

At this juncture, I wish to place on record my gratitude to all the members of the Mumbai study group *viz.*, CA. Shriniwas Y. Joshi (Convenor), CA. Gautam Shah, CA. Sandeep D Welling, CA. Vipul K Choksi, CA. Vikas Kumar, CA. Abhijit Sanzgiri, CA. Niranjan Joshi, CA. Ashutosh Pednekar, CA. Dhananjay Gokhale, CA. Manish Sampat, CA. G. N. Sampath, CA. Shivratan Agarwal, CA. Parag Hangekar, CA. Sanjay Khemani, CA. Sanjay Rane, CA. Abhay Kamat, CA. Pankaj Tiwari, CA. Ketan Jogalekar, CA. Nachiket Deo, CA. Parag Kulkarni, CA. Dilip Dixit, CA. Jitendra Ranawat and CA. Prakash Kulkarni for working on this herculean project despite the demands of their professional and personal lives. My sincere thanks to (i) all the Members of Jaipur Study Group constituted under my convenorship, *viz.,* CA. Bhupendra Mantri, CA. Vishnu Dutt Mantri, CA. Vikas Gupta, CA. Ajay Atolia, CA. Anil Mathur, CA. Vijay Kumar Jain, CA. Prahalad Gupta, CA. Jugal Kishore Agrawal, CA. P. D. Baid, CA. Mukesh Gupta, CA. Ram Avtar Sharma, CA. Vikas Rajvanshi, CA. Vimal Chopra, CA. Thalendra Sharma, CA. Varun Bansal, CA. Mukesh Khandelwal, and CA. Keshav Garg (ii) all the Members of Delhi Study Group constituted under the convenorship of CA. Sanjay Vasudeva, Vice Chairman, AASB, *viz.,* CA. V Rethinam, CA. Rajiv Puri, CA. M. M. Khanna, CA. Simran Singh, CA. Bupinder Singh, CA. Rakesh Gupta, CA. Lalit Ahuja, CA. D. S. Rawat, CA. Bhuvnesh Maheshwari, CA. Nitin Jain, CA. Ashish Agarwal, CA. Anuj Dhingra, CA. Himanshu Garg and Mr. Rakesh Sharma (iii) all the Members of Kolkata Study Group constituted under the joint convenorship of CA. Debashis Mitra and CA. Ranjeet Kumar Agarwal *viz.,* CA. Dipankar Chatterji, CA. Santanu Ghosh, CA. Veena Hingarh, CA. Arif Ahmed, CA. Rajendra Nath Basu, CA. Sukamal Chandra Basu, CA. Mrityunjay Ray, CA. Nirupam Haldar CA. Krishanu Bhattacharyya, CA. Sunil Singhi, CA. Vikash Banka, CA. Ajay Agarwal, CA. Selu Jhunjhunwala, CA. M. R. Jain, CA. Anindra Nath Chatterjee, CA. Tushar Basu and CA. Ashok Kumar Samanta (iv) all the Members of Chennai Study Group constituted under the joint convenorship of CA. G. Sekar, CA. M P Vijay Kumar, CA. K. Sripriya *viz.,* CA. R. Sundararajan, CA. Sivaprasad N., CA. Sukumaran T. G., CA. G.N. Ramaswami, CA. Anusha Sreenivasan, CA. Asir Raja Selvan M, CA. S. Ramesh, CA. Vijay T. C., Dr. S. Gurusamy, CA. V. Chandrasekaran, CA. T. R. Chandrasekaran, CA. Mahesh Krishnan, CA. Uttamchand Jain and CA. Vittalraj to review the exposure draft of Guidance Note on Audit of Banks 2018 edition.

I wish to place on record my sincere thanks to Honourable President, ICAI, CA. Naveen N.D. Gupta, Honourable Immediate Past President, ICAI, CA. Nilesh S. Vikamsey and Honourable Vice President, ICAI, CA. Prafulla Premsukh Chhajed for their whole hearted support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their support and guidance to the activities of the Board. I also wish to place on record my gratitude to CA. Sanjay Vasudeva, Vice Chairman, AASB and all the members and special invitees on the Board for the year 2017-18, without whose support, the Guidance Note would not have been possible in the given time. I also wish to thank CA. Megha Saxena, Secretary, CA. Rajnish Aggarwal, CA. Nitish Kumar and other staff members of her team for their hard work in giving the Guidance Note its final shape.

I am sure that the members would find the Guidance Note useful as its earlier editions while conducting the audits of banks/ bank branches.

Jaipur	**CA. Shyam Lal Agarwal**
March 09,	Chairman
2018	Auditing and Assurance Standards Board

Contents

Contents of Accompanying CD

I

Knowledge of the Banking Industry

1.01 The banking industry is the backbone of any economy as it is essential for sustainable socio-economic growth and financial statements in the economy. There are different types of banking institutions prevailing in India which are as follows:

(a) Commercial Banks
(b) Regional Rural Banks
(c) Co-operative Banks
(d) Development Banks (more commonly known as 'Term-Lending Institutions')
(e) Foreign Banks
(f) Payment Banks
(g) Small Finance Banks
(h) EXIM Bank

1.02 All these banks have their unique features and perform various functions / activities subject to complying with the RBI guidelines issued from time to time. Section 6 of the Banking Regulation Act, 1949, lists down the forms of business in which banking companies may engage. The text of the Section 6 has been reproduced in **Appendix I** of the Guidance Note (given in CD accompanying the Guidance Note).

1.03 Of these banks, commercial banks are the most wide spread banking institutions in India. Commercial banks provide a number of products and services to general public and other segments of economy. Two of the main functions of commercial banks are (1) accepting deposits and (2) granting advances. In addition to their main banking activities, commercial banks also undertake certain eligible Para Banking activities which are governed by the RBI guidelines on Para Banking activities.

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

1.05 The provisions regarding the financial statements of banks are governed by the Banking Regulation Act, 1949. The Third schedule to the aforesaid Act, prescribes the forms of balance sheet and profit and loss account in case of banks. Readers may refer **Appendix II** of the Guidance Note (given in CD accompanying the Guidance Note) for text of third schedule to the Banking Regulation Act, 1949. Further, in case of banking companies, the requirements of the Companies Act, 2013, relating to the balance sheet, profit and loss account and cash flow statement of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the financial statements, as the case may be, of a banking company. It may be noted that this provision does not apply to Nationalised Banks, State Bank of India, its Subsidiaries and Regional Rural Banks (RRBs).

1.06 The provisions regarding audit of Nationalised Banks are governed by the Banking Regulation Act, 1949 and the RBI Guidelines. The provisions regarding audit of Banking Companies are governed by the Banking Regulation Act, 1949, RBI Guidelines and the provisions of the Companies Act, 2013. The illustrative formats of auditor's report are given in **Appendices III to VI** of the Guidance Note (given in CD accompanying the Guidance Note) as follows:

Appendix III - Illustrative Format of Report of the Auditor of a Nationalised Bank

Appendix IV - Illustrative Format of Report of the Auditor on the Standalone Financial Statements of a Banking Company

Appendix V - Illustrative Format of Report of the Branch Auditor of a Nationalised Bank

Appendix VI - Illustrative Format of Report of the Branch Auditor of a Banking Company

1.07 The auditors (both central statutory auditors and branch auditors) should also ensure that their audit report complies with the requirements of SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

1.08 Besides the main audit report, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a Long Form Audit Report (LFAR). The matters to be dealt with by auditors in LFAR have been specified by the RBI. If the auditor intends to issue modified opinion, reasons for such modified opinion need to be mentioned.

1.09 For the reference and benefit of the members, **Appendices VII to XI** of the Guidance Note (given in CD accompanying the Guidance Note) provide the illustrative formats of Engagement Letter in case of a Nationalised Bank, Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor, Engagement Letter to be sent to the Appointing Authority of the Banking Company, Engagement Letter to be sent to the Appointing Authority of the Banking Company (Separate only for Internal Financial Control u/s 143(3)(i) of Companies Act, 2013) and Written Representation Letter to be obtained from Branch Management.

1.10 Further various Illustrative Audit Checklists and Broad features of the Gold Monetization Scheme are given in Appendices XII to XVII of the Guidance Note (given in CD accompanying the Guidance Note) as follows:

Appendix XII Illustrative Checklist on Audit Considerations in a CIS environment

Appendix XIII Illustrative Checklist on Bank Audit in Computerised Environment

Appendix XIV The Broad features of the Gold Monetization Scheme

Appendix XV Illustrative Audit Checklist for Capital Adequacy

Appendix XVI Illustrative Audit Checklist for Service Tax

Appendix XVII Illustrative Audit Checklist for Goods and Services Tax

Important Note

Readers may refer the CD accompanying the Guidance Note wherein the details of the following Chapters of "Part I - Knowledge of the Banking Industry" have been given:

Chapter 1: Banking in India

Chapter 2: Accounting and Auditing Framework

Chapter 3: Accounting Systems

Chapter 4: Legal Framework

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 planning and preliminary work to be undertaken by the central/branch auditor before actually commencing the audit work.

Statutory Central Auditors (SCAs)

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

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

- Period of appointment.
- Particulars of other central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment, way in which the audit has to be conducted and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, restriction on accepting other assignments from the bank, etc.
- A statement of division of work and review and reporting responsibilities amongst joint auditors. (Generally this is decided at a later stage)
- Scope of assignment which includes any special reports or certificates to be given by the SCAs in addition to the main report. Presently, the SCAs have to furnish the following reports/certificates in addition to their main audit report:
  a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the

Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.

b) Long form audit report.

c) Report on compliance with SLR requirements.

d) 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.

e) Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).

f) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.

g) 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.

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

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

j) Authentication of capital adequacy ratio, including disclosure requirements and other ratios reported in the notes to accounts.

k) Certificate in respect of DICGC claims.

l) 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.

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

n) Asset liability management.

o) Certificate on Corporate Governance in case of banks listed on Stock Exchange. In some banks this certification may not be offered to the central auditors.

p) Certification on claim of various interest subsidies and interest subvention.

- 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 by the proprietor/any of the partners of the audit firm/members for his/their families or by firm/ company in which he/they are partners/directors.

1.05 In terms of the existing guidelines, an audit firm which takes up statutory central audit assignment in private and foreign banks will not qualify to take up statutory audit in public sector banks during that particular year. These revised guidelines will come into effect from the year 2012-13. In case a firm not appointed as SCA of any PSB, such a firm can be appointed as SCA of four private sector banks and four foreign banks simultaneously each year. As per RBI guidelines to private sector banks it has been decided that, an audit firm, after completing its four year tenure in a particular private/foreign bank, will not be eligible for appointment as SCA of the same bank for a period of six years.

1.06 With respect to PSBs and other Private banks which are listed on stock exchanges, there could a possibility that the partner and/or his relatives are shareholders of such PSBs and other Private banks. Care should be taken to dispose off the shares or take corrective action, as per the code of conduct of the ICAI, SEBI regulations, Companies Act and the firm’s internal policies, in such a scenario prior to acceptance of the Statutory Audit.

Internal Assignments in Banks by Statutory Auditors

1.07 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”, decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the same 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.

1.08 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.

Communication with Previous Auditor

1.09 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.

1.10 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.

1.11 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 to 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. Further it is seen, nowadays, that auditors communicate with each other electronically by email and often soft copies are used, however it is always advisable to subsequently procure the hard copies of the letters and proof of delivery and file the same in the audit files.

1.12 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.

1.13 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.

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

Some Important Standards on Auditing (SA) for the Initial Considerations

Terms of Audit Engagements

1.15 Standard on Auditing (SA) 210, "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 assignment.

1.16 When establishing the terms of engagement, the auditor must agree on its understanding with the management as to the objectives and scope of the audit engagement, the extent of management's responsibilities and its own responsibilities. This minimises the risk of misunderstandings in future and there is no expectation gap from both the parties.

1.17 The form and content of audit engagement letter may vary for one bank to another, 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/bank 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 and/or quality review under the Chartered Accountants Act, 1949.

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

- Arrangements regarding the planning and performing the audit, including the fact that the audit will be carried out in accordance with the auditing standards generally accepted in India. Further, it should be spelt out that the audit would be performed to obtain reasonable assurance about whether the financial statements are free of material misstatements. It should clearly be spelt out that the audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements including assessment of the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. However, having regard to the nature of the audit and volume and complexity of transactions, 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 of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.
- 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.

1.19 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.

1.20 An illustrative format of engagement letter in case of a Nationalised Bank is given in ***Appendix–VII*** of this Guidance Note. An illustrative format of engagement letter to be sent to the appointing authority of the Nationalised Bank by Branch Auditor is given in ***Appendix – VIII*** of the Guidance Note.

1.21 An illustrative format of engagement letter to be sent to the appointing authority of the Banking Company (Where auditor's responsibility regarding reporting on Internal Financial Controls is contained within the same Engagement Letter) is given in ***Appendix – IX*** of this Guidance Note. An illustrative format of Engagement Letter to be sent to the appointing authority of the Banking Company (Containing auditor's responsibility regarding reporting on Internal Financial Controls only) is given in ***Appendix – X*** of the Guidance Note.

Initial Engagements

1.22 Standard on Auditing (SA) 510, "Initial Audit Engagements-Opening Balances", deals with the auditor's responsibility relating to opening balances when conducting initial audit engagement. Opening balances include financial statement amounts as well as matters requiring disclosures. The sheer volume makes verification of opening balances a challenge by itself where normal traditional techniques of verification are not in practice.

1.23 The auditor needs to perform the audit procedures as mentioned in SA 510 and if after performing those 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 past experience in the industry, 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.

Planning

1.29 SA 300, "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 SA 220, "Quality Control for an Audit of Financial Statements" regarding the acceptance of the client relationship and the specific audit engagement; and

(b) Establish understanding of terms of engagement as per SA 210, "Agreeing the Terms of Audit Engagements".

1.30 Planning would involve establishing overall audit strategy to set the scope, nature, timing, extent of resources required and direction of audit. The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed as and when necessary. Further the audit plan should be communicated to the audit team. SA 220, "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. Before starting initial audit engagement, the auditor should perform procedures required under SA 220 regarding client acceptance etc. The auditor also needs to ensure that a proper communication has been sent to the predecessor auditor. The auditor should also keep in mind the requirements of SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".

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

Establish the Engagement Team

1.32 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, time available to complete the assignment, nature, and complexity of the bank's operations.

1.33 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.

1.34 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

1.35 It is the auditor's responsibility to identify and assess risk of material misstatement in financial statements and assertion levels, through understanding, the entity, its environment and its internal control system. This would help him in designing and implementing various audit procedures as response to such assessed risk areas and reduce the risk to acceptable low levels.

1.36 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 in the financial statements whether due to fraud or error, and sufficient to design and perform audit procedures.

1.37 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 comments in the audit report. Such knowledge is used by the auditor in assessing inherent 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.

1.38 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 regarding the nature, timing and extent of work done by them and review of their audit reports, especially how issues raised are closed.
- Discussion with peers (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.
- General reading and keeping abreast with the latest developments in the Industry and general economic scenario.
- In case of audit of foreign branches, knowledge of the local laws and trade practices of the geographical location of bank would also be used.

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.

Review of Closing Instructions and Communication with Branch Auditors

1.39 It is a common practice that all public sector banks issue closing instructions to branches, based on which 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. These instructions issued by the HO are called ‘accounts closing instructions’ and include the format of the financial statements and other relevant returns, significant accounting policies to be followed, other instructions necessary for the conduct and completion of the audit, timelines of audit completions and consolidations etc. Many a times, besides general instructions this may also include specific directions on review and verification of certain information required by the SCA for their audit. Considering the significance of these instructions, it is advisable that before these instructions are sent to branches, the SCA 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 SCA should particularly examine whether the instructions are in consonance with the accounting policies of the bank and are in such compliant that stand the test of SA 600 – Using the Work of Another Auditor, so that the SCA has the comfort and confidence in the procedures adopted by the branch auditors by relying on the information and assurance provided by them.

1.40 Further, in many cases, immediately after the appointment of branch auditors but before the commencement of audit, the bank’s management organizes a face to face meeting between the SCA and the branch auditors, wherein the SCA issues specific instructions for the conduct of audit detailing the areas of concern that require extra care and special notice by branch auditors.

Co-ordination with Bank Management

1.41 A proper and smooth co-ordination between the auditor and the bank management is essential for an effective audit and timely completion of the assignment. In the past, many a times, the audit work has got delayed due to non-availability of books, information, records, etc. To minimise the possibility of such an occurrence, it is advisable that after accepting the appointment, the SCA 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 well in advance. Further it is also advisable to complete verification of certain non-financial areas (like documentation, verification of sanction and post sanction terms, review, monitoring and supervision etc.) before the year end so that the pressure of completion of audit post year end is minimal.

1.42 With the introduction of CBS, the auditor can also request for the data dump in a soft copy (depending upon the confidentiality compliances) well in advance and can complete his analysis, testing, verification and sampling sitting in the comfort of his own office without personal visits to the concerned department of the bank.

1.43 The bank's management can also be requested to have a training session for the engagement team on the use of the CBS and the various reports that can be generated from it. This would help the engagement team to be well prepared before starting the actual audit on the field.

Relationship among Joint Auditors

1.44 Public sector banks in India as well as some private sector banks appoint more than one firm as statutory auditors. There is also a rotation policy in place. The joint auditors should mutually decide and divide the audit work amongst themselves so as to ensure equitable distribution of work. This is usually done so in consultation with the management. The division of work as well as the areas of work to be covered by all of them should be approved by all, adequately documented and communicated to the management and in case of public sector banks, communicated to RBI also. With all banks on CBS platform and with the level of automation, the division of work is usually done based on various departments at the HO, like Treasury, central accounts, etc. or geographical areas. However certain areas of work, owing to their nature or importance would often not be divided and would be covered by all the joint auditors.

1.45 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.

1.46 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.

1.47 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. In case of a Bank having foreign branches, the SCA should review the completeness and accuracy of information obtained by the Bank from its foreign branches and the auditors of such branches.

1.48 There may be a situation, where foreign branches are located in jurisdictions, where the local law, does not mandatorily require such branch to be audited. Bank managements may in such case, voluntarily get the branch audited. The auditor should accordingly consider the status of the branch i.e., audited or unaudited while reporting on the financial statements of the bank.

1.49 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 his 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.

Statutory Branch Auditors (SBAs)

1.50 This section discusses the matters to be considered by a proposed statutory branch auditor (SBA) upon receiving intimation of appointment and before commencing the actual audit engagement. It 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 branch auditors typically contains the following:

- Appointment under the Banking Regulation Act, 1949, and the underlying duties and responsibilities of the SBA.
- Particulars of branch(s) to be audited and of the region/zone to which the branch reports.
- Particulars of statutory central auditors.
- Particulars of previous auditors.
- Guidelines for conducting audit of Branches, completion of audit, eligible audit fees and reimbursement of expenses etc.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance, declaration of indebtedness, declaration of fidelity and secrecy, other undertaking by the firm/SBA, specimen signatures, etc.
- Scope of work - Besides the statutory audit under the provisions of the Banking Regulation Act, 1949, SBA is also required to verify certain other areas and issue various report and certificates like LFAR, Tax Audit Report, certificates for cash verification on odd dates, Ghosh & Jilani reports etc.

Co-ordination with Branch Management

1.51 Now a days typically, SBA, are given limited time within which they have to undertake the audit of branches allotted to them. Co-ordination between the auditor and the branch management is essential for an effective audit, timely completion with the highest audit quality. NOC from the previous auditor should be obtained and kept on record by SBA. It is advisable that immediately after accepting the appointment, the SBA should send a formal communication to the branch management/HO accepting his appointment and other declarations and undertakings so required. Further, the SBA should also specify the books, records, and other information that he would require in the course of his audit. Such a communication would enable the branch management to keep the requisite documents, information, etc., ready.

1.52 After the completion of the appointment formalities, the SBA should immediately visit the concerned branches allotted, so as to get the feel of the business, nature and competences of the staff and understanding of the flow of information and authority. Thereafter the SBA should draw up a detailed plan for the audit and it is advisable to complete the entire non-financial verification (like documentation, sanctioning terms, review of the supervision and monitoring terms, review of the concurrent/internal audit and inspection reports before the year-end. An illustrative format of written representation letter to be obtained from the branch management is given in ***Appendix – XI*** of this Guidance Note.

Standard on Auditing (SA) 600, "Using the Work of Another Auditor"

1.53 The SBA's report on the financial statements examined by him is forwarded to the SCA with a copy to the management of the bank. The SCA, 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. In such a reporting arrangement, Standard on Auditing (SA) 600, "Using the Work of Another Auditor" needs to be emphasized.

1.54 Nowadays with all banks operating on CBS platform and moving towards more centralization of functions at HO adds to the dynamics of reporting. Considering the volume of transactions to be verified and the organizational structure of bank, particularly in the case of public sector banks, SCA's reliance on work done by the SBA is of utmost importance.

1.55 The SCA would be the Principal Auditor (PA), who is responsible for the reporting on the financial information for the bank as a whole and the SBA would be the other auditor (OA) other than the PA, who is responsible for reporting on financial information of the branch as a component. As per SA 600, the degree of reliance, SCA would have on the SBA would depend upon many considerations, few of which are discussed as follows:

(a) the materiality of the portion of the financial information which the SBA audits and its effect on the overall financial position;
(b) the technical competence and knowledge of the SBA and the degree of confidence he provides to the SCA;
(c) the SCA's assessment of 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.

1.56 The SCA should perform procedures to obtain sufficient appropriate audit evidence, that the work of the SBA is adequate for the SCA's purposes in the context of the specific assignment. The SCA might discuss with the SBA the audit procedures applied or review a written summary of the SBA's procedures and findings which may be in the form of a completed questionnaire or check-list or an Audit Summary Memorandum. This is usually done via the personal meeting between the SCA and all the SBA or via the bank's closing instruction (as discussed before). The nature, timing and extent of procedures will depend on the circumstances of the engagement and the SCA's knowledge of the professional competence of the SBA. The SCA 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 SBA's practice.

1.57 The SCA should consider the significant findings of the SBA. The SCA may consider it appropriate to discuss with the SBA 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 SCA or the SBA.

1.58 In certain circumstances, the SBA 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.

1.59 The SCA should document in his working papers the extent of reliance he has relied upon the work done by other auditors with reasons therefor. The SCA should also document the procedures performed as prescribed by SA 600 and his conclusions reached. The SCA should document how he has dealt with a specified opinion (i.e. qualified, adverse or disclaimer) of the SBA in framing his own report.

1.60 Further, it is also the responsibility of the SBA to inform or bring to the notice of the SCA any areas of concern that have come to his knowledge in the context in which his work is to be used by the SCA. For example, by bringing to the SCA'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 SCA should advise the SBA of any matters that come to his attention that he thinks may have an important bearing on the SBA's work.

1.61 When the SCA has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the SBAs, 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 SBAs have been included in the financial information of the entity, e.g., the number of divisions/branches/ subsidiaries or other components audited by SBAs. The SCA would not be responsible in respect of the work entrusted to the SBAs, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the SBAs.

Engagement and Quality Control Standards

1.62 The auditor/audit firm should establish a system of quality control designed to provide reasonable assurance that the auditor/firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances and will survive the test of any regulatory, legal or other action that may arise in future. This system of quality control should consist of policies designed to achieve its objectives and the procedures necessary to implement and monitor compliance with those policies. The nature of the policies and procedures developed by individual or firms to comply with SQC will greatly depend on various factors such as the size, maturity, geographical location, type of work handled and other operating characteristics.

1.63 The ICAI has issued various Engagement and Quality Control Standards applicable to an audit of financial statements which are mandatorily to be followed by all practitioners. Understanding of the concepts in these Engagement Standards would help the auditor in discharging his duties in a diligent way.

Special Audit Considerations in Foreign Banks

1.64 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.

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

1.66 Auditors of foreign bank will have to modify their audit procedures so as to take care of the operational structure and operations of these banks. Some of the important elements related to foreign banks which may have a bearing on the audit plan and procedure are listed below:-

- Management structure.
- More centralised operational functions.
- High level of automation and IT functions - Core banking software are used globally.
- Requirement for compliance with foreign legal and regulatory requirements.
- Cross border flow and processing of data.
- Complex treasury operations and cross border forex deals.
- Highly structured and well documented operational processes.
- Complex treasury transactions.

II-2

Risk Assessment and Internal Control

Characteristics of a Bank

2.01 Banks have certain characteristics distinguishing them from most other commercial enterprises e.g.,

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

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

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

- the particular nature of risks associated with the transactions undertaken;
- the scale of banking operations and the resultant significant exposures which can arise within short period of time;
- the extensive dependence on IT to process transactions;
- the effect of the statutory and regulatory requirements;
- the continuing development of new products and services and banking practices which may require concurrent development of accounting principles and auditing practices. Evolution of technology and providing services through multi-various digital banking channels including net banking, mobile banking has exposed banks to huge operational and financial risk.

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

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

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 and paragraph 26 of SA 315 provides a basis for designing and performing further audit procedures.

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 and enable them to issue 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; and
- to assist in issuing audit report on internal financial controls in terms of Section 143(3)(i) of the Companies Act, 2013, wherever applicable[1].

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 In addition to the considerations mentioned in paragraph 11 of SA 315, when obtaining an understanding of the bank and its environment, including its internal control, the auditor is required to:

[1] The ICAI has issued the Guidance Note on Audit of Internal Financial Controls over Financial Reporting in September 2015 in accordance with Section 143(3)(i) of the Companies Act, 2013. This Section casts a new reporting requirement for statutory auditors of companies under the Act, to state in their audit report whether the company has adequate internal financial controls system in place and to opine on the operating effectiveness of such controls. Members should refer the Guidance Note for comprehensive details on the aforesaid reporting.

- 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 Auditor should be aware of significant internal controls in transaction flow embedded in applications not only of the bank but also consider significant applications used by outsourced service providers in according with SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation".

2.09 Management may prepare a variety of information so as to operate the business more effectively and efficiently. The auditor may consider to use this 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).

2.10 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 factors assume importance:

- Understanding the bank's corporate governance structure, RBI has laid down specific guidelines to be complied with by the banks, with regard to the formation of various committees of board of directors and determination of their specific functions, extent of audit coverage, etc. Provisions of clause 49 of the Listing Agreement also need to be complied 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 various deposit, loan and treasury products and services that are offered and continue to be developed and modified by the bank in response to market conditions and guidelines issued by the RBI from time to time. Similarly, the auditor should obtain an understanding of the nature of services rendered through off balance sheet and other similar instruments; inherent risks arising as a result thereof; and auditing, accounting and disclosure implications thereof.
- Understanding the regulatory requirements of other regulatory authorities like SEBI, IRDA for other products like depository participants, investment banking, insurance, distribution, mutual fund selling, etc. The same is important, as the bank may face penal action in case of non-compliance with respective regulation.

- 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. The auditor may ask for report under SA 402 "Audit Considerations Relating to An Entity Using a Service Organisation."

2.11 The auditor may decide to visit the significant operating units of the bank, especially, in case of multi-location bank. This would enhance the auditor's 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 and acquire understanding of their significant policies, and other relevant factors affecting the working of that particular operating unit.

2.12 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

2.13 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.

2.14 The overall control environment of a bank generally includes a mix of the following:

I. Board of Directors or senior management and its Committees

2.15 The organisational structure of a bank assists it in managing its responsibility of oversight and control. 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.

2.16 Banks also have an Audit Committee, Shareholder Grievance Committee, etc. Further, function specific committees such as, the Investment Committee, Credit Committee, Information Technology Committee, CSR Committee, etc. also exists, which report to the Board of Directors or the Executive Committee.

2.17 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

2.18 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 usually carried out either by a separate department within the bank or at times by independent firms of chartered accountants. Apart from these, the inspectors of RBI also review the system and transactions as received.

2.19 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 No. DBS.CO.PP.BC.14 /11.01.005/ 2003-04, dated June 26, 2004 on "Risk Based Supervision – Follow up of Risk Management Systems in Banks".

2.20 As per section 138 of Companies Act, 2013 and Rules thereunder, the following classes of companies shall be required to appoint an internal auditor or a firm of internal auditors, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company:-

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

Provided that an existing company covered under any of the above criteria shall comply with the requirements of section 138 and this rule within six months of commencement of such section.

Explanation- For the purposes of this rule –

(i) the internal auditor may or may not be an employee of the company;

(ii) the term “Chartered Accountant shall mean ”Chartered Accountant whether engaged in practice or not.

2.21 The audit committee of the company or the Board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

2.22 It should be noted that Internal Audit differs from Concurrent audit in certain ways. While Concurrent audit examines transactions close to the occurrence to find errors so as rectify the same and understand the process gaps so that the process gaps can be remediated so that the occurrence of errors will be eliminated. Though Concurrent audit has also become risk based, the movement is from the transactional gap to the control. Internal audit is predominantly risk and control based with focus on control assurance. For example, even if a design of a control is not in place, internal audit will highlight the same even if there is no transactional error.

2.23 RBI has issued circulars on risk based internal audit of banks where the focus is clearly on prioritizing the audit work based on the degree of the risk.

III. Revenue Audit

2.24 Revenue audit is usually conducted depending on size and volume of 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 revenue audit is also known as 'income and expenditure audit' or 'income leakage audit'.

IV. Branch Inspection

2.25 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. This is typically in the nature of internal audit.

V. Head Office (HO) Inspection

2.26 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.

2.27 HR is a key area of HO inspection with focus on employee engagement, training based on current and future job roles and skill set gaps, employee selection and screening methods, employee attrition etc. Another key area is the audit of the Risk Assessment process or the manner in which risks are identified and periodically reviewed by the bank, controls are designed in response to mitigate the risks, ongoing review of efficacy of the controls to identify residual risks and whether they are within the risk appetite of the Bank.

VI. Concurrent Audit

2.28 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 no. 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.

2.29 On July 16, 2015, RBI issued circular no. DBS.CO.ARS. No. 2/08.91.021/2015-16 on Concurrent Audit System in Commercial Banks - Revision of RBI's Guidelines, which includes guidelines on scope of concurrent audit, coverage of business/branches, types of activities to be covered, appointment of auditors and accountability, facilities for effective concurrent audit, remuneration and reporting system. A minimum coverage of concurrent audit is listed in Annexure II forming part of the aforesaid Circular. This circular is available on the RBI's website **rbi.org.in.**

VII. Systems Audit

2.30 The bank carries out a systems audit periodically to assess the effectiveness of the hardware, software and operations to identify any changes required therein based on the guidelines mentioned in 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". Also refer to the guidelines relevant to Information System Audit in the circular no. DBS.CO.ITC.BC.No.6/31.02.008/2010-11 dated April 29, 2011.

2.31 The SBA/SCA may interact with the Information Systems (IS) auditor to understand the scope and audit plans of the systems audit and security audit. These audits should be preferably undertaken prior to the statutory audit so that the IS audit reports are available to the SBAs/SCAs well in time, for examination and incorporating comments, if any, in the audit reports.

2.32 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 the areas of IT Governance, Information Security, IT Operations, IT Outsourcing, IS Audit, Cyber Fraud, Business Continuity Planning, Customer Education and Legal Issues, applicable Cyber Security Framework..

VIII. Vigilance Function in banks

2.33 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, Cyber Fraud Reporting requirements of RBI.

IX. RBI Inspection

2.34 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. RBI categories the issues noted in the course of the inspection into various actionable on the part of the bank as major or minor.

Understand the Bank's Accounting Process

2.35 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 of 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.

2.36 When obtaining an understanding of the accounting process, the auditors, ordinarily, focus only on such processes that relate to the effectiveness and efficiency of operations and compliance with laws and regulations and 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, Transactions flow automated across CBS, digital banking, payments and settlement systems, card operations etc. and their integration with external systems such as NPCI, international payment gateways, SWIFT and INFINET etc.

2.37 The auditors should also document their 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

2.38 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. 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. Delegation of Powers

2.39 Banks have detailed policy on delegation of powers. The financial and administrative powers of each committee/each official/each position are fixed and communicated to all persons concerned. This policy on delegation of powers is approved either by Board of Directors or Executive Committee.

II. Authorisation of Transactions

2.40 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:

- 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.
- All transactions entered into the applications require authorization at different level based on authority to get executed.
- Any deviation from the laid down procedures requires confirmation from/intimation to higher authorities.
- Branches have to send periodic confirmation to their controlling authority on compliance of the laid down systems and procedures.

SBAs should specifically review the delegation of powers to note the authorization, approval, exception, waiver and ratification powers of each bank official.

III. Segregation and Rotation of Duties

2.41 A fundamental feature 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. Functions typically segregated are authorisation of transactions; execution of transactions; physical custody of related assets; maintenance of records and documents etc.

2.42 Banks usually adopt the following measures:

- 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. 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.

2.43 RBI *vide* its circulars and notifications suggested banks to establish effective segregation in its functions, for example, the master circular 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.

IV. *Maintenance of Adequate Records and Documents*

2.44 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 and also that the work of finalisation of accounts is 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 Bank branches have a unique code number which is circulated amongst all offices of the bank and 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 specifically assigned for the same. 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 DBR No. BP. BC.6/21.04.141/2015-16 dated July 1, 2015, "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks" 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 Auditors.

- All inter-office transactions are to be reconciled at regular intervals within a specified time frame.

V. *Accountability for and Safeguarding of Assets*

2.45 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 and covers direct physical access and also indirect access through 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 which are immediately advised to branches to exercise caution.
- Specimen signatures of all officers are captured and scanned in the system and available for view/access in all branches which were earlier maintained in a book. 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.
- Instruments of fund remittances above a cut-off level are to be signed by more than one official.
- Important financial messages, when transmitted electronically, are generally encrypted.

- Negative lists like stop-payment cheques or stop payment instructions 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.

VI. *System Configuration and Account Mapping*

2.46 Information technology (IT) has played a major role in providing a competitive edge to banks in differentiating themselves in the market place and to deliver their services more effectively at a lower cost.

VII. *Independent Checks*

2.47 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 independent checks covering virtually every key aspect of their functioning.

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 (TCWG)*: TCWG should approve the documented 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. TCWG are also responsible for laying down the risk appetite and 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 in a Documented Risk Register. 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 faced by the bank.
- *Control activities*: A bank should have appropriate controls including embedded in IT System 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. The following are certain common questions /steps, which have to be kept in mind whilst undertaking / performing control activities:

Nature of Questions	Questions to be considered / answered
Who	• Who performs the control? • Does the above person have requisite knowledge and authority to perform the control?
What	• What evidence is generated to demonstrate / prove that the control is performed?
When	• When and with what frequency is the control performed? • Is the frequency enough to prevent, detect and correct Risk of Material Misstatements?
Where	• Where is the evidence of performance of the control retained? • For how long is the evidence retained? • Is the evidence accessible for / available for audit?
Why	• Why is the control being performed? • What type of errors are prevented or detected

	through the performance of the control?
How	• How is the control performed? • What are the control activities? • Can these activities be bypassed? • Can the bypass, if any, be detected? • How are exceptions/deviations resolved on identification? • What is the time frame for resolving the exceptions / deviations?

2.49 RBI has directed banks *vide* its Master Direction No. RBI/FMRD/2016-17/31 FMRD Master Direction No. 1/2016-17 on 'Risk Management and Inter-bank Dealings' dated July 5, 2016 (updated March 21, 2017), 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.

2.50 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's overall risk appetite. Banks install checks in their daily processes to ensure that these limits are being adhered to at all times.

2.51 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 Auditor 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 auditors should have a reporting line to those charged with governance 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. TCWG and management require risk management information that is timely, accurate and easily understood and that enables them to assess the changing nature of the bank's risk profile.

Engagement Team Discussions

2.52 The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:

- An opportunity for 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 effect 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.

2.53 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.

2.54 The engagement team discussion ordinarily includes a discussion of the following matters:

- Errors that may be more likely to occur;
- Errors which have been identified in prior years;

- Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures; changes to level of automation of transaction flow, extension and interconnection of transaction systems, outsourced operations etc;
- Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- Need to maintain professional skepticism throughout the audit engagement;
- 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).

2.55 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. RBI mandate of revised fraud reporting guidelines including cyber security incidents. 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 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.

2.56 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.

2.57 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

2.58 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 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 depending on the characteristics of the audit engagement.

2.59 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.
- Consider the various RBI Circulars, Master Circulars and Master Directions issued from time to time, as applicable.
- Consider the requirements of various Accounting Standards, Guidance Notes and Standards on Auditing, to the extent applicable, to assess the nature and extent of audit procedures to be performed.
- 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.

2.60 The auditor 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

2.61 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 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 SA 210, "Agreeing the Terms of Audit Engagements".

2.62 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 the 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.

2.63 Ordinarily, to develop the audit plan the auditor would need to gather detailed information about the bank and its operating environment, which will enable to plan audit procedures for each significant account balances and disclosures. The requisite detailed information may be obtained from the following:

- Understanding of the bank, its environment and the bank's internal control;
- Understanding the bank's accounting process;
- Reading the minutes of various committees of the bank;
- Reading the Annual Financial Inspection for the prior year(s);
- 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;
- Consideration of expectations and concerns of management, which could impact the timing of the audit procedures. 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 / concurrent auditors;
- Statutory or other legal and regulatory requirements;
- Using the work of an expert;
- Specific assertion level risks for classes of transactions, account balances, disclosures and audit procedures based on overall engagement risk;
- Impact of multiple locations, subsidiaries and associates on audit procedures;
- Consideration of the nature, timing, and extent of audit procedures required under SA 540, "Auditing Accounting Estimates, Including Fair Value

Accounting Estimates, and Related Disclosures" for fair value measurements and disclosures; and

- Consideration of appropriateness of going concern assumptions.

2.64 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.

2.65 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. In this regard, the auditor is also required to perform the procedures as given in SA 510, "Initial Audit Engagements-Opening Balances".

2.66 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

2.67 The auditor should summarise audit plan by preparing an audit planning memorandum in order to:

- Describe the expected scope and extent of the audit procedures to be performed.
- Highlight all significant issues and risks identified during planning and risk assessment activities, as well as decisions of 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.

2.68 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

2.69 SA 320, "Materiality in Planning and Performing an Audit" defines the materiality in the context of an audit. It describes that 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 light of surrounding circumstances, and are affected by the size or nature of a misstatement, or combination of both;
- Judgments about matters 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.

2.70 SA 320 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.

2.71 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 bank, 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.

2.72 As per SA 450, "Evaluation of Misstatements Identified During the Audit", the auditor is required to accumulate material misstatements identified during the audit, 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 required to reassess materiality determined in accordance with SA 320 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, unless prohibited by law or regulation, 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. 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

2.73 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. 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 as mentioned in paragraph A16 of SA 570, Going Concern.

2.74 There are certain specific events or conditions, which the auditor should consider to assess the ability of the bank to continue as a going concern:

- Rapid increase in the volume of derivative business without necessary controls being put in place.
- Decline in the projected profitability, if the bank is at or near its minimum level of regulatory capital.
- Increasing level of non-performing assets.
- 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 showing credit weakness.
- Potential risks to going concern arising from failure of IT/Cyber security risks e.g. Ransom ware attacks locking down critical banking IT data and application resources.
- Low provision coverage ratio.

Operating Framework for Identifying and Dealing with Frauds

2.75 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 RBI, *vide* its Circular No. DBS. CO.FrMC.BC.No.10/23.04.001/2010-11 dated 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.
- 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.

2.76 RBI has accordingly prescribed certain guidelines to be incorporated by the banks in their operating framework for identifying and dealing with frauds. These guidelines have been detailed in the following paragraphs.

2.77 The operating framework for tracking frauds and dealing with them should be structured along the following tracks:

(i) Detection and reporting of frauds.
(ii) Corrective action.
(iii) Preventive and punitive action.
(iv) Provisioning for Frauds.

(i) Detection and Reporting of Frauds

2.78

(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 'wilful default'. In this connection, a wilful 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 of 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.
- 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.
- 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'.

(ii) Corrective Action

2.79 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.

2.80 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.

(iii) Preventive and Punitive Action

2.81 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 banks. 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 reports". Accordingly, all such exception reports should be perused by the designated officials and a *post facto* authorization for the transactions accorded.

2.82 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. 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.

2.83 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".

(iv) Provisioning for Frauds

2.84 RBI has vide its circular RBI/2015-16/376 DBR.No.BP.BC.92/21.04.048/ 2015-16 dated 18th April, 2016, decided to amend the provisioning norms in respect of all cases of fraud, as under:

a. Banks should normally provide for the entire amount due to the bank or for which the bank is liable (including in case of deposit accounts), immediately upon a fraud being detected. While computing the provisioning requirement, banks may adjust financial collateral eligible under Basel III Capital Regulations - Capital Charge for Credit Risk (Standardised Approach), if any, available with them with regard to the accounts declared as fraud account;
b. However, to smoothen the effect of such provisioning on quarterly profit and loss, banks have the option to make the provisions over a period, not exceeding four quarters, commencing from the quarter in which the fraud has been detected;
c. Where the bank chooses to provide for the fraud over two to four quarters and this results in the full provisioning being made in more than one financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year by credit to provisions. However, banks should proportionately reverse the debits to ‘other reserves’ and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year;
d. Banks shall make suitable disclosures with regard to number of frauds reported, amount involved in such frauds, quantum of provision made during the year and quantum of unamortised provision debited from ‘other reserves’ as at the end of the year.

Assess the Risk of Fraud

2.85 As per SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the auditor’s objectives 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, internal auditors and others 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 as well as the controls in place to prevent and detect fraud.

- 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. The auditor should also obtain information from the management regarding the various frauds which have occurred in the year under audit or previous years to identify system lacunae which led to the lapse. The auditor should ascertain whether the necessary rectification/ remedial action have been taken to prevent similar frauds from happening again. The auditor should also ascertain the necessary controls (preventive, detective or deterrent – manual or automated) in place to ensure early detection of frauds post occurrence.
- 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 regulatory authorities.
- Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
- Actual, suspected, or alleged fraud that the bank is investigating.
- Process the bank undertakes to respond to internal or external allegations of fraud affecting the bank.
- Understanding 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. This also helps to corroborate management's responses to the inquiries mentioned above.

2.86 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.

2.87 Some of the common fraud risk factors in deposit taking, dealing and lending activities areas are summarised hereunder:

	Deposit Taking	**Dealing**	**Lending**
Management and	• Camouflage of	• Off market /	• Loans to fictitious

employee frauds	depositors by hiding their identity in connection with funds transfer or money laundering. • Unrecorded deposits. • Theft of customer deposits particularly, from dormant accounts.	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 counter-parties. • 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 no time stamping of deals or alterations or overwriting on deals sheets. • Exploiting weaknesses in matching procedures due to absence of proper	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.

		guidelines.	
External Frauds	• Money Laundering. • Fraudulent instructions. • Counterfeit currency.	• Fraudulent custodial sales. • False information or documents regarding counter-parties.	• Impersonation and false information on loan applications. • Fraudulent valuations. • Misappropriation of loan funds by agents / customers

2.88 ICAI in February 2016 issued the Revised Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013. Part B of the Guidance Note paragraph 11 deals with reporting to RBI in case of frauds noted in audit of banks. Auditors of banking companies may also refer the aforesaid Guidance Note for further clarity.

2.89 The MCA issued the Companies (Amendment) Act, 2015 in May 2015 which, *inter alia,* amends section 143(12) of the Companies Act, 2013.The amended section 143(12) reads as follows:

> "Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:
>
> Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:
>
> Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed."

Further, the MCA through its notification dated 14 December 2015 has also amended Rule 13 of the Companies (Audit and Auditors) Rules, 2014. The amended Rule 13 requires the reporting of a fraud as follows:

(1) If an auditor of a company, in the course of the performance of its duties as statutory auditor, has reason to believe that an offence of fraud, which involves or

is expected to involve individually an amount of rupees one crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

(2) The auditor shall report the matter to the Central Government as under:-

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than two days of his knowledge of the fraud, seeking their reply or observations within forty-five days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government with in fifteen days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with their seal and shall indicate Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

(3) In case of a fraud involving lesser than the amount specified in sub- rule (I), the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and he shall report the matter specifying the following:-

a) Nature of Fraud with description;
b) Approximate amount involved; and
c) Parties involved.

(4) The following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year shall be disclosed in the Board's Report:-

a) Nature of Fraud with description;

b) Approximate Amount involved;
c) Parties involved, if remedial action not taken; and
d) Remedial action taken.

The auditor of a banking company would need to comply with provisions of section 143(12) and the related Rules also.

2.90 RBI circular dated 7th May 2015 on framework for dealing with loan frauds has introduced the concept of a Red Flag Account (RFA), i.e., an account where suspicion of fraudulent activity is thrown up by the presence of one or more early warning signals (EWS).

2.91 Some Early Warning signals which should alert the bank officials about some wrongdoings in the loan accounts which may turn out to be fraudulent include:

1) Default in payment to the banks/ sundry debtors and other statutory bodies, etc., bouncing of the high value cheques.
2) Raid by Income tax /sales tax/ central excise duty officials.
3) Frequent change in the scope of the project to be undertaken by the borrower.
4) Under insured or over insured inventory.
5) Invoices devoid of TAN and other details.
6) Dispute on title of the collateral securities.
7) Costing of the project which is in wide variance with standard cost of installation of the project.
8) Funds coming from other banks to liquidate the outstanding loan amount.
9) Foreign bills remaining outstanding for a long time and tendency for bills to remain overdue.
10) Onerous clause in issue of BG/LC/standby letters of credit.
11) In Merchanting trade, import leg not revealed to the bank.
12) Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
13) Delay observed in payment of outstanding dues.
14) Financing the unit far away from the branch.
15) Claims not acknowledged as debt high.
16) Frequent invocation of BGs and devolvement of LCs.
17) Funding of the interest by sanctioning additional facilities.
18) Same collateral charged to a number of lenders.

19) Concealment of certain vital documents like master agreement, insurance coverage.
20) Floating front / associate companies by investing borrowed money.
21) Reduction in the stake of promoter / director.
22) Resignation of the key personnel and frequent changes in the management.
23) Substantial increase in unbilled revenue year after year.
24) Large number of transactions with inter-connected companies and large outstanding from such companies.
25) Significant movements in inventory, disproportionately higher than the growth in turnover.
26) Significant movements in receivables, disproportionately higher than the growth in turnover and/or increase in ageing of the receivables.
27) Disproportionate increase in other current assets.
28) Significant increase in working capital borrowing as percentage of turnover.
29) Critical issues highlighted in the stock audit report.
30) Increase in Fixed Assets, without corresponding increase in turnover (when project is implemented).
31) Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
32) Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
33) Substantial related party transactions.
34) Material discrepancies in the annual report.
35) Significant inconsistencies within the annual report (between various sections).
36) Poor disclosure of materially adverse information and no qualification by the statutory auditors.
37) Frequent change in accounting period and/or accounting policies.
38) Frequent request for general purpose loans.
39) Movement of an account from one bank to another.
40) Frequent ad hoc sanctions.
41) Not routing of sales proceeds through bank.
42) LC's issued for local trade / related party transactions.
43) High value RTGS payment to unrelated parties.
44) Heavy cash withdrawal in loan accounts.
45) Non submission of original bills.

2.92 Besides the above Red flags, auditor could also review –

a) Cheque/bills discounting facility used for liquidation of funds without any physical collateral or just for deferment of liability.

b) Repayment of third party loans despite bank's loan account irregular or out of order.

c) Maintenance of bank accounts with other bank without consent of lender bank.

d) Inordinate delay in conducting stock inspections by bank officials and/or stock auditors at the instance of the borrower not to show its weakness and misutilisation of funds.

e) Unauthorised changes to CBS parameters, unauthorised/fraudulent direct entries, NPA date tampering etc.

2.93 RBI in the Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC. BC.No.1/23.04.001/2016-17 on "Frauds – Classification and Reporting by commercial banks and select FIs" dated July 1, 2016 (updated July 03, 2017) has stated that the following acts constitute fraud:

- Fraudulent removal of pledged stocks / disposal of hypothecated stocks without the knowledge of the bank / inflating the value of stocks in the stock statements & drawing excess bank finance.

- Diversion of funds, lack of interest or criminal neglect on the part of the borrowers partners etc., in adhering to financial discipline and managerial failure with *mala fide* intent leading to the unit becoming sick and laxity in effective supervision over the operations in borrowable accounts on the part of bank functionaries rendering the advance difficult for recovery and resulting in financial loss to the bank.

- The Master Direction states that banks should conduct an annual review of the frauds to consider-

  a) Whether the systems in the bank are adequate to detect frauds, once they have taken place, within the shortest possible time.

  b) Whether frauds are examined from staff angle and, wherever necessary, the staff side action is taken without undue delay.

  c) Whether deterrent punishment is meted out, wherever warranted, to the persons found responsible without undue delay.

  d) whether frauds have taken place because of laxity in following the systems and procedures or loopholes in the system and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned or the loopholes are plugged.

e) Whether frauds are reported to the local Police for investigation.

2.94 Diversion of Funds, inflating value of stocks, showing unpaid stocks as paid stocks, not providing for bad debts etc., are common practices by unscrupulous borrowers in Banks and frequently reported by Concurrent / Stock auditors in Banks.

2.95 Auditors should take due cognizance of the same and banks could be asked to report the same as frauds on a case to case basis after due consideration of the borrower's intent and the frequency of such instances, risk of default as a result of such practices, materiality of the amount financed by the bank and outstanding, availability of collateral and loan to value ratio or margin of safety.

Assess the Risk of Money Laundering

2.96 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 direction no. RBI/DBR/2015-16/18 Master Direction DBR.AML.BC.No.81/ 14.01.001/2015-16 dated December 08, 2016 on "Know Your Customer (KYC) Direction, 2016", 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 unusual 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) and 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 Financial Intelligence Unit India (FIU-IND).

2.97 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.

2.98 Banks were advised to complete the process of risk categorization and compiling/updating profiles of all of their existing customers in a time-bound manner latest by end-March 2013.

2.99 Such review of risk categorisation of customers has to be carried out at a periodicity of not less than once in six months.

- *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.

2.100 The RBI master direction 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"[2] 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 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 Directions on Know Your Customer (KYC). 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

[2] 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.

account is opened and also to monitoring of transactions in order to protect themselves and their customers from misuse by such fraudsters.

2.101 Money laundering involves three steps namely - Placement – Layering -- Integration.

- Placement involves introducing money in the financial system by some means.
- Layering means carrying out transactions generally complex to camouflage the illegal source.
- Integration means acquiring wealth generated from the transactions of the illicit funds.

2.102 Some methods in which money laundering takes place are as under -

- Breaking up of cash into smaller amounts and depositing it in to the bank below the monitored reporting thresholds.
- Physically moving the cash into locations or jurisdictions and depositing it in off shore banks with lesser stringent enforcement laws and regulations.
- Using business typically known to receive revenue in cash to be used to deposit criminally derived cash.
- Trade based laundering – Over or Under Invoicing.
- Shell companies operating in jurisdictions not requiring reporting of beneficial owner to earn tax favored profits.
- Round Tripping wherein money is deposited in a controlled foreign corporation offshore preferably a tax haven where minimal records are kept & then shipped back as FDI to earn tax favored profits through a shell company.
- Use of Casinos – Chips are purchased with laundered cash and on winning, the buyer either gets back the winnings in cheque or gets a receipt for the winnings.
- Real estate Transactions – seller agrees to understate the value of the property and collects the difference in cash.
- Bank capture – Buying a controlling interest in a Bank in a jurisdiction with weak money laundering controls and then move money through the bank without much scrutiny.

2.103 Banks use computer software in place whereby they generate alerts based on thresholds as per parameters given in IBA guidance. The bank scans through these alerts and in case they find anything suspicious they have to report the same to the Financial Intelligence Unit. This reporting varies from bank to bank as the definition of "suspicious" is interpreted by various banks differently. Banks should have adequate documentation in place justifying why a transaction was not reported as Suspicious when they had alerts of the same. Banks also need to review these alerts from time to time. If a Suspicious Transaction Reports (STR) is reported in a Low risk account, the classification in the account may need upgradation to a High risk profile account.

2.104 Central Statutory Auditors should review the process of closure of AML alerts. AML alerts are transactions identified by AML application as exceptional. The same needs to be closed after getting explanation from customer regarding genuineness of transactions. In many Banks the AML alerts are closed based on information provided by Branch Managers, which he/she receives from customer. At Branch level the Statutory Branch Auditors may review process of documenting explanations received from customer regarding AML alerts.

Central Statutory Auditors should review the process of modifications/deletion in parameters entered in AML application for generation of alerts.

Assess Specific Risks

2.105 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.

2.106 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.
- Ascertain account balances or disclosures wherein control lapses or errors have been identified in the past.
- 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.

2.107 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.

2.108 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;
- absence of secondary review;
- 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.

2.109 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.

2.110 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

2.111 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.

2.112 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 / RTGS / NEFT 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

2.113 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.

2.114 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.

Risk Control Matrix (RCM)

2.115 The various risks, both at the financial statement level and at the process level which are assessed together with the controls relevant against the same can be documented in the form of a RCM, which is a comprehensive document which captures at one place, for each business cycle, the following information:

- The risks of material misstatement including the fraud risks and any other significant risks which must be separately identified.
- The account balances affected against each of the risks identified above.
- The financial statement assertions which are addressed for each of the above risks and accounts balances.
- The controls which address each of the risks and assertions. A control may address more than one risk or assertion as discussed earlier.
- The frequency of the control.
- Who is responsible for testing and reporting on the control and the document(s) which need to be prepared to evidence the exercise of the control.

2.116 An illustrative format of the RCM is given hereunder:

RISK CONTROL MATRIX--------BUSINESS CYCLE#

Risk (what could go Wrong?)	Account Balances Affected	Description of Control Activity*	Control Type Preventive / Detective	Manual / Automated control
* Should also cover/address the responsibilities, frequency, and documentary evidence. The frequency could also be specified in separate column.				

The following are some of the common business cycles for which separate RCMs could be prepared, depending upon the nature of the entity's business and the materiality of the particular process, which are relevant from the point of view of Internal Financial Controls Over Financial Reporting:

- Financial Closing and Reporting.
- Bill to collect. (Revenue and Receivables)
- Procure to Pay. (Purchase / Expenses and Accounts Payables)
- Payroll.
- Treasury.
- Cash and Bank.
- Fixed assets and Depreciation.
- Taxation.
- Lending.
- Borrowing
- Deposits. (Separately for Term Deposits and Current and Savings Accounts)
- Derivatives and FX.
- Payment and settlements systems and channel reconciliations.
- Third party products / cross selling products.

2.117 An important element in the preparation of the RCM is to understand the interplay between the business cycles and the related activities / processes and the account balances affecting the same, to the extent it impacts the financial reporting. Finally, the RCM should also help to identify controls which are relevant and not relevant.

2.118 Preparation of a RCM is one of the documentation methods for the Internal Control Framework and would assist in reporting on the operating effectiveness of Internal Financial Controls, wherever applicable. Further, whilst the preparation of the same is recommended by the Management as a part of its assessment of the design and operating effectiveness of the controls for Board Reporting, in terms of Section 134(5)(e) of the companies Act, 2013, in case the same is not prepared the auditor can use the same for testing the operating effectiveness of Internal Financial Controls over Financial Reporting. The requirement of IFCFR is applicable to the banks registered under the Companies Act, 2013. As such the other banks such as public sector banks, RRBs do not have to legally adhere to the requirements in the form mentioned in this paragraph. However, the banks may follow this voluntarily to help them monitor the control environment effectively. The Management should put in place a system to periodically test the effectiveness of the significant controls identified in the RCMs.

Value-at-risk ('VAR')

2.119 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

2.120 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.

2.121 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.

2.122 RBI, vide its circular no. DBOD. No. BP. BC.101 / 21.04.103/ 2006-07 dated June 26, 2007 on "Guidelines on Stress Testing" 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.

2.123 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.

2.124 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.

2.125 The results of the various stress tests should be reviewed by the senior management and reported to the Board. The circular emphasizes that these results should be an essential ingredient of bank's risk management systems.

2.126 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.

2.127 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.

2.128 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 III Framework

2.129 The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) had 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 had *inter alia* proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. The RBI 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" and also Master Circular No. DBR.No.BP.BC.1/21.06.201/2015-16 dated July 1, 2015 on "Basel III – Capital Regulations". Vide these circulars the RBI has prescribed the final guidelines on Basel III capital regulations. The reader may refer to the chapter 1, "Basel III" of Part VI of the Guidance Note for the detailed guidance on the New Capital Adequacy Framework, i.e., Basel III.

Annexure 1

Risks Associated with the Banking Activities

Risk is a function of probability or likelihood of occurrence and the significance of the impact. Risk implies vulnerability and threat. The key is the impact as an event may have a very low probability of occurrence or even remote probability but the impact could be disastrous. In such cases risks do not get identified or get due focus thus diluting controls necessary for their mitigation. Another key factor is the speed at which risks permeate through the entity once affected. Globalization of the economy has led to integration of world economies & increased the risks & an event occurring anywhere in the world can have an impact on Banks in India.

Risks associated with 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. The risk of liquidity risk turning into a solvency risk needs to be monitored as risk can swiftly move across the entity.

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. For example, money laundering risk is a Regulatory risk. (The circular - DBS.CO.PP.BC.6/11.01.005/2006-07 dated April 20, 2007 on "Compliance Function in Banks" which 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, procedures, compliance programme, etc. is relevant).

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 counter party 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 out of possibility of bank not having sufficient value of assets to meet its obligations on the due date, whereas liquidity risk means the risk related to disposal of assets.

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.

Following are examples of some events/ transactions that give rise to one or more of the abovementioned risks (though they may not have a direct impact on the financial statements of a bank:

- **Cyber Risks -** Use of Internet / Mobile Banking has changed the dimension of banking and with it resulted in new risks – Cyber risks or risks associated due to Identity Thefts, Hacking, Spam, Phishing / Vishing / Dos or DDos attacks, e-mail spoofing, virus attacks, Use of malicious codes, compromise of digital signatures etc., resulting in loss or compromise of data is very common. Risks associated with usage of Debit & Credit Cards or through ATM operations are also increasing.
- Cyber criminals can commit a crime much faster than conventional fraudsters plus have the added advantage of anonymity. The level of anonymity makes attempting and successfully conducting a cyber crime

relatively easier than conventional frauds. It also makes dealing with cyber criminals a daunting aspect.

- Usage of Social Networking sites has exploded over the past few years especially amongst the youth. Personal information is routinely exchanged on a real time basis on social networking sites. This is misused by people purporting to be trusted members of the group while in eventuality they may be fraudsters. Confidential private information exchanged over emails also can be easily tracked and misused.
- **Hacking or Cracking** means illegal intrusion into the information on a computer system or network. The motive could include greed, power, revenge, adventure, desire to access forbidden information, destructive mindset and wanting to sell to earn revenue.
- **Phishing** refers to the acquiring of sensitive information such as user names, passwords or credit card details by masquerading as a trustworthy entity in an electronic communication. The word is an eulogy of the fishing technique of using a bait to lure the victim. It directs users to enter details on a fake website whose look and feel are almost identical to the legitimate one. It exploits the user's trust in not being able to identify the site being visited or the program being used is not the real one.
- **Vishing and Smishing** are phone scams similar to "phishing". Vishing is a telephone call claiming to be from a legitimate company requesting your personal information to resolve an urgent financial matter Smishing is accomplished through text messages on a cell phone by asking a person to call a particular number or click on a link that could contain malicious code that could potentially steal information stored in that person's cell phone without his/her knowledge.
- **Data theft** is aided by use of hand held devices like flash drives, I-pods, digital cameras and the ability to transmit large amounts of data quickly vide e-mail, web pages, USB drives, DVD storages & other hand held devices.
- **E mail spoofing** is sending an email to another person in such a way that it appears that the email was sent by someone else. The mail appears to originate from one source but is actually sent from another source.
- **Denial of Service or DOS** attacks floods the bandwidth of the victim's network or fills his email box with spam mail depriving him of service that he is entitled to access or provide.
- **Dissemination of viruses** by use of malicious software that attaches itself to other software. Some of the common viruses are Virus worms, Trojan horse, Web jacking, Email bombing.

- **Impersonation:** A crime in which an imposter obtains key pieces of personal information in order to impersonate someone else. The imposter assumes the identity of that person to make transactions, purchases or get loans or credits. This could also be done for illegal immigration, hiding from creditors or people who want to be anonymous for personal reasons. The person whose identity is assumed suffers various consequences as a result of being held responsible for the perpetrators actions.
- **Botnets -** networks of compromised computers, controlled by remote attackers in order to perform such illicit tasks as sending spam or attacking other computers.
- **Malvertising –** is a method whereby users download malicious code by simply clicking at some advertisement on any website that is infected.
- **Cyber Extortion**: refers to blackmailing the victim and extorting money to stop the DOS attacks or give back the information stolen or discontinue vandalism etc.
- **Cyber Terrorism / Warfare**: Refers to Distributed Denial of service attacks, hate websites and hate emails, attacks on service network etc.
- **Computer Vandalism** refers to damaging or destroying data rather than stealing or misusing it. Programs are used which attach themselves to a file and then circulate.
- **PUPs (Potentially Unwanted Programs)** are less harmful but annoying malware which installs unwanted software in your system including search agents and toolbars.
- **Software piracy** through either theft or illegal copying of genuine programs or by counterfeiting and distribution of product intended to be passed as originals.
- **Misuse of Digital Signature:** If the private key is not stored securely, it can be misused without the knowledge of the owner of the Private key to issue unauthorized digital certificates for cyber espionage, malware diffusion or sabotage.
- **Man in the Middle Attacks (MITM)** refers to attacks where the attacker secretly relays or possibly alters the communication between two parties who believe they are directly communicating with each other. The attacker intercepts all messages between the two victims and injects new ones and in fact controls the entire conversation.
- **Credit Card Frauds** – involving Debit or Credit cards for obtaining goods without paying or obtaining unauthorized funds from an account.

- Use of fake identities, documentations or impersonation to obtain genuine cards.
- Using a stolen or lost Credit card for illegal purchases before the holder notifies the issuing bank and the issuing bank puts a block on the account.
- Skimming is the theft of payment card information used in a legitimate manner by using basic methods like photocopying receipts or advanced methods like using small electronic devices (skimmers) to swipe & store hundreds of victim card numbers.
- Tele Phishing is obtaining a list of individuals with their name & phone numbers luring victims into thinking that they are speaking with a trusted organization while handing over sensitive information such as card details.
- A Merchant at a POS(Point of Sale) terminal may allow a fraudster to get goods on a stolen credit card for consideration. He may provide the details of customer cards to the fraudster for a consideration. He can connive with the fraudster & allow him to substitute the imprinter to collect data which can then be used to multiply cards.
- The merchant may at times swipe the card for a nonexistent transaction & accommodate another by lending him money from the value of the transaction he has received from the paying bank.
- At times a card holder may himself declare the card as stolen or lost to the issuer. Soon after he himself uses the card to its limits. The loss on the card post intimation is the loss of the banker / issuer & gains are made in this manner.
- Various credit cards are applied simultaneously at the same time by a fraudster with no previous default history & with the intention to use the card to the fullest and not to repay. At times the fraudster may agree to a one time settlement of the dues at a much lesser amount than what he owes.
- Auditor has to review whether risks faced by the Branch are appropriately identified and assessed and whether appropriate controls are put in place, implemented and monitored to reduce/mitigate risks to an acceptable level. Testing of efficiency, effectiveness of controls and reporting to give an assurance thereon is a key audit function.

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 Computer Information Systems ('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 In today's environment all banks have set up and implemented large scale computerisation projects, which has resulted in changes in the processing and storage of information. Information generated by IT systems are also used for decision making. The importance, extent of use and complexity of a bank's information systems affect 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. The nature of audit evidence and the techniques used to evaluate them have also undergone a significant change. Audit procedures are now transformed from "Auditing around the computer" to "Auditing through the computer".

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.
- The use of multiple channels of delivery of services to a bank's customers such as ATM, EFT, internet banking, card-based payment systems, etc.
- The integrity of financial data moving through data interfaces between several systems.
- Potential risk of management override of controls through privileged access to information systems.
- Potential segregation of duty issues arising from access to multiple systems granted to users.
- The extensive use of third party vendors (service organizations) to whom financial data processing activities or management of IT infrastructure is outsourced.

3.05 Electronic Funds Transfer ('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, 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 also 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 access violations, is an important part of the audit. Further, if the system is hosted outside India, Auditor can obtain report of service organization as per SAE 3402, "Assurance Reports on Controls At a Service Organisation" or equivalent work/report from that country.

3.08 RBI's circular No -DBOD.COMP.BC.No.130/ 07.03.23/ 2000-01 dated 14th June 2001 on Internet banking in India – Guidelines, states in Para II on Legal Issues as follows, "Considering the legal position prevalent, there is an obligation on the part of banks not only to establish the identity but also to make enquiries about integrity and reputation of the prospective customer. Therefore, even though request for opening account can be accepted over Internet, accounts should be opened only after proper introduction and verification of the identity of the customer".

3.09 RBI has issued guidelines to scheduled commercial banks on cyber security framework vide its circular no RBI/2015-16/418 DBS.CO/CSITE/BC.11/ 33.01.001/2015-16 dated June 2, 2016. As per this circular, banks are required to report promptly (Within 2 to 6 hours) the cyber-attack incidents, in the format given in Annexure 3 of the aforesaid circular.

3.10 Banks should immediately put in place a cyber-security policy elucidating the strategy containing an appropriate approach to combat cyber threats given the level of complexity of business and acceptable levels of risk, duly approved by their Board.

3.11 Confirmation in this regard should be communicated to Cyber Security and Information Technology Examination (CSITE) Cell of Department of Banking Supervision, Reserve Bank of India, Central Office, World Trade Centre-I, 4th Floor, Cuffe Parade, Mumbai - 400 005 at the earliest, and in any case not later than September 30, 2016.

3.12 A Cyber Crisis Management Plan (CCMP) should be immediately evolved and should be a part of the overall Board approved strategy.

Categorisation of Banks based on level of Computerisation

3.13 Banks may be divided into three board categorises based on the level of computerisation:

- Non-computerised banks.
- Partially Computerised banks.
- Fully computerised banks.

The importance, extent of use and complexity of information systems of each bank may be different than the others. For effectively using a risk-based audit approach, an auditor needs to evaluate the IT risks for a bank before determining the nature, timing and extent of audit procedures.

Special care has to be taken while doing an audit in a fully computerised environment (where the Bank uses Core Banking Solution-CBS).

Responsibility of Central Auditor *vis-à-vis* Branch Auditor in fully computerised bank

3.14 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, especially 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 consider necessary to 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.

3.15 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 not be 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 and then to base their audit opinion on explanations and representations coupled with test of controls and substantive checking to the extent possible. These banks are also required to adhere to the guidelines of the RBI with regard to computerisation and the checks and controls around it.

3.16 Generally, the branch auditors do not have access to the overall IT policy, processes, controls and accounting procedures implemented by the bank. Moreover, the branch auditors confront following practical issues at fully computerised branches:

- Accounting manual, entries, calculations and framework is built in computerised accounting systems.
- Critical IT and manual controls are centralised at HO level.
- Limited access to periodical MIS and exception reports generated by the system.
- Documentation of critical processes performed for accounting and book keeping (IT and Manual).
- Access to primary records and entry level transactions.
- Audit sampling.
- Hard copies of transactions.
- Independent IT Audit at branches, etc.

3.17 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

3.18 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, asset classification, income recognition, expense booking, overdue identification, month-end and year-end procedures, valuation and re-valuation of various items of the financial statements, KYC, ALM, etc.
- Controls and recording of various e-banking and internet banking products & Channels.
- Manual processing of key transactions.
- MIS reports being generated and the periodicity thereof.
- Hard copies being generated and the periodicity thereof.
- Process of generating information related to various disclosures in the financial statements and the involvement of the IT systems.
- Major exception reports and the process of generation thereof along with logic embedded in generation of such reports.
- Major IT related issues (including frauds and failures) faced and resolved/unresolved during the year, such as, data/system corruption, system break-down, etc., having bearing on the preparation and presentation of financial statements.
- Significant observations of internal auditors, concurrent auditors, system

auditors, RBI inspection and internal inspection, etc., related to computerised accounting and overall IT systems.

- Customer complaints related to mistakes in transactions (interest application, balances, etc.).
- In order to ensure that the technology deployed to operate the payment system/s authorised is/are being operated in a safe, secure, sound and efficient manner and as per the process flow submitted by the bank for which authorisation has been issued, banks are required to get a System audit done by a firm of Chartered Accountants / Certified Information System Auditor. The scope of the System audit would include evaluation of the hardware structure, operating systems and critical applications, security and controls in place, including access controls on key applications, disaster recovery plans, training of personnel managing systems and applications, documentation, etc. The system auditor is also required to comment on the deviations, if any, in the processes followed from the process flow submitted to RBI while seeking authorisation.[3]
- Compliance documentation with RBI IT and Security directives and guidelines.

Role and responsibilities of the central auditor

3.19 Based on the information received from the bank, the statutory central auditor would:

- Need to review whether 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.
- Consider the need for sending a detailed note to the branch auditors explaining their roles and responsibilities in the light of what is stated above.
- Review whether access to primary and subsidiary records is provided and use of data analysis tools is allowed at central and branch level.
- Perform test of controls and substantive checking of sample transactions at the central level and if required, share the results with the branch auditors.
- Based on the work undertaken, identify key issues to be taken up with the Audit Committee and the Board of the bank.

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[3] 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".

- Consider whether the significant adverse observations in the periodic system audit reports need to be shared with the branch auditors and also be considered while framing the opinion of true and fair view of the financial statements of the bank.

Role and responsibilities of branch auditors

3.20 Based on the guidance and information received from the central auditor, the branch auditors need to ensure that:

- Their roles and responsibilities are clearly understood and implemented.
- To the extent possible, data analysis tools are used for better and effective audit.
- Test of controls and substantive checking of sample transactions is carried out at the branch level and, where considered necessary, the results are shared with the statutory central auditors.
- Significant observations having bearing on the true and fair view are reported to the statutory central auditors.
- Any other limitations on audit which are required to be reported to the central auditors are reported in a timely manner.

Audit in a CIS environment

Assessment of Inherent and Control Risks

3.21 The nature of banking operations is such that the auditors may not be able to reduce audit risk to an acceptably low level by the performance of substantive procedures alone. 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 processed by banks, which makes reliance on substantive procedures alone impracticable.
- The geographic spread of banks' operations.
- Complex trading transactions (Highly inter connected and automated systems such as card. mobile banking and payment systems).

3.22 In most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management that allow the auditors to be able to assess the level of inherent and control risks as less than high. The auditors obtain sufficient appropriate audit evidence to assess the level of inherent and control risks.

3.23 The auditor's procedures would need to be adapted 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 in ***Appendix XII*** of this Guidance Note. Further, an illustrative checklist on Bank Audit in computerised environment, which is divided in two parts, viz., Part I, Bank Audit in computerised environment and Part II, automatic teller machines is given in ***Appendix XIII*** **of** this Guidance Note.

3.24 The principal objective of the auditor in undertaking an audit in a CIS environment is to evaluate the effectiveness of controls. In simple words, controls are those policies and procedures which the organisation implements to minimise the events and circumstances whose occurrence could result in a loss / misstatement. There are mainly four types of controls.

A. *Deterrent controls* - Deterrent Controls are designed to deter people, internal as well as external, from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.

B. *Preventive Controls* - Preventive Controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.

C. *Detective Controls* - When a cause of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or minimise the extent of the damage. Thus, detective controls limit the losses if an unlawful event has occurred.

D. *Corrective Controls* - Corrective Controls are designed to recover from a loss situation. For example, Business Continuity Planning is a corrective control. Without corrective controls in place, the bank has risk of loss of business and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

3.25 The auditor should obtain a preliminary understanding of the IT environment and various controls put in place by the management, including entity-level controls and then test and evaluate whether the controls are operating effectively. The auditor should discuss the methodology adopted by the bank in implementing controls and their monitoring with the Head of the IT department and the Head of the audit department. These discussions will enable the auditor to get a view on the manner in which the bank has implemented controls. Based on these discussions, the auditor could interact with the various officials of the bank to determine whether they are sensitised to the control expectations of the management considering the technology deployed. If this sensitisation level is low, the auditor may need to perform more extensive audit procedures.

Security Control Aspects

3.26 The key security control aspects that an auditor needs to address when undertaking audit in a computerised bank include:

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Ensure that the system prevents unauthorised amendments to the programmes.
- Verify whether "access controls" assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- Verify that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verify that changes made in the parameters or user levels are authenticated.
- Verify that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verify that all modules in the software are implemented.
- Verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials. It is important for auditor to understand the nature of exception and its impact on financials.
- Verify that the account master and balance cannot be modified/amended/altered except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.

- Verify that balance in general ledger tallies with the balance in subsidiary book.
- 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 promptly.
- Since back up is taken at centralised location, Central Auditor should:
  - Check 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.
  - Ideally, daily backup should be taken in 6 sets, one for each weekday and 12 sets for each month end. 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 security patches are applied to systems as and when they are released by the vendors / developers.
- Verify that there are no unauthorised software installed / existent in the Servers / PCs.
- Verify that access to the computer room is restricted to authorised persons only.

Outsourcing of Financial Services by Banks

3.27 Outsourcing is a worldwide phenomenon, finding presence in every industry, including the banking industry. 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 issued circulars 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" read with circular DBOD.No.BP.97/ 21.04.158/2008-09 dated December 11, 2008 and circular DBS.CO.PPD.BC.5/ 11.01. 005/2008-09 dated April 22, 2009.

3.28 The circular defines “outsourcing” as “a bank’s use of a third party (either an affiliated bank within a corporate group or a 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.

3.29 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.

3.30 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. RBI cyber security framework dated 2 June 2016 also mandates several controls over outsourced operations/vendor arrangements. The auditor should accordingly undertake procedures necessary to meet these requirements. The scope of the auditor’s procedures would, however, be within the requirements of the SA 402, “Audit Considerations relating to an Entity Using a Service Organisation”.

3.31 As per another circular no RBI/2014-15/497 DBR.No.BP.BC.76/ 21.04.158/2014-15 dated March 11, 2015, auditor needs to check that in certain cases, like outsourcing of cash management, which involve reconciliation of transactions between the bank, the service provider and its sub-contractors reconciliation of transactions between the bank and the service provider (and/ or its subcontractor), are carried out in a timely manner. An ageing analysis of entries pending reconciliation with outsourced vendors was placed before the Audit Committee of the Board (ACB). Auditor should also check the reason for old outstanding items therein.

Security and Risk Mitigation Measures for Electronic Payment Transactions

3.32 Electronic Payments effected through alternate products/channels are becoming popular among the customers with more and more banks providing such facilities to their customers. One such initiative by RBI is mandating additional factor of authentication for all Card Not Present (CNP) transactions. Banks have also to put in place mechanisms and validation checks for facilitating on-line funds transfer, such as: (i) enrolling customer for internet/mobile banking; (ii) addition of beneficiary by the customer; (iii) velocity checks on transactions, etc.

3.33 With cyber-attacks becoming more unpredictable and electronic payment systems becoming vulnerable to new types of misuse, it is imperative that banks introduce certain minimum checks and balances to minimise the impact of such attacks and to arrest/minimise the damage. Accordingly, banks are required by the RBI to put in place security and risk control measures vide its circular DPSS (CO) PD No.1462/02.14.003/2012-13 dated February 28, 2013 and circular no RBI/2015-16/418 DBS.CO/CSITE/BC.11/33.01.001/2015-16 dated June 2, 2016.

Opening and Operation of Accounts and Settlement of Payments for Electronic Payment Transactions Involving Intermediaries

3.34 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, RBI vide its circular no. DPSS.CO.PD.No.1102 /02.14.08/ 2009-10 dated November 24, 2009 issued guidelines for opening and operation of accounts and settlement of payments for electronic payment transactions involving intermediaries to ensure safe and orderly conduct of such transactions. As per RBI Circular No BI/2010-11/339 DPSS.CO.OSD.No.1448/06.08.001/2010-2011 dated December 28, 2010, banks are required to obtain quarterly certificate from the concurrent auditor on the operations of the intermediaries' accounts including all the intermediaries accounts maintained with bank.

E –Banking

3.35 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 internet. Customers access e-banking services using an intelligent electronic device, such as, a personal computer (PC), personal digital assistant (PDA), smart phones, automated teller machine (ATM), kiosk, etc.

Risks associated with E-banking

Transaction/ Operations Risk

3.36 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.

3.37 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.

3.38 The auditor should examine whether 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 reconciliations. Information security controls, in particular, become more significant requiring additional processes, tools, expertise and testing.

Credit Risk

3.39 Generally, the bank's credit risk is not increased by the mere fact that a loan is originated through an e-banking channel. However, the bank should ensure that additional precautions are in place when originating and approving loans electronically including assuring management information systems effectiveness by preparing a track of the performance of portfolios originated through e-banking channels. The following aspects of on-line loan origination and approval tend to make risk management of the lending process more challenging:

- Verifying the customer's ID for on-line credit applications and executing an enforceable contract;
- Monitoring and controlling the growth, pricing, and on-going credit quality of loans originated through e-banking channels;
- Monitoring and oversight of third-parties operations doing business as agents or on behalf of the banks;
- Valuing collateral and perfecting liens over a potentially wider geographic area; and
- Collecting loans from individuals over a potentially wider geographic area.

If not properly managed, these aspects can significantly increase credit risk.

Compliance/ Legal Risk

3.40 Compliance and legal issues arise out of the rapid growth in usage of e-banking services and the differences between the electronic and paper-based processes. E-banking is a new delivery channel where the laws and rules governing the electronic delivery of certain financial products or services may be ambiguous or still evolving. Specific regulatory and legal challenges include:

- Uncertainty over the legal jurisdictions applicable to the transaction taking place through e-banking;
- Delivery of credit and deposit related disclosures/notices as required by law or regulation;
- Retention of required compliance documentation for on-line advertising,

applications, statements, disclosures, notices; and

- Establishment of legally binding electronic agreements.

3.41 Banks offering e-banking services, both informational and transactional, assume a higher level of compliance risk because of the changing nature of the technology, the speed at which errors can be replicated, and the frequency of regulatory changes to address e-banking issues. The potential for violations is further heightened by the need to ensure consistency between paper and electronic advertisements, disclosures and notices.

Reputational Risk

3.42 The rise of the sophisticated cyber crime has become one of the fastest growing security and reputational risks to banks. The cyber crime landscape features malware exploits that can routinely evade traditional security controls. The reactive attack and penetration approaches of the past may no longer be sufficient to deal effectively with that level of ingenuity of cyber attacks and are being replaced with new forms of cyber intelligence capable of enhancing traditional security programs. Adding a layer of complexity to the issue is the rise of social networking, online communications, and online financial transactions. The bank has a significant role to play in identifying and addressing this risk thereby safeguarding its reputation and instilling the confidence in its customers.

Mobile Banking

3.43 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.

3.44 With a view to ensure that the banks adequately address the risks associated with mobile banking, the RBI has issued Master Circular No. RBI/2016-17/17 DPSS.CO.PD.Mobile Banking No. 02/02.23.001/2016-17 dated July 1, 2016 on "Mobile Banking Transactions in India – Operative Guidelines for Banks". The guidelines are applicable to all scheduled commercial banks (including Regional Rural Banks), Urban Cooperative Banks, State Cooperative Banks and District Central Cooperative Banks. A bank needs to obtain prior approvals of the RBI before commencement of mobile banking services in India.

3.45 In carrying out an audit of mobile banking transactions, the auditor is primarily concerned about aspects such as authentication procedures, understanding the information security framework, compliances with regulatory requirements, etc.

- *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 bank needs 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 evaluate the bank's compliance with these requirements.
- *Compliance with Regulatory Guidelines:* Banks need to ensure that the guidelines on KYC norms, anti-money laundering, risks and controls in computers and telecommunications, etc., issued by the RBI which apply to mobile banking are also adhered to. The auditor also needs to examine whether the transaction limit, as stipulated by the RBI, is adhered to and imposed on mobile banking transactions.

3.46 The dependence of banks on mobile banking service providers may place knowledge of bank systems and customers in a public domain. Mobile banking system may also make the banks dependent on small firms (i.e., mobile banking service providers) with high employee turnover. It is therefore imperative that sensitive customer data, and security and integrity of transactions are protected. It is necessary that the mobile banking servers at the bank's end or at the mobile banking service provider's end, if any, should be certified by an accredited external agency. In addition, banks should conduct regular information security audits on the mobile banking systems to ensure complete security.

3.47 Transactions up to Rs. 5000/- can be facilitated by banks without end-to-end encryption. The risk aspects involved in such transactions may be addressed by the banks through adequate security measures. (Circular DPSS.CO.No.2502/02.23.02/ 2010-11 dated May 4, 2011)

3.48 RBI Circular dated 4th December 2014 on Mobile Banking Transactions in India - Operative Guidelines for Banks has felt the need for greater degree of standardization in procedures relating to on-boarding of customers for mobile banking (new customers, existing account holders whose mobile numbers are available with the bank but not registered for mobile banking, and existing account holders where mobile number is not available with the bank), as also the subsequent processes for authentication, including accessible options for generation of MPIN by customers.

3.49 Where banks are providing E-Wallet facility, auditor should evaluate proper controls and checking of transactions through E-Wallets and presentation of the balances of E-Wallet in the financial statements based on underlying arrangement for providing such facility.

PART - III

III-1
Advances-Agriculture

Introduction

1.01 Indian Agriculture has always been the backbone of Indian economy despite sustained progress in industrial and service(s) sector. It still contributes around 18% of the GVA (Gross Value Added) and provides employment opportunities to around 50% of the population. Indian agriculture has been source of raw materials to many of our leading industries like cotton, jute textile industries, sugar, flour mills, vanaspati, oil mills etc. Besides, many industries like handloom weaving, rice-dehusking etc. depend indirectly on the agriculture. Rapid growth in agriculture is essential not only for self-reliance but also to earn valuable foreign exchange.

1.02 The agriculture sector in India is pre-dominantly dependent on Monsoon rains which more often than not tend to be of erratic nature. Hence, agricultural credit is considered as one of the most basic input for conducting all agricultural development programmes. In India there is an immense need for proper agricultural credit as the economic condition of Indian farmers generally is of subsistence. From the very beginning the prime source of agricultural credit in India has been money lenders as many of the commercial banks were generally discouraged by inherent characteristics of Indian agriculture like uncertain character of Indian agriculture, small amounts of individual loans, inadequate security for loans, difficulty in recovery of loans from farmers and lack of business experience of working with rural sector.

1.03 With a view to ensure wider spread of agricultural credit, the Government adopted the institutional credit approach through various agencies like co-operatives, commercial banks, regional rural banks etc. to provide adequate credit to farmers, at a cheaper rate of interest. The long term and short term credit needs of these institutions are also being met by National Bank for Agricultural and Rural Development (NABARD). It is the evolution of agricultural finance. It has the objective of promoting the health and the strength of the credit institutions which are in the forefront of the delivery system namely, cooperatives, commercial banks and regional rural bank. It is, in brief, an institution for the purpose of refinance; with the complementary work of directing, inspecting and supervising the credit- flows for agricultural and rural development.

1.04 The evolution of institutional credit to agriculture could be broadly classified into four distinct phases –

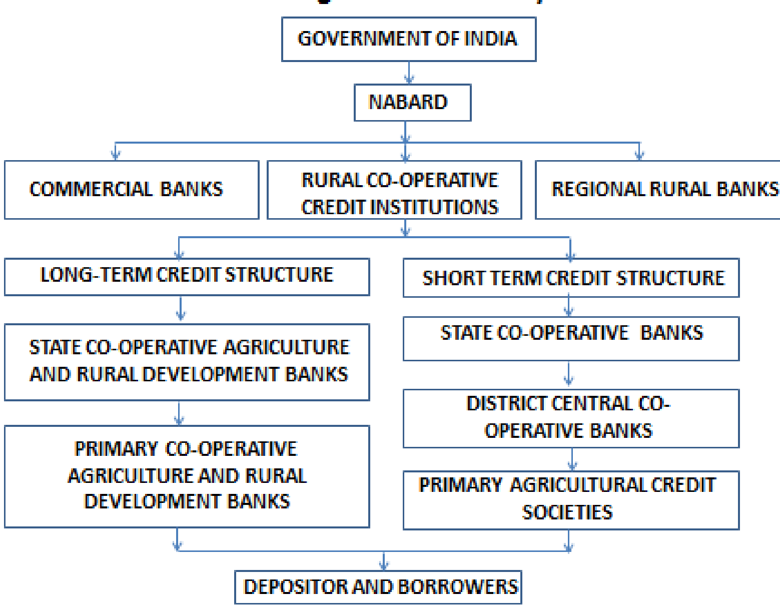
i. 1904-1969 (predominance of co-operatives and setting up of RBI);

ii. 1969-1975 [nationalization of commercial banks and setting up of Regional Rural Banks (RRBs)];

iii. 1975 - 1990 (setting up of NABARD) and;

iv. From 1991 onwards (financial sector reforms): The genesis of institutional involvement in the sphere of agricultural credit could be traced back to the enactment of the Cooperative Societies Act in 1904. The establishment of the RBI in 1935 reinforced the process of institutional development for agricultural credit.

Structure of Agriculture Credit System in India



1.05 Following measures were announced in Union Budget 2016-17 for Agriculture & Farmers' Welfare:

- The target for agricultural credit in 2017-18 has been fixed at Rs. 10 lakh crore.
- Special efforts will be made to ensure adequate credit to the under serviced areas, the eastern states and Jammu & Kashmir.
- Support to NABARD for computerisation and integration of all 63,000 functional Primary Agricultural Credit Societies (PACS) with the Core Banking System (CBS) of District Central Cooperative Banks (DCCBs). This will be done in 3 years at an estimated cost of R1, 900 crore, with financial participation from state governments.
- The coverage of Pradhan Mantri Fasal Bima Yojana (PMFBY) will be increased from 30 per cent of cropped area in 2016- 17 to 40 per cent in 2017-18 and 50 per cent in 2018-19.
- Government will set up new mini labs in Krishi Vigyan Kendras (KVKs) and ensure 100 per cent coverage of all 648 KVKs in the country. In addition, 1,000 mini labs will be set up by qualified local entrepreneurs.
- Enhancement in the corpus of Long Term Irrigation Fund (LTIF) with NABARD from Rs. 20,000 crore to Rs. 40,000 crore.
- A dedicated Micro Irrigation Fund will be set up in NABARD with an initial corpus of Rs. 5,000 crore, to achieve the goal 'per drop more crop'.
- The coverage of National Agriculture Market (e-NAM) will be expanded from the current 250 markets to 585 APMCs. States will be urged to undertake market reforms and de-notify perishables from APMC.
- A model law on contract farming would be prepared and circulated among the states for adoption.
- A Dairy Processing and Infrastructure Development Fund will be set up in NABARD with a corpus of Rs. 8,000 crore over three years. The initial corpus will be Rs. 2,000 crore.

1.06 Government has increasingly begun to tap institutional finance from banks and other term lending institutions for financing various developmental programmes in the State in view of the need to supplement plan financing. Banks in the State have also played a pivotal role in this regard. However, credit should be utilized in prudent manner to maximize returns and spread the benefit over wider sections of the population. Successful implementation of socioeconomic developmental programmes calls for effective co-ordination between financial agencies and government departments. It also helps in improvising efficiency of resource allocation & identifying infrastructural gaps.

1.07 The State Level Bankers' Committee ('SLBC'), constituted by the Reserve Bank of India under the Lead Bank Scheme periodically takes up the review performance and monitors progress under special schemes. At the district level the District Consultative Committee with the Chief Executive Officer of Zilla Panchayat as chairperson and representatives of financial institutions and Heads of Government departments at the district level as members' monitors the implementation of government sponsored schemes & Service Area Credit Plans. At the block level, Block Level Bankers' Committee chaired by Lead District Manager with bank managers and departmental heads of government at block level as members periodically reviews the implementation of government sponsored schemes & Service Area Credit Plans and sorts out problems encountered in the implementation of various programmes. In order to select & prioritise the works for loan assistance from National Bank for Agriculture and Rural Development (NABARD) under Rural Infrastructure Development Fund (RIDF) Scheme, launched in 1995-96, a Cabinet Sub-Committee on RIDF has been constituted under the chairmanship of the Minister for Public Works. There is also a High Power Committee chaired by the Additional Chief Secretary and Development Commissioner for reviewing the implementation of RIDF projects. These policy measures have resulted in the increase in the share of institutional credit of the rural households.

Role of Commercial Banks (CBs) in providing agricultural credit

1.08 Commercial banks are guided by priority sector lending policy of providing credit to various deserving sectors/sections including agriculture and allied activities.

1.09 Commercial banks entered the field of agricultural credit in a major way following their nationalisation in 1969. Growth in commercial bank credit to agriculture, which was lower than the growth in aggregate bank credit during the 1990, picked up sharply in the first half of the 2005 and largely coincided with the growth in aggregate bank credit. There was a downturn in the growth in commercial bank credit to agriculture after 2005-06, when growth in aggregate bank credit also slowed down. Previously Commercial Banks (CBs) were confined only to urban areas serving mainly to trade, commerce and industry. Their role in rural credit was abysmally low i.e., 0.9 per cent in 1951-52 and 0.7 per cent in 1961-62. The insignificant participation of CBs in rural lending was explained by the risky nature of agriculture due to its heavy dependence on monsoon, unorganized nature and subsistence approach. In the year 1990-91 share of commercial banks increased up to 54 percent. At present, they are the largest source of institutional credit to agriculture.

Priority Sector Lending (PSL)

1.10 With a view to regulate and encourage the flow of agricultural credit by all scheduled Commercial Banks, the RBI from time to time, issues a number of guidelines /instructions/directives to banks on Priority Sector Lending.

1.11 Priority Sector Lending programme has been an integral part of the banking policy in India. It is a major public policy intervention through which credit is directed to the sectors of national priorities critical for both employment and equity. The Priority Sector Lending programme of India is one among the longest serving directed lending programmes in the world. This scheme is intended to give loans to the important sectors of the economy (agriculture, small scale industries etc.) in such a way to ensure maximum credit flow to the last man in the last village of the country through a strong banking network. The origin of the PSL programme can be traced back to the Credit Policy for 1967-68, when public sector banks were advised to increase their involvement in financing of certain sectors identified as priority sectors in line with the national economic policy. Priority sector lending in its present form was introduced in 1980, when it was also made applicable to private sector banks and a sub-target was stipulated for lending to the "weaker" sections of the society within the priority sector.

Meaning – Priority Sector & Priority sector advances

1.12 Priority sector refers to those sectors of the economy which may not get timely and adequate credit in the absence of this special dispensation. Priority sector advances are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.

1.13 In terms of RBI Master Direction- RBI/ FIDD/ 2016-17/ 33 Master Direction FIDD.CO.Plan.1/04.09.01/2016-17 "Master Direction- Priority Sector Lending- Targets and Classification" dated July 7, 2016 (updated December 22, 2016) the categories under priority sector are as follows:

(i) Agriculture
(ii) Micro, Small and Medium Enterprises
(iii) Export Credit
(iv) Education
(v) Housing
(vi) Social Infrastructure
(vii) Renewable Energy
(viii) Others

1.14 The targets and sub-targets for agriculture set under priority sector lending for all scheduled commercial banks operating in India are furnished below for domestic scheduled commercial banks and foreign banks with 20 branches and above:

Agriculture	18 percent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher. Within the 18 percent target for agriculture, a target of 8 percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher is prescribed for Small and Marginal Farmers. Foreign banks with 20 branches and above have to achieve the Agriculture Target within a maximum period of five years starting from April 1, 2013 and ending on March 31, 2018 as per the action plans submitted by them and approved by RBI. The sub-target for Small and Marginal farmers would be made applicable post 2018 after a review in 2017.[5]

Computation of Adjusted Net Bank Credit (ANBC)

1.15

Bank Credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934].	I
Bills Rediscounted with RBI and other approved Financial Institutions	II
Net Bank Credit (NBC)*	III (I - II)

[5] Additionally, domestic banks are directed to ensure that the overall lending to non-corporate farmers does not fall below the system-wide average of the last three years achievement. All efforts should be maintained to reach the level of 13.5 percent direct lending to the beneficiaries who earlier constituted the direct agriculture sector. The applicable system wide average figure for computing achievement under priority sector lending will be notified every year. For FY 2015-16, the applicable system wide average figure is 11.70 percent.

Bonds/debentures in Non-SLR categories under HTM category+ other investments eligible to be treated as priority sector +Outstanding Deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd. on account of priority sector shortfall + outstanding PSLCs	IV
Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing as per circular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014.	V
Eligible advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements.	VI
ANBC	III+IV-V-VI

* For the purpose of priority sector computation only. Banks should not deduct / net any amount like provisions, accrued interest, etc. from NBC

A. The computation of priority sector targets/sub-targets achievement will be based on the ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposures, whichever is higher, as on the corresponding date of the preceding year.

B. For the purpose of priority sector lending, ANBC denotes the outstanding Bank Credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934] minus bills rediscounted with RBI and other approved Financial Institutions plus permitted non SLR bonds/debentures under Held to Maturity (HTM) category plus other investments eligible to be treated as part of priority sector lending (e.g. investments in securitised assets).

C. The outstanding deposits under RIDF and other funds with NABARD, NHB, SIDBI and MUDRA Ltd. in lieu of non-achievement of priority sector lending targets/sub-targets will form part of ANBC.

D. Advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements, as per the Reserve Bank's circulars DBOD.No.Ret.BC.36/12.01.001/2013-14 dated August 14, 2013 read with DBOD.No.Ret.BC.93/12.01.001/2013-14 dated January 31, 2014 and DBOD mailbox clarification issued on February 6, 2014 will be excluded from the ANBC for computation of priority sector lending targets, till their repayment.

E. The eligible amount for exemption on account of issuance of long-term bonds for infrastructure and affordable housing as per Reserve Bank's circular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014 will also be excluded from the ANBC for computation of priority sector lending targets.

F. For the purpose of calculation of Credit Equivalent Amount of Off-Balance Sheet Exposures, banks may be guided by the Master Circular on Exposure Norms issued by the Department of Banking Regulation.

Agriculture Credit

1.16 Hitherto the agriculture advances were bifurcated into direct / indirect agriculture advances, however, in terms of revised guidelines issued by Reserve Bank of India (RBI-2014-15/573 FIDD.CO.Plan.BC.54/04.09.01/2014-15 dated April 23, 2015), the present distinction has been dispensed with and the lending to agriculture sector has been defined to include (i) Farm Credit (which will include short-term crop loans and medium/long-term credit to farmers) (ii) Agriculture Infrastructure and (iii) Ancillary Activities.

1.17 A list of eligible activities under the three sub-categories is indicated below:

(i) Farm Credit

A. Loans to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data of such loans] and Proprietorship firms of farmers, directly engaged in Agriculture and Allied Activities, *viz.,* dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. This will include:

   a. Crop loans to farmers, which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.

   b. Medium and long-term loans to farmers for agriculture and allied activities (*e.g*. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and developmental loans for allied activities.)

   c. Loans to farmers for pre and post-harvest activities, *viz*., spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.

   d. Loans to farmers up to Rs. 50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.

e. Loans to distressed farmers indebted to non-institutional lenders.

f. Loans to farmers under the Kisan Credit Card Scheme.

g. Loans to small and marginal farmers for purchase of land for agricultural purposes.

B. Loans to corporate farmers, farmers' producer organizations/companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture up to an aggregate limit of Rs. 2 crore per borrower.

This will include:

a. Crop loans to farmers which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.

b. Medium and long-term loans to farmers for agriculture and allied activities. (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and developmental loans for allied activities.)

c. Loans to farmers for pre and post-harvest activities, *viz.*, spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.

d. Loans up to Rs. 50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.

(ii) Agriculture Infrastructure

a. Loans for construction of storage facilities (warehouses, market yards, godowns and silos) including cold storage units/ cold storage chains designed to store agriculture produce/products, irrespective of their location.

b. Soil conservation and watershed development.

c. Plant tissue culture and agri-biotechnology, seed production, production of bio-pesticides, bio-fertilizer, and vermi composting.

For the above loans, an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system, will apply.

(iii) Ancillary activities

a. Loans up to Rs. 5 crore to co-operative societies of farmers for disposing of the produce of members.

b. Loans for setting up of Agriclinics and Agribusiness Centres.

c. Loans for Food and Agro-processing up to an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system.

d. Loans to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on contract basis.

e. Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi-Purpose Societies (LAMPS) for on-lending to agriculture.

f. Loans sanctioned by banks to MFIs for on-lending to agriculture sector as per the conditions specified in paragraph IX of the aforesaid Master Directions.

g. Outstanding deposits under RIDF and other eligible funds with NABARD on account of priority sector shortfall.

1.18 For the purpose of computation of achievement of the sub-target, Small & Marginal Farmers will include the following:-

- Farmers with landholding of up to 1 hectare (Marginal Farmers). Farmers with a landholding of more than 1 hectare and up to 2 hectares (Small Farmers).
- Landless agricultural labourers, tenant farmers, oral lessees and share-croppers, whose share of landholding is within the limits prescribed for small and marginal farmers.
- Loans to Self Help Groups (SHGs) or Joint Liability Groups(JLGs), i.e. groups of individuals Small and Marginal farmers directly engaged in Agriculture and Allied Activities, provided banks maintain disaggregated data of such loans.
- Loans to farmers' producer companies of individual farmers, and co-operatives of farmers directly engaged in Agriculture and Allied Activities, where the membership of Small and Marginal Farmers is not less than 75 percent by number and whose land-holding share is also not less than 75 percent of the total land-holding.

1.19 Kisan Credit Card (KCC)

a) In terms of RBI Cir. No. RPCD:F.S.D. BC No. 77/05/09/2011-12 dated 11th May, 2012 revised scheme for issue of Kisan Credit card was introduced by

RBI which was subsequently modified vide various circulars. Latest Master cir. No. RBI/2017-18/4 FIDD:CO.FSD.BC. No. 7/05.05.10/2017-18 dated 3rd July, 2017.

b) The scheme was simple and hassle free for both the farmers and bankers. The scheme was aimed at providing adequate & timely credit support under single window to the farmers for their cultivation and other needs as indicated below:

- Short term credit limits
  - i. To meet the short term credit requirement for cultivation of crops
  - ii. Post harvest expenses
  - iii. Produce marketing loan
  - iv. Consumption requirement of farmer household
  - v. Working capital for maintenance of farm assets & activities allied to agriculture like dairy, inland fishery etc.
- Long term Credit Limit: Investment credit requirement for agriculture & allied activities.

c) It may be noted that KCC is not a type of loan, but is a channel for granting either short term or long term agricultural finance.

1.20 Interest Application

a) Unlike normal loans, the interest on agricultural advances is not charged at monthly rests but is charged normally at half yearly or annual rests.

b) Compounding of Interest is generally not permitted in respect of an Agricultural advance, unless it turns out to be a non-performing advance.

Examples of Interest application according to crop seasons and for other activities:

Crop Season	**Kharif**	**Rabi**	**Horticulture**
Disbursement Period	April 01 to Sept 30	Oct 01 to March 31	
Interest Application	Annual	Annual	Annual
Interest Application date	31st March	30th June	31st March
Compounding	Annual	Annual	Annual
Due Date	31st March	30th June	One year after first disbursement

			every year.
Compounding from date	After 31st March	After 30th June	After end of year (to be calculated from date of first disbursement every year)
Penal Interest	If overdue, after 31st March	If overdue, after 30th June	If overdue, from the due date

	Allied Activities	
	Dairy, Poultry	**Goat Rearing, Piggery**
Repayment	Quarterly	Half Yearly / Yearly
Interest Application	Quarterly	Half Yearly / Yearly
Interest application date	Quarter end	Half Year end / Year end
Compounding Frequency	Quarterly	Half Yearly / Yearly
Compounding from date	After Quarter end	After Half Year end / Year end
Penal Interest	If overdue, after Quarter end	If overdue after half year /year end.

Interest Subvention

1.21 Public / Private Sector Scheduled Commercial Banks (in respect of loans given by the rural and semi urban branches) are eligible under the scheme. Interest subvention of 2% p.a. is allowed on their own funds used for short term crop loans upto Rs.3.00 lakh per farmer. Short term credit made available at 7% p.a. to farmers is considered for interest subvention. This is calculated on the crop loan amount from the date of its disbursement/ drawal up to the date of actual repayment of the crop loan by the farmer or up to the due date of the loan fixed by the banks, whichever is earlier, subject to a maximum period of one year.

From 2011-12, additional interest subvention of 3% to those farmers, who repay their short term crop loans promptly and on or before the due date. Farmers, who promptly repay their crop loans as per the repayment schedule fixed by the banks, extended loans at an effective interest rate of 4% p.a.

Interest subvention scheme to post harvest loans

1.22 Scheme extended to small and marginal farmers (having Kisan Credit Card) for a further period upto six months, post-harvest, against negotiable warehouse receipt for keeping their produce in warehouses. To discourage distress sale by farmers and to encourage them to store their produce in warehouses against warehouse receipts.

1.23 Auditors have to submit certificate of Interest Subvention alongwith annual accounts of the branch audited by them.

Audit Procedure

1. Obtain written representation from the management about the scheme and its applicability.
2. Obtain list of eligible borrowers with outstanding balance.
3. Interest on the loan account has been properly charged.
4. The subvention is computed properly for the eligible year and credited in respective borrower account.
5. Inquire about any rejection made in earlier year claims and reasons thereof.

As per RBI circular, the auditor need to certify the correctness of the claim, so the substantive testing needs to be carried out for examinations.

Non-achievement of priority sector targets

1.24 Scheduled Commercial Banks having any shortfall in lending to priority sector shall be allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/ MUDRA Ltd., as decided by the Reserve Bank from time to time. The achievement will be arrived at the end of financial year based on the average of priority sector target /sub-target achievement as at the end of each quarter.

1.25 While computing priority sector target achievement, shortfall / excess lending for each quarter will be monitored separately. A simple average of all quarters will be arrived at and considered for computation of overall shortfall / excess at the end of the year. The same method will be followed for calculating the achievement of priority sector sub-targets. An Illustrative example is given in

Annex A of Master Directions – Priority Sector lending – Target and Classification issued dated December 22, 2016.

1.26 The interest rates on banks' contribution to RIDF or any other Funds, tenure of deposits, etc. shall be fixed by Reserve Bank of India from time to time.

1.27 The misclassifications reported by the Reserve Bank's Department of Banking Supervision would be adjusted/ reduced from the achievement of that year, to which the amount of declassification/ misclassification pertains, for allocation to various funds in subsequent years.

1.28 Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.

Term wise Categories of Agriculture Credit

1.29 The credit needs of cultivators fall into three broad categories:

i. Crop Loan or Short Term - mainly for financing current expenditure in connection with the raising of crops.

ii. Medium Term - for meeting outlay relating to the replacement and maintenance of assets and for capital investment designed to increase the output from land. Such loans are generally repayable in 3 to 5 years. They are sanctioned for purposes such as deepening of wells, sinking of new wells, installation of pump sets, purchase of agricultural machinery or a pair of bullocks, etc.

iii. Long Term - for capital investments in agriculture such as sinking of new wells, construction of tube wells, land levelling, bunding, terracing, purchase of tractors, power tillers and other costly machinery, electrical motors, purchase of land, etc. Such loans are generally repayable over a period of 5 to 15 years and in exceptional cases in 20 years.

As per the extant RBI guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State depending upon the duration of crops raised by an agriculturist.

State Level Banker's Committee (SLBC)

1.30 The Agriculture finance is supervised and monitor by State Level Banker's Committee ('SLBC') and its decisions are implemented by all banking sector having branches in the state. Every state has its own SLBC and guidelines have been issued to banks to develop agricultural finance.

1.31 The SLBC is an inter-institutional forum for co-ordination and joint implementation of development programmes and policies by all the financial institutions operating in a state. Although SLBC is envisaged as a bankers' forum, Government officials are also included. The Lead Bank designated as 'Convenor Bank'. The State Level Banker's Committee meets once a quarter.

1.32 The SLBC of the respective state decides the crop season for each crop, which effectively means the period upto harvesting of the crop raised and the banks of the respective state have to adhere with the crop season as decided by the SLBC of that respective state. Hence, practically it may occur that same crop may have different harvesting season in different states as decided by the respective SLBC of those states. In these cases the auditor needs to verify whether the Banks have the requisite mechanism to map the crop season(s) vis-à-vis the crop season(s) as defined by the SLBC of each state as any discrepancies may have a direct impact on identification of NPAs.

Examples: Harvesting Season as defined by SLBC in different states

A. SLBC Rajasthan

1.33 As per guidelines[6], the SLBC has to determine crop season for each crop so as to decide the NPA norms to be followed in the State for asset classification under Agriculture Advance. Based on the sowing , harvesting period prevailing in the State & looking to the crop pattern, Agro Climatic condition, the Crop season for Kharif & Rabi season was proposed as under, which was unanimously approved by the house.

Kharif Crop - April – Dec - Due date of repayment may be fixed 31st March

Rabi Crop - Oct – April - Due date of repayment may be fixed 30th June

B. SLBC Gujarat

1.34 Short duration Mono cropping farmers:

PARTICULARS	KHARIF SEASON	RABI / SUMMER SEASON
Year of sanction of Loan	2004-05	2004-05
Month of sanction	April 04 to June 04	October 04 to November 04
Season start	June -July 04	November-December 04

[6] Excerpts from minutes of 108th meeting of SLBC Rajasthan held on 16.03.2011.

Harvest Time	October-November 04	February-March 05
Due date for Repayment	31.03.2005	30.06.2005
1st crop season	June 05 to December 05	October 05 to March 06
2nd crop season	June 06 to December 06	October 06 to March 07

Short duration Double cropping farmers:

PARTICULARS	KHARIF SEASON	RABI / SUMMER SEASON
Year of sanction of Loan	2004-05	2004-05
Month of sanction	April - June 04	October - November 04
Season start	June -July 04	November-December 04
	October-November 04	February-March 04
Due date for Repayment	31.03.2005	30.06.2005
1st crop season	October 04 - March 05	June 05 - December 05
2nd crop season	June 05 - December 05	October 05 - March 06

Two Crops seasons is considered as under:

- If a farmer is growing Crops only in Kharif season and land remains fallow during the rest of the year, two crop seasons will spread over two years. Similar is the case if crops are grown only in Rabi season by a farmer. In this case, repayment date will be fixed once in a year.
- If the farmer is growing Kharif as well as Rabi crops, two crop seasons will spread over one year period. There will be two repayment dates during one year period.

(Excerpts from minutes of 119th State Level Bankers' Committee Meeting held on December 22, 2008 at Dena bank)

Security for Crop Loan

1.35 An essential feature of the crop loan system is that a cultivator's eligibility for loan and its size are determined not with reference to the value of the land or any other tangible security that he is in position to offer but on the basis of the size of the land holding he cultivates and the crops he grows. The repayment of loans is expected out of the sale proceeds of the crops raised. A distinction has to be drawn between:

i. loan to a cultivator and loan for agricultural production;

ii. Loans given without reference to outlays on the crops and repaying capacity generated thereby will fall in the former category; whereas, crop loans fall in the latter category, as they are essentially need based and production-oriented (and not security oriented).

1.36 While the security offered will not be the basis for a crop loan, it does not mean that the security aspect should be completely done away with. Security is necessary to provide against the possibility of a loan becoming unrealisable. Many Cooperative Societies Acts and Banks provide for a charge on the "standing crops as security" for advances made for agricultural purposes. If the crops grown are really to constitute the security for advances, it is necessary to ensure that the repayment of loan is made out of the sale proceeds of crops grown. However, partly because of the ineffective linking of credit with marketing and partly because of inadequate and inefficient supervision, the credit agency has little or no control over the sale of crops. Further, it is also difficult to enforce the charge on crops in spite of the provision therefor in the Cooperative Societies Acts.

1.37 Mortgage of land would appear to be a sound security from the point of view of the lending agency. But insistence on such security is likely to create difficulties to the borrowers. Firstly, the procedure and formalities which an execution of mortgage involves are generally time consuming and elaborate. Secondly, it may handicap a borrower in raising medium or long term loans for which mortgage of land is normally insisted upon. Thirdly, a large number of cultivators would be deprived of loans because of their inability to provide mortgage security e.g., tenants, oral lessees, etc.

NPA Norms for Agriculture Advances

1.38 NPA classification of Agricultural Loans is linked with:

i. Nature of crop

ii. Duration of crop / crop season

Applying a single form for NPA & setting up the system parameters in CBS is difficult. System is required to be configured to capture relevant SLBC guidelines for crop seasons & classification of crops and also implementation of relaxations due to natural calamities.

1.39 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.

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**.**

1.40 These NPA norms should be made applicable only to Farm Credit extended to agricultural activities as listed at paragraph 6.1 of the Master Direction on Priority Sector Lending – Targets and Classification RBI/FIDD/2016-17/33 Master Direction FIDD.CO.Plan.1/04.09.01/2016-17 dated July 07, 2016 (updated December 22, 2016). An extract of the list of these items is furnished in the Annex – 2 of the Master Circular – Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

1.41 In respect of agricultural loans, other than those specified in the Annex - 2 and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

1.42 It is important to note that the duration of crops / crop season and the overdue period for NPA's would be determined by the State Level Bankers' Committee ('SLBC') of each state as per the extant guidelines of RBI. Further, based on the harvesting period as noted by the SLBC would be taken into consideration while identification of accounts as NPA's.

C. Maharashtra SLBC

1.43 Based on the resolution and minutes of 71st steering committee meeting of SLBC held on Sep 6, 2004 following guidelines have been framed for identification of NPA's in respect of Farm credit (erstwhile Direct Agricultural Advances) and come into effect from Sep 30, 2004.

It was decided that in Maharashtra State except sugarcane and banana, all other crops would be reckoned as Short duration crops.

A. Short Duration Crops:

1. Kharif / Rabi crops: A loan granted for Kharif / Rabi crop will be treated as NPA if the instalment of principal or interest thereon remains overdue for a period of 21 months from repayment due date.
2. Horticulture Crops: A loan granted for Horticultural crop will be treated as NPA if the instalment of principal or interest thereon remains overdue for a period of 24 months from repayment due date.

B. Long Duration Crops:

1. Perennial Crop Sugarcane (Adsali): A loan granted for sugarcane (Adsali) will be treated as NPA if the instalment of principal or interest remains overdue for a period of 18 months from repayment due date.
2. Perennial Crop Banana (Mrig Bahar): A loan granted for banana crop will be treated as NPA if the instalment of principal or interest remains overdue for a period of 21 months from repayment due date.
3. Repayment due date means the date fixed at the time of sanction of loan for repayment of crop loan or instalments/interest of term loan.

C. Agricultural term Loan:

Depending upon the duration of crops raised (e.g., short duration, long duration or both), by an agriculturalist, respective overdue period as applicable to the crops mentioned above in (A) and (B) will be applicable for identification of NPAs in agricultural term loans availed by the borrower.

While identifying NPAs following points may be noted:

1.44

a. Term loan/s availed with crop loan/s: Where an agriculturist has availed loans both for short duration as well as long duration crops along with Term loan/s, such term loan/s will be classified as NPA if either of the loans for short duration or long duration crops is classified as NPA.

   Example 1: An agriculturist avails following loans

   i) Crop loan for kharif crop (a short duration crop) is availed on 1.6.2004 for which repayment due date prescribed is 31.03.2005.

   ii) Crop loan for Adsali sugarcane (a long duration crop) is availed on 1.7.2004 for which repayment due date prescribed is 30.06.2006.

   iii) A term loan for deepening of well is availed on 01.05.2004 for which first repayment instalment is due on 30.06.2006.

   If crop loan for Kharif crop remains overdue up to 31.12.2006 (i.e. overdue for 21 months after repayment due date of 31.03.2005) this crop loan along with the crop loan for sugarcane and term loan for deepening of well, will be classified as NPA with effect from 31.12.2006

b. Term loan/s availed without crop loan: where an agriculturist has availed only Agricultural Term Loan without availing any crop loan, details of crops grown (i.e. whether kharif / Rabi, horticulture, sugarcane or banana) are required to be obtained, verified and recorded. Based on the duration of these crops, overdue period for each crop as stated in (A) or (B) above will be identified and recorded. If the term loan remains overdue for the period identified as above, the same will be classified as NPA.

Example 2: In the example 1 referred to above, if only term loan is availed without availing crop loan for kharif crop & sugarcane, which are actually grown by the borrower, overdue period will be identified as 21 months for kharif crop and 18 months for sugarcane crop as mentioned above paras. The term loan will become NPA if its instalment of principal or interest remains overdue for 18 months from repayment due date i.e., from 30.06.2006 (overdue period applicable will be the lower of 18 or 21 months as applicable for crops grown by the borrower). Thus the loan for deepening of well will become NPA on 31.12.2007.

RBI Clarification received by Maharashtra SLBC

1.45 Loan may be treated as NPA immediately on completion of two crop seasons / one crop season (as the case may be, depending on the duration of the crops) after the repayment due date. Two crop seasons after the due date should refer to only those two consecutive crop seasons in which the farmer usually undertakes crop production.

1.46 The crop season for each crop, means the period up to harvesting of the crops raised. The asset classification norms assume that there is normal crop yield during the season for which credit is extended. Hence, immediately after consecutive two harvest seasons (as per the cultivation pattern followed by the farmer borrower) from repayment due date, the account is to be identified as NPA as per the revised guidelines. In case the yield is affected by natural calamities as declared by the State Government, the loan accounts should be restructured / rescheduled.

Example of NPA identification

1.47 Example of NPA identification for various types of Crop loans is given as follows.

Particulars	**Rabi Season**	**Kharif Season**	**Rabi Season**	**Sugarcane**	**Banana**
Year of Finance	2014-15	2015	2015-16	October	July
Date of Finance	From 1/10/2014	From 1/4/2015	From 1/10/2015	From 1/10/2014	From 1/7/2014

Season starts	Oct. 2014	May/June 2015	Oct. 2015	Oct-Nov.14	July-Oct.14
Harvesting Time	March / April 2015	Nov. 2015	March/ April 2016	Oct/Dec.15	Sept.15-Dec.15
Repayment Due date	Up to 30/9/2015	Up to 31/3/2016	Up to 30/9/2016	Up to 31/12/2015	Up to 31/12/2015

First Crop Season after due date: (For Dual Crop Farmer i.e. he is growing Rabi and Kharif Crop both in a year)

Season starts	May/June 15	Oct., 2015	June 16	1/10/2015	1/7/2015
Harvesting Time	Nov. 2015	March/ April 16	Nov. 2016	Oct./Nov.16	Sept.16-Dec.16

Second Crop Season after due date: (For Dual Crop Farmer i.e. he is growing Rabi and Kharif Crop both in a year)

Season starts	Oct/Nov 15	May/June 2016	Oct./Nov 16		
Harvesting Time	March/ April 2016	Nov. 16	March 2017		
NPA Date	30/6/2016	31/12/16	30/6/2017	31/12/2016	31/12/2016

First Crop Season after due date: (For Mono Crop Farmer i.e. he is growing only one crop in a year.)

Season starts	Oct/Nov 15	May/June 2016	Oct./Nov 16		
Harvesting Time	March/ April 2016	Nov. 16	March 2017		

Second Crop Season after due date: (For Mono Crop Farmer i.e. he is growing only one crop in a year.)

Season starts	Oct/Nov 16	May/June 2017	Oct./Nov 17		
Harvesting Time	March/ April 2017	Nov. 17	March 2018		
NPA Date	30/6/2017	31/12/7	30/6/2018		

Allied Activity (Instalment)				
Type	**Dairy**	**Goat Rearing**	**Piggery**	**Poultry**
	(equated quarterly installment with moratorium period, first installment will due on Sept 30, 2013)	(equated half yearly / yearly installment considering moratorium period of six months first installment is due on June 30, 2014)	(equated half yearly / yearly installment considering moratorium period of six months first installment is due on June 30, 2014)	(equated quarterly installment with moratorium period, first installment will due on Sept 30, 2013)
Loan Disbursed	1-Jun-13	1-Jul-13	1-Jul-13	1-Jun-13
Due Date	30-Sep-13	30-Jun-14	30-Jun-14	30-Sep-13
Overdue Date	1-Oct-13	1-Jul-14	1-Jul-14	1-Oct-13
Compounding	1-Oct-13	1-Jul-14	1-Jul-14	1-Oct-13
NPA turning date	31-Dec-13	30-Sep-14	30-Sep-14	31-Dec-13
Remark	After 90 days overdue	After 90 days overdue	After 90 days overdue	After 90 days overdue

Investment Credit (Instalment)	
Type	Investment Credit - Minor Irrigation system to a farmer cultivating cotton
Loan Disbursed	1-Jun-13
Due Date	31-Mar-14
Overdue Date	1-Apr-14
Compounding	1-Apr-14
NPA turning date	31-Mar-16
Remark	After two crop season. First crop season will end at March 2015 and other will end at March 2016

Some of the Key Points while Auditing Agriculture Advances

1.48 The audit approach for agriculture advances has to be on the similar lines as that of other advances. The following is a summary of few Key aspects in the audit of Agricultural Advances:

a. Sanctioned amount of Agriculture Loans should be as per scale of finance applicable to the land under cultivation and the crop being cultivated. Further, necessary securities should be obtained as per the guidelines framed by the bank.

b. Auditors should verify that the agricultural credit is extended only after obtaining 'No dues/ No objection certificates' from the existing credit agencies in the area of finance.

c. Disbursement of agricultural finance is required to be carried out in various 'stages' based on the requirements of farming activity. This needs to be ensured strictly. In some cases, the expenditure is incurred by farmer from his/her own sources or from non-institutional lenders and subsequently banks are requested to reimburse the same. In such cases, auditors have to carefully verify the facts from the documents/evidences available on record. Under all situations, auditors should verify that the bank holds documents evidencing the utilisation of loans for agricultural activities.

d. For crop loans, primary security is normally the standing crops under cultivation, as such pre and post sanction visits by the officers of bank, who are experts in Agriculture finance and adequate documentation of visit report is a key control.

e. While verifying the security offered for agricultural loans, it is to be confirmed that the security is legally enforceable. Standing crops and agricultural machinery and implements are secured by a hypothecation charge, while the agricultural land is secured by a mortgage charge. Auditors have to ensure that amongst others, the following has been duly taken on record by the banks:

- Copy of the land revenue extracts.
- Land Tax Assessment and payment receipt.
- Copy of record with sub registrar (wherever applicable)
- Original copies of the title deeds
- Search of title deeds and Legal opinion from the advocate on the Bank's approved panel
- Valuation of land from a valuer on the Bank's approved panel.

f. Loans granted to farmers against the security of NSC, KVP or Fixed Deposits of Banks, which has been utilised for agricultural purposes, is allowed to be classified under the category of finance to agriculture. However, auditors should carefully verify the loan documents and other supporting documents to ensure that non-agricultural loans are not classified as Agricultural Finance.

g. Agricultural Advances are required to be serviced through realisation of sale proceeds to crop. Auditors should be skeptical about the nature and timing credits coming in to service the agricultural loans and ensure that they are from genuine sources.

Agricultural Advances Affected by Natural Calamities

1.49 Paragraph 4.2.13 of the Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015 deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, *viz.,* conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's latest Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" dated July 1, 2015 and directions contained in RBI Master Direction FIDD.No.FSD.BC.02/05.10.001/2016-17 dated July 1, 2016 (updated July 03, 2017) on "Master Direction - Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2017". In such cases the NPA classification would be governed by such rescheduled terms. Asset classification of remaining amount (if any), not restructured, continue to be governed by original terms & conditions.

1.50 Additional finance granted due to natural calamities treated as standard assets, and will be governed by the terms & conditions of its sanction. Different dues from the borrower (e.g. current dues, dues which are not restructured etc.) will be classified under different asset classification norms. This is accepted departure from the basic principle of IRAC norms, i.e. NPA should be borrower-wise and not facility-wise.

1.51 In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remain overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not 'long duration" would be treated as "short duration" crops.

Agricultural Debt Relief Schemes

1.52 Debt Relief schemes for agricultural sector (i.e. Crop Loan Waiver schemes) are under implementation in the States of Uttar Pradesh, Punjab & Maharashtra. The salient features of the schemes are as under:

Scheme in Uttar Pradesh

1.53 Uttar Pradesh Government Crop Loan Redemption Scheme -2017 provides for the upliftment and sustainable development of small and marginal farmers.

1.54 The government of Uttar Pradesh shall provide loan redemption of up to Rs. 1 lakh to individual small and marginal farmers whose Crop loan was disbursed by Lending Institution as on or before 31 March 2016. For the purpose of calculating the loan redemption amount, the outstanding (including the accrued interest) as on March 31, 2016 would be reduced by the repayments/ credits received from the farmer during Financial Year (FY) 2016 -17 (after 31st March 2016 till 31st March 2017) without taking into account the money withdrawn by the farmer or new sanctions during FY 2016-17.

Criteria

1.55 The scheme laid down the following criteria for eligible farmers:

a) The farmer taking the loan, bank branch (through which the loan has been granted) and the farmer’s owned land, all shall be in the state of Uttar Pradesh.

b) The total area of all the lands owned by the Small farmer would not exceed 2 hectares and by the marginal farmers would not exceed 1 hectare.

c) The farmer whose crop loans were restructured due to occurrence of natural calamities in accordance with the guidelines of the Reserve Bank of India (RBI) will be covered under this scheme.

d) Crop loans taken by farmers for cultivation on government-leased land, as per the Revenue Records of government.

Excluded loans

1.56 Crop loans availed by Self Help Groups (SHGs) and Joint Liability Groups (JLGs) Loans to farmers by companies or corporate guaranteed even though disbursed by lending institutions, other institutions like Trusts, Partnerships, Micro Finance Institutions (MFIs)/Urban Cooperative Banks (UCBs), Loans extended to sugar factories for onward lending to member farmers Term loans given for any purposes, Loan or cash credit accounts given for fisheries or any kind of activities allied to agriculture.

1.57 Any loan (including crop loan) taken by particular farmer against the same piece of land, for the same purpose but from more than one bank would not be eligible for any redemption. However, if the farmer has availed the loan from multiple banks for multiple crops against the security of different agricultural lands, the redemption would be given on proportional basis, subject to a maximum aggregate of Rs. 1 lakh Cases where money withdrawn from the Kisan Credit Card (KCC) account has been misutilized or not used for crop purposes, but deposited in any term/ recurring deposit account will also be excluded.

NPAs

1.58 Crop loans of individual small and marginal farmers classified as NPAs by the lending institutions in line with the RBI norms would form part of the loan redemption scheme for NPAs. In case of NPAs, loans prescribed under the scheme, disbursed up to 31st March 2016, would be taken into consideration. Recovery charges while calculating the outstanding balance for NPA accounts will not be part of the eligible amount. The redemption amount for NPA loans would be up to Rs 1 lakh.

Scheme in Punjab

1.59 The scheme as announced by Punjab Government envisages that in case of marginal farmer (less than 2.5 acres) the entire eligible amount of those farmers who have total outstanding crop loan liability upto Rs. 2 lakh shall be provided as debt relief and in case of eligible amount of more than Rs.2 lakh, only Rs.2 lakh shall be provided as debt relief. In case of small famers (from 2.5 acres to less than 5 acres), the entire eligible amount of those farmers who have total outstanding crop loan liability upto Rs.2 lakh, shall be provided as debt relief.

1.60 The debt waiver scheme would cover crop loan disbursed to farmers in the state by scheduled commercial banks, cooperative credit institutions (including urban cooperative banks and regional rural banks, collectively called as the 'lending institutions'.

1.61 In the case of a farmer who has taken loans from two separate lending institutions, the first priority shall be given to the Cooperative institutions and second to the Public Sector Banks and third to the Commercial Banks in that order. The amount eligible for debt relief shall comprise of the outstanding liability under crop loan (principal and interest) as on March 31, 2017. The interest outstanding from April 1, 2017 till date of notification shall be additional.

Scheme in Maharashtra

1.62 Crop loan waiver for scheme for farmers in Maharashtra State will waive loans up to Rs 1.5 lakhs completely. The waiver scheme—'Chhatrapati Shivaji Maharaj Krushi Sanman Yojana' will benefit around 89 lakh farmers in the state and will make around 40 lakh debt-free. "Those farmers who have paid back their loans regularly, we will give 25 per cent loan return benefit to them.

1.63 The government will tie up with banks to cope with the financial burden which would be repaid in instalments over four years. "The 7/12 land extracts of farmers having loans up to Rs 1.5 lakh will be cleared, thereby making around 40 lakh cultivators debt-free. Farmers, whose crop loan has been restructured from 2012 to 2016 and who are still defaulters as on June 30, 2016, will get incentives up to 25 per cent of the crop loan or Rs 25,000, whichever is less. For 6 per cent farmers, the government will bring in an OTS (one time settlement) scheme, under which those who have debts of Rs 1.5 lakh, will get 25 per cent of the outstanding amount or Rs 1.5 lakh, whichever is less".

Audit Procedure

1.64

1. Obtain the copy of relevant schemes and bank's circular in this regard. .
2. Obtain list of eligible borrowers with outstanding balance.
3. Check the claim amount statement submitted to RO/ZO for claiming the same.
4. Check the accounting entries passed for the credit of eligible amount in the account of the borrower.
5. Verify accounting of interest and other charges to be borne by the landing institution as per the scheme.
6. Ensure reporting requirement as per closing instructions of the bank.

7. Obtain written representation from the management about the scheme and its applicability including cutoff amount and period of loan disbursed.

III-2
Advances-Other than Agriculture

This Chapter is divided into following parts:

A. Introduction
B. Type of Advances and Nature of Security
C. Bank's Process
D. Regulatory Aspects
E. Accounting and Audit Process

A. Introduction

2.01 Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

2.02 Audit of advances is one of the most important areas covered by auditors. It is necessary that auditors should have adequate knowledge of the banking industry and the regulations governing the banks. Auditors must be aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls.

2.03 Advances generally comprise of:

a) money lent by the bank to its customers including interest accrued and due;
b) debit balances in the account of the depositors;
c) Inter-Bank Participation Certificates.

2.04 Every bank has its credit policy approved by its board of directors. The credit policy is generally in line with the applicable RBI guidelines, relevant acts and regulations. The auditors must acquaint themselves with the credit policy of the bank and composition of its advances portfolio. Generally, this policy is regularly updated by the bank. The auditor should obtain the latest policy of the bank. The bank's corporate office periodically send the guidance/circular to their branches, the auditor should be aware about those circular/guidance during the course of their branch audit.

B. Type of Advances and Nature of Security

Fund Based and Non-Fund Based Credit Facilities

2.05 Fund based credit facilities are those where, upon sanction, there is an actual outflow of funds from the bank to the borrower, whereas non-fund based facilities are those, at the time of sanction which do not involve such outflow of the bank's funds. Typical examples of fund based facilities are term loan, cash credit and overdraft and that of non-fund based facilities are letters of credit, bank guarantees, letter of comfort, etc. Non-fund based facility may turn into a fund based facility on due date / occurrence of the specified event like devolvement of bills under LC, invocation of Bank Guarantee, etc.

Cash Credit

2.06 Cash credit facility is provided usually to entities (borrowers) engaged in manufacturing and / or trading activities to enable them to meet the gap in their working capital requirements. This facility is repayable on demand. The cash credit facility is generally granted against the security of stocks of goods (net of trade creditors), standing crops, bills / book debts representing genuine sales (restricted to pre-defined age of such book debts).

2.07 Cheque book is issued to the borrower for withdrawal of money against the limit sanctioned. The withdrawals are permitted within the drawing power balance available against facility amount approved. This is a revolving facility and is, generally, reviewed and renewed annually or on other intervals as per the policy of the bank. The Bank based on the credit assessment of the borrower performs periodical review of the borrower.

2.08 The cash credit advances are generally on 'floating' interest rate basis. The rate is reset periodically, depending upon any changes in the bank's base rate (MCLR – Marginal Cost of fund based Lending Rate) / spread in relation to the class of borrower / risk perception about the borrower.

Working Capital Demand Loan (WCDL)

2.09 WCDL is granted for a fixed period on the expiry of which it has to be liquidated, renewed or rolled over. Depending on the terms of sanction the repayment of WCDL can either be in the form of instalments spread over the tenure of the facility or bullet payment at the end of the tenure of the loan,. As the nomenclature suggests, WCDL is generally granted to meet the gap in working capital requirement. WCDL is considered as a part of working capital facility at the time of renewal or roll over.

Term Loans

2.10 Term loans are repayable in instalments spread over a period of time excluding the moratorium period, if granted. The moratorium period is assessed by the lender based on future cash flows and requirements of borrower. However, if there is a default in compliance with terms and conditions by the borrower, the bank has the right to demand repayment of the entire loan outstanding, before due date. In few cases, there are terms for increase in interest rate of the borrower as stipulated in sanction terms and conditions. The amount, periodicity of repayment, last draw down date and other terms and conditions are fixed at the time of sanction and duly recorded in the loan documents. The amount and 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. The disbursal may happen in one tranche or more than one tranches as per the requirements of the borrower. Generally, the bank also opens a current account of the borrower so he can utilize the funds. The cheque books are issued for current account under this facility.

2.11 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 'variable' 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. Interest is charged on reducing balance method.

2.12 The term loans are generally extended for the following purposes:

- For setting up of plants, 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.(WCTL)

- For Marketing / Launching / Branding etc.

2.13 Banks may 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. The bank policy provides guidance and documentation to be obtained for end use of funds.

Foreign Currency Loans

2.14 Banks are authorised to lend in foreign currency. These loans are sanctioned 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. These loans may be issued independently or through conversion of rupee term/working capital loan to foreign currency loan for a stipulated period as per the guidelines issued by RBI.

Overdrafts

2.15 The overdraft facility may be either secured or clean (i.e., without security) and does not generally carry a fix repayment schedule. The most common form of security for an overdraft arrangement is term deposit receipts. In such cases, care is taken to ensure that lien marking is done in the system and also on physical fixed deposit receipt (and not on fixed deposit advice). Fixed deposits are generally for specific period and need to be renewed on the maturity. The care should be taken to ensure that interest rate spread between overdraft and fixed deposit are maintained. Also, the bank has updated lien mark on new fixed deposit. Overdrafts may also be granted against other securities like immovable properties, life insurance policies, shares, bonds, NSCs, Kisan Vikas Patra, Indira Vikas Patra, etc. The bank has to ensure that proper margin i.e. security value and loan amount has been kept while sanctioning the overdraft.

Bills

2.16 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.

2.17 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 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.

2.18 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. The bills may be domestic (denominated in rupee for domestic trade) or foreign (denominated in foreign currency for import/export).

2.19 The RBI has issued guidelines for regulation of discounting and rediscounting of bills (Ref. Master Circular No. DBR.No.Dir.BC.10/13.03.00/ 2015-16, dated July 01, 2015, "Loans and Advances-Statutory and other Restrictions".

Export

Export Credit

2.20 Exporters are 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'. All type of advances sanctioned to finance the production cycle – i.e. from procurement of raw materials to bringing them to the port for despatch fall under 'pre-shipment credit' category. It also includes financing of working capital expenses towards rendering of services. The advance is given 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 submission of individual orders; in the latter case, EPC becomes a running account. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/ services. 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. 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 9 months 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 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.

2.21 Pre-shipment credit granted in a foreign currency is called 'Packing Credit in Foreign Currency' (PCFC) advance and has to be repaid out of the export bills discounted under the Export Bills Rediscounting (EBR) scheme or out of export proceeds. Each bank designates a few select branches to handle PCFC and EBR transactions. The Rupee Export credit is also allowed to be shared between export order holders and manufacturer of the goods to be exported. Similarly, bank may extend PCFC 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. (Ref. Para 5.12 of the Master Circular No. DBR No.DIR.BC.14/04.02.002/2015-16 dated July 1, 2015, "Rupee/Foreign Currency Export Credit & Customer Service to Exporter"). PCFC may be made available to both the supplier of EOU/EPZ/SEZ unit and the receiver of EOU / EPZ / SEZ unit and PCFC for supplier EOU / EPZ / SEZ unit will be for supply of raw material/components of goods which will be further processed and finally exported by receiver EOU / EPZ / SEZ unit. The PCFC extended to the supplier EOU/EPZ/SEZ unit will have to be liquidated by receipt of foreign exchange from the receiver EOU/EPZ/SEZ unit, for which purpose, the receiver EOU/EPZ/SEZ unit may avail of PCFC. The stipulation regarding liquidation of PCFC by payment in foreign exchange will be met in such cases not by negotiation of export documents but by transfer of foreign exchange from the banker of the receiver EOU/EPZ/SEZ unit to the banker of supplier EOU/EPZ/SEZ unit. Thus, there will not normally be any post-shipment credit in the transaction from the supplier EOU/EPZ/ SEZ unit's point of view. In all such cases, it has to be ensured by banks that there is no double financing for the same transaction. Needless to add, the PCFC to receiver EOU/EPZ/SEZ unit will be liquidated by discounting of export bills or by receipt of export proceeds as per Master Circular DBR No.DIR.BC.14/04.02.002/2015-16 dated July 01, 2015, on "Rupee/Foreign Currency Export Credit & Customer Service to Exporter". In this context, attention of the readers is also invited to RBI's Circular No. DBOD.Dir.BC.NO.57/04.02.001/2013-14 on "Export Credit in Foreign Currency" dated September 25, 2013.

Import

Trade Credit – Buyer's Credit

2.22 In Indian context, this facility is provided by overseas banks / foreign branches of Indian banks to the importers of capital goods and raw material through Indian Banks to its customers (importers) towards payment of imports in India. The overseas bank either (i) credits the amount of Buyer's credit in the NOSTRO account of the Indian bank and the Indian bank remits the funds to the overseas supplier of the importer for payment of import bill or (ii) remits the funds to the overseas supplier of the importer for payment of import bill of the importer. The typical flow of transaction of Buyer's Credit (with underlying import through LC transaction) is as follows:

1) The borrower imports goods from foreign supplier against Foreign Letter of Credit (FLC) drawn in favour of foreign supplier;
2) The borrower either through its Indian bank or on its own approaches foreign bank (or overseas / foreign branches / offices of Indian banks) for availing Buyer's Credit for payment to be made to the foreign supplier;
3) The borrower's bank arranges the credit and provides a quote with details like the tenure, rate of interest applicable (including margin) and foreign currency conversion rate to the borrower.
4) The Letter of Comfort is issued by Indian bank to the foreign bank on approval of terms and conditions through SWIFT message for the proposed Buyers Credit;
5) The foreign Bank remits funds to the NOSTRO Account of Indian bank which is handling import transaction, on the strength of the Letter of Comfort (LoC)/ Letter of Undertaking (LoU) which is issued by the Indian bank in its favour;
6) The Indian bank remits the funds to foreign supplier through its NOSTRO Accounts;

7) The Indian bank subsequently retires and reverses the Letter of Credit in its book and passes another entry for creation of a non-fund based (contingent) liability of Letter of Comfort;
8) On the due date of Buyer's Credit, the Indian bank remits the funds (inclusive of interest) to the overseas bank and recovers the similar amount from its customer;
9) With respect to liability towards Letter of Comfort, the Indian banks accounts for the same as a "Contingent Liability".

The entries of the inward and outward remittances (specified in steps 4 and 5) are to be recorded in the books of accounts (NOSTRO Mirror Account) of the Indian bank.

Nature of Security

2.23 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.

Primary and Collateral Securities

2.24 The term 'primary security' refers to the security offered by the borrower for 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 is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Mode of Creation of Security

2.25 Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off, or lien.

Mortgage

2.26 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".

2.27 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. The government mandate to register all types of mortgages with Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) should be strictly followed by banks.

Pledge

2.28 A pledge is defined under section 172 of the Indian Contract Act, 1872, as "the bailment of goods as security for payment of a debt or performance of a promise." A pledge 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. 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

2.29 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.

Assignment

2.30 Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him. The transfer of debt, right or property is subject to all the liabilities and equity to which the transferor was subject on the date of transfer. In other words, the assignee cannot get a better title than that of the assignor.

Set-off

2.31 Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. A lending bank has the right of set-off in the absence of an agreement, express or implied, to the contrary with the borrower. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and in the same right (i.e., the capacity of the account holder in both the accounts should be the same). For 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.

Lien

2.32 Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

Types of Securities

2.33 The characteristics of a good security from the view point of the lending bank are marketability; easy ascertainability of value, stability of value, clean title and transferability/transportability. The most common types of securities accepted by banks are the following.

Personal Security of Guarantor

2.34 The personal security of guarantor comprises a guarantee by a third party for payment of loan outstanding, in the event of default by the borrower. No charge is created on the guarantor's movable or immovable assets.

Fixed and Floating Charges

2.35 A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The creator of the charge (i.e., the borrower) cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender). A floating charge, 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.

Margin

2.36 Margin on Loans is upfront payment by the borrower towards the purpose of the loan sanctioned. Banks provide finance after keeping suitable margin, depending upon the risk perception of the bank. Margin is deducted from the value of the assets to take care of any downward fluctuations in the market value of the assets. Generally margin in prescribed in every sanction letter in terms of percentage of security value, as per credit policy of bank. For certain types of loans such as advances against gold ornaments and jewellery, RBI has defined limits on the loan to value

Stock Exchange Securities and Other Instruments

2.37 Stock exchange securities include shares, debentures and bonds which are traded on stock exchanges. 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. The banks have policy for shares against which they provide the loan and periodically re-assess the eligible share as security for lending against the same. 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. Further, the banks are not allowed to provide loans against security of its own shares.

2.38 These 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 is 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 physical shares, if they are accompanied by blank transfer deeds duly signed by the person in whose name they are registered; in case of shares held in dematerialised form, authorisation slips should be obtained from the borrower and 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 in whose name they are registered.

2.39 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.

2.40 In the case of advances against bearer securities (Kisan Vikas Patras/ Indira Vikas Patras), banks obtain independent/direct confirmation of the genuineness of the certificates from issuing authorities. In the case of bearer securities, only possession by the bank is sufficient.

2.41 In the case of government paper and inscribed stock, the banks should get them registered in their own name while accepting them as security.

2.42 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 from holding shares in any company, whether as pledge, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

Goods

2.43 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. 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 and is financed against paid stocks.

2.44 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 (generally, monthly), 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, etc. In case of large advances, the inventory is subject to inspection and verification (stock audit) by external agency at stipulated intervals. The auditor may go through the same for determining existence and adequacy of security and also to determine the irregularity in the account, if any.

2.45 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.

2.46 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.

2.47 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

2.48 A document of title to goods is a negotiable or quasi-negotiable instrument. According to section 2(4) of the Sale of Goods Act, 1930, a document of title is any document used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive the goods represented thereby. Documents of title include:

- Bill of lading
- Railway receipt
- Transporter's receipt
- Dock warrant
- Warehouse-keeper's certificate
- Wharfinger's receipt
- Warrant or order for delivery of goods

Before being pledged with the bank, these documents have to be appropriately endorsed in favour of the bank.

Gold Ornaments and Bullion

2.49 Gold ornaments are accepted by banks as security on the basis of assessor'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, vide its Master Circular No. DBR.No.Dir.BC.10/13.03.00/2015-16 on Loans and Advances-Statutory and Other Restrictions dated July 1, 2015, directed banks to give preference to hallmarked jewellery for granting advances. RBI has, *vide* its Circular No. DBOD.BP.BC.No.86/21.01.023/2013-14 on "Lending against Gold Jewellery" dated January 20, 2014, issued guidance in respect of Advances against Gold Ornaments and Jewellery for the purpose of Medical Expenses and Meeting Unforeseen Liabilities". In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.79/21.04.048/2013-14 on "Non-Agriculture Loans against Gold Ornaments and Jewellery" dated December 30, 2013 containing guidelines on bullet repayment of loans extended against pledge of gold ornaments and jewellery for other than agricultural purposes.

Life Insurance Policies

2.50 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.

Plantations

2.51 Advances are made to agriculturists such as tea gardeners to finance their growing crops. When the produce is harvested, processed and sold, the money is repaid to the bank.

2.52 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. Please refer chapter on Agricultural advances for detail.

2.53 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. Finance is taken from the bank to incur expenditure on the crop. As such, the amount of the advance increases as the crop grows.

Immovable Property

2.54 Before advancing money on mortgage of immovable property, the lending bank has to satisfy itself that the borrower has a clear and unencumbered title to the property, and that the property is marketable and adequately insured. For this purpose, banks also ascertain whether the property in question has already been mortgaged to any other financial institution and if so, the details of the charges already created on the property. In respect of advances to public companies against the mortgage of a block of assets, it is essential that the provisions of section 180(1)(a) of the Companies Act, 2013 need to be kept in view.

Third Party Guarantees

2.55 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 classified as 'secured' advances and would be classified as 'unsecured' advances in the financial statements.

2.56 The guarantee bond executed by the guarantor in favour of the bank may be in bank's own prescribed form or otherwise. Such bonds are generally executed by holding companies, overseas customers, overseas principals, insurance companies, etc. A letter of continuity is also obtained from the guarantor.

Banker's General Lien

2.57 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.

2.58 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.

2.59 The term 'negative lien' is commonly used to refer to an undertaking given by the borrower to the bank that 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.

C. Bank's Process

Procedure for Sanction, Documentation, Disbursement, Supervision and Renewal of Advances

2.60 Each bank has its own procedures for sanctioning, disbursal, supervision and renewal of advances. Following is the common process across banks w.r.t. advances.

Sanction

Loan Application

2.61 Initiation of process of sanction of advance is receipt of a formal request from the applicant. The request may be in the form of a standard format (Loan Application Form) of the bank or in the form of a letter in which case the bank requests the intending borrower to furnish the standard format duly filled in. All applications are entered in a Loan Applications Received Register (the exact nomenclature may vary from bank to bank). The required supporting documents are to be furnished along with the application. The Bank should ensure that the documents are obtained from respective borrowers as per the Loan policy of the Bank.

Credit Appraisal

2.62 The proposal is evaluated in the context of the directions of the RBI including prudential exposure limits and the bank's own credit policy and risk management guidelines. Besides, the proposal is appraised on the following parameters to ensure technical feasibility, economical viability and commercial acceptability (the degree of scrutiny depends largely on the amount of the advance):

- Performance of the unit *vis-a-vis* other similar units.
- Conduct of its accounts with the lenders.
- Experience, competence and profile of the management of the unit.
- Guarantees and collateral securities offered.
- Trend and ratio analysis to see that the unit's growth is healthy, financials are sound, liquidity is comfortable and the promoters have a reasonable stake in the unit.
- Availability of inputs for production.
- Market condition.
- 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.
- CIBIL, RBI List of defaulter, Credit and confidential reports from other banks. These are to be checked from respective websites.
- Various disclosure/notices issued by the government/government authority such as with regard to shell companies, defunct companies, directors of these types of companies, etc.
- Latest Govt. policy about particular industry / Locational restriction, etc.

Sanctioning Authority

2.63 If the official concerned finds the proposal acceptable, a detailed appraisal note is submitted along with necessary supporting documents with recommendations to the authority having powers to sanction it. Each official who has been vested with powers to sanction advances has a monetary ceiling upto which he can sanction advances to the specified kind of borrowers (like individuals, partnerships, companies, etc.) and/or for the specified activities (like agriculture, industry, professional education, business, etc.) and / or for the type of facility (term loan, overdraft, cash credit, etc.). Such powers are properly documented and circulated by the bank to all its offices as Delegation of Powers. The officials at the branch can sanction only those advances, which fall within their delegated powers. For advances, which require to be sanctioned by higher authorities, the branch has to carry out the appraisal and send the proposal along with its recommendations to its controlling office for necessary sanction. As and when the advance is sanctioned by the competent authority (which could be an official, a committee of officials or the board of directors of the bank, depending on the amount involved), the fact of sanction along with detailed terms and conditions of the sanction are communicated by the controlling office to the branch.

Documentation and Disbursement

2.64 After the sanction of the advance, the branch communicates the terms and conditions of the sanction to the applicant and obtains its consent for the arrangement. Thereafter, the documents as prescribed by the bank are obtained, charges created and, the bank's charge over the unit's assets noted with the authorities concerned, e.g., Registrar of Companies, Road Transport Authority, Insurance Company, Land Records Authority, CERSAI, etc. In the case of an advance to a partnership firm, while the account is opened in the trade name of the firm, the security documents are got executed from the partners in both their individual capacity (i.e., without mentioning the name of the firm or affixing the stamp of the firm) and in their capacity as partners of the firm. This is to ensure that the advance may be recovered from the assets of the firm as well as from the individual assets of the partners. The bank generally records the sanction details and stipulation in the system. In many cases, the system is updated for pre-sanction, pre-disbursement documents for each loan. The document discrepancy report then acts as a check for documents received and pending for monitoring purposes.

2.65 After the above formalities have been completed, the advance is released in the following manner:

- Term loans (granted generally for acquisition of fixed assets, etc.) are disbursed on the basis of quotations/ proforma invoices obtained by the borrower from the vendors and submitted to the bank either along with the application or later. In case of large projects, the schedule and status of completion of projects have also to be seen. Banks generally stipulate a stated percentage of the cost to be met by the borrower from his own funds. Once the borrower provides his contribution to the bank, the branch debits the Term Loan account with the balance amount and pays the amount to the vendor directly along with a letter stating the purpose of the funds. The term loan may be released in one or more instalments. As and when the asset is received by the borrower, the bank officials inspect it, record the particulars in their books, and obtain copies of the final invoices for their record from the borrower.
- There may be instances where, on business considerations, the borrower has already acquired the asset. In such a case, he submits the documentary evidence to the branch and seeks reimbursement to the extent permissible. The branch officials inspect the asset and verify books of account of the borrower and, if satisfied, credit the eligible amount to the borrower's account (current / cash credit, as desired by the borrower) by debiting his term loan account.
- Cash credit advances are released on the basis of drawing power calculated as per the stock statements (which may be book debts, stock-in-trade, trade creditors, advance received from customers, advance given to trade creditors, Buyer's Credit, etc.) submitted by the borrower as per the periodicity laid down in the terms of sanction. The branch officials verify the stock statements (in some cases, tangible securities like stock-in-trade are also physically verified) and calculate the 'drawing power' based on the security held by the borrower and the margin prescribed in the sanction. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the

Member Banks (Circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association). This 'drawing power' is noted in the system in respect of Cash Credit accounts and is a guide to the official concerned while authorising debits to the account.

- The procedures of many banks require the branch manager to periodically submit a certificate to the controlling authority (i.e., regional or zonal office) that all disbursements during the relevant period have been made only after completion of the necessary formalities.
- Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) - The auditor needs to keep abreast the mandatory requirements related to registration of mortgages and compliance thereof by the lender bank, as applicable to the various forms of securities offered as security for the advances.

Monitoring and Supervision

2.66 The following are the procedures usually adopted by banks for monitoring and supervision of advances after disbursement:

- Regular inspection of the borrower's assets and books. The main purposes of inspection are as follows:
    - To ensure that the amounts disbursed have been utilised for purposes for which the advance was sought.
    - To check that the borrower has not acquired / disposed of any asset without the consent / knowledge of the bank, depending upon the terms of the advance. Acquisition of fixed assets from working capital funds may amount to diversion of short-term funds which, from the viewpoint of the bankers, is not a sign of financial prudence.
    - To cross-check the figures declared in the stock statements with the books maintained by the borrower (including excise and other statutory records, as applicable) as well as to physically verify the stock items, to the extent possible.
    - To check that the unit has been working on projected levels particularly in the areas of sales and production and the general working of the unit is satisfactory.
    - To ensure that the borrower has not availed of finance against stocks for which it has itself not made the payment.
    - To ensure that the borrower has not availed of unauthorised finance from any other lender.
    - To ensure that the borrower has not made any investment in, or

advances to, its associates without the bank's approval, if such approval is required as per the terms of the loan or otherwise diverted the funds.

  - To check that there is a regular turnover of stocks and the unit does not carry any obsolete, unusable stocks. Generally, banks place a limit on the age of stocks which are eligible for bank finance; the items older than such limit are not financed. Similarly, in the case of book debts, debts outstanding beyond a specified period are also not eligible for bank finance. However, the trade creditors irrespective of age are required to be netted off against the stock to calculate the amount of 'paid stock'.
  - To ensure that the borrower continues to be engaged in the activity for which the loan has been granted.

- Periodic review of the progress in implementation of the project (to note whether project timelines given at the time of processing loan are being adhered to. If there are delays, it may hamper the project completion and may affect servicing of loan). Generally, in large and complex project, banks appoint lead engineer agency who provides the status of the project on periodically basis.
- Review of the conduct of the account.
- Obtaining and scrutinising stock statements.
- Obtaining other relevant financial data periodically and analysis of the data. Banks obtain information at monthly / quarterly / half yearly / yearly intervals about on the levels of sales, production, profit, cash accruals, break up of assets and liabilities, cash flows etc. The analysis covers the following points:
  - Comparison of the data with the projections contained in the appraisal note to find out the deviations, the reasons thereof, and the corrective action to be taken, wherever necessary.
  - Comparison of the unit's performance, on an on-going basis, with other similar units.
  - Ratio analysis based on the provisional data submitted by the unit to find out the liquidity and solvency position and any diversion of short-term resources towards long term uses.
  - Observing the credits to the account.
- Whenever the above analysis indicates weaknesses in operations, or the need for additional documentation or security, a dialogue is held with the borrower, with consequent follow-up.

2.67 RBI, *vide* its circular no. DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11 dated January 14, 2011 on "End Use of Funds - Monitoring", has advised to evaluate and strengthen the efficacy of the existing machinery in the banks for post-sanction inspection by the bank officers, supervision and follow-up of advances. There needs to be a proper process of stock audit of the borrowers. Effective monitoring of the end use of funds lent is of critical importance in safeguarding a bank's interest. Further, this would also act as a deterrent for borrowers to misuse the credit facilities sanctioned, and in the process, help build a healthy credit culture in the Indian banking system.

Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair recovery of lenders – Framework for revitalisation of distressed assets

2.68 The RBI has issued guidelines for classification of standard assets into three sub-categories, viz., SMA-0, SMA-1 and SMA2 in order to recognise the financial distress in any performing asset at an early stage, besides regulatory compliances like forming of Joint Lender's Forum, reporting to CRICL, etc. for specified categories of Special Mention Accounts (SMA). In case if the bank does not follow the said regulatory compliances, such accounts are subjected to accelerated provisions. These provisions are elaborately given in Paragraphs 4.111 to 4.114 of Part III of the Guidance Note.

Renewal of Advances

2.69 Working capital advances are generally granted for one year at a time and require renewal if the borrower wants to continue the facility beyond that period at the same level, reduced level or increased level, depending upon the borrower's needs, its financial ratios, the bank's perception of risk and so on. Loans repayable over a period of time in instalments are not renewed. However, some banks have a system of reviewing these loans from time to time primarily with the objective of risk evaluation and interest rate resetting. The procedure described above for sanction of advances is also followed, to the extent applicable, for renewal of advances already granted to an applicant.

2.70 The RBI guidelines require banks to renew the advances within 6 months of the expiry of the limit. Hence no working capital limit can remain without reviewed for more than 18 months. It should be ensured that the latest audited balance sheet, various compliance proofs should be on bank's record. Further the various monitoring reports such as inspections, stock audit and operations in the account should be taken cognisance of during renewal.

2.71 Non-renewal sometimes may appear to be administrative delay but it may not be so. Hence stricter compliances should be ensured.

Nature of Borrowing Arrangements

2.72 The following paragraphs explain the different ways in which a banking arrangement can be tied up by a borrower.

Sole Banking

2.73 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

2.74 In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. Salient features of the arrangement are:

- The consortium has a formal leader, called the 'lead bank' (normally though not necessarily, the bank with the largest exposure).
- The consortium frames and adopts its rules within the RBI framework for conducting its business with the borrower.
- There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also.
- The lead bank is responsible for overall monitoring.
- The member banks of the consortium have rights over the security in an agreed proportion.
- The borrower maintains direct business relationship with all member banks of the consortium.
- Minutes of the consortium meetings are circulated amongst the members.
- Banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.

Multiple Banking

2.75 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.

2.76 The RBI, *vide* its Circular No. DBOD No. BP. BC.46/ 08.12.001/2008-09 dated September 19, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements", encourages the banks to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

(i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks, as prescribed in the RBI Circular No. DBOD.No.BP.BC.94 /08.12.001/2008-09 dated December 08, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements". In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crores and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.

(ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.

(iii) Obtain 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.

D. Regulatory Aspects

Guidelines of the RBI on Income Recognition, Asset Classification, Provisioning and Other Related Matters

2.77 Detailed guidelines w.r.t. Income Recognition, Asset Classification and provisioning requirements have been given in Chapter 4 of Part III of the Guidance Note.

Restrictions on Advances

2.78 The Master Circular no. RBI/2015-16/95 DBR.No.Dir.BC.10 /13.03.00/2015-16 dated July 1, 2015, on "Loans and Advances - Statutory and other Restrictions" issued by the RBI contains detailed requirements and guidelines in respect of statutory and other restrictions on loans and advances by banks.

Statutory Restrictions

Advances against Bank's own Shares

2.79 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

2.80 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.

2.81 Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 8 of the Companies Act, 2013 or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor. There are certain exemptions given in the aforesaid Master Circular in this regard.

2.82 For the above purpose, the term 'loans and advances' shall not include the following:

(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 whole time 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.

2.83 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.

Restrictions on Power to Remit Debts

2.84 Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contained in Section 180 of the Companies Act, 2013, a banking company shall not, except with 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

2.85 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.

2.86 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 owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.

2.87 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

2.88 In terms of Section 68 of the Companies Act, 2013, 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 sub-section (2) of section 68 of Companies Act, 2013. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

Regulatory Restrictions

Granting Loans and Advances to relatives of Directors

2.89 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. Accordingly, the Banks should not grant loans and advances without the approval of Board of Directors/Management Committee aggregating Rupees twenty five lakhs and above to –

a. directors (including the Chairman/Managing Director) of other banks;

b. any firm in which any of the directors of other banks is interested as a partner or guarantor;

c. any company in which any of the directors of other banks holds substantial interest or is interested as a director or as a guarantor;

d. any relative other than spouse and minor/dependent children of their own Chairmen/Managing Directors or other Directors;

e. any relative other than spouse and minor/dependent children of the Chairman/Managing Director or other directors of other banks;

f. any firm in which any of the relatives other than spouse and minor/ dependent children as mentioned in (d) & (e) above is interested as a partner or guarantor;

g any company in which any of the relatives other than spouse and minor / dependent children as mentioned in (d) & (e) above hold substantial interest or is interested as a director or as a guarantor.

Restrictions on Grant of Loans and Advances to Officers and the Relatives of Senior Officers of Banks

2.90 Loans and 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. Loans and advances and award of contracts to relatives of senior officers of the bank or proposals for credit facilities to the relatives of senior officers of the bank sanctioned by the appropriate authority should be reported to the Board. Further, when a credit facility is sanctioned by an authority, other than the Board, to -

- any firm in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a partner or guarantor; or
- any company in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a director or as a guarantor, such transaction should also be reported to the Board.

Credit facility will not include loans and advances such as housing loans, car advances, consumption loans, etc., granted to an officer of the bank under any scheme applicable generally to bank employees.

Restrictions on Grant of Financial Assistance to Industries Producing / Consuming Ozone Depleting Substances (ODS)

2.91 Banks should not extend finance for setting up of new units consuming/producing the Ozone Depleting Substances (ODS). No financial assistance should be extended to small/medium scale units engaged in the manufacture of the aerosol units using chlorofluorocarbons (CFC) and no refinance would be extended to any project assisted in this sector.

Restriction on Advances against Sensitive Commodities under Selective Credit Control (SCC)

2.92 With a view to prevent speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Section 21 & 35A of the Banking Regulation Act, 1949, 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.

2.93 Commodities presently under the Selective Credit Control include:

a) food grains i.e. cereals and pulses,

b) selected major oil seeds indigenously grown, viz. groundnut, rapeseed / mustard, cottonseed, linseed and castor seed, 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.

Restriction on payment of commission to staff members including officers

2.94 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

2.95 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

2.96 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, 2015 Master Circular on Exposure Norms'. The restrictions, *inter alia*, on Loans and Advances – Statutory and Other Restrictions loans and advances against shares and debentures, are:

(a) No loans to be granted against partly paid shares.

(b) No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.

2.97 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

2.98 Banks may grant advances against the security of shares, debentures or bonds to individuals subject to the following conditions:

(i) **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.

(ii) **Margin:** Banks should maintain a minimum margin of 50 percent of the market value of equity shares / convertible debentures held in physical form. In 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.

(iii) **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.

Advances to Share and Stock Brokers/ Commodity Brokers

2.99

(i) Banks and their subsidiaries are not permitted to undertake financing of 'Badla' transactions. 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. This could be towards their 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. Banks may also grant working capital facilities to such stock brokers 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 utilization 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 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.

(ii) The requirement relating to transfer of shares in bank's name in respect of shares held in physical form mentioned at SI. No. (ix) of paragraph 2.3.1.14 of Master Circular on Loans and Advances would not apply in respect of advances granted to share and stock brokers provided such shares are held as security for a period not exceeding nine months. In 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.

Bank Finance for Market Makers

2.100 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 only be eligible for grant of advances by scheduled commercial banks.

b) Market Making may be for equity as well as for debt securities including State and Central Government securities.

c) 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.

d) 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.

e) 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.

f) The ceiling of Rupees ten lakhs / Rupees twenty lakhs for advances against shares/debentures to individuals will not be applicable in the case of Market Makers.

2.101 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 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.
- 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.

- Approval process for identification of eligible securities against which loan can be provided
- Periodic re-assessment of eligible security so that they continued to be allowed as eligible security

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 Individuals against shares to joint holders or third party beneficiaries

2.102 While granting advances against Shares held in joint names to joint holders or third party beneficiaries, banks should ensure that no advances to other joint holders or third party beneficiaries is granted to circumvent the above limits placed on loans/advances against shares and other securities.

Financing of Initial Public Offerings (IPOs)

2.103 Banks should ensure that no advances exceed the limit of Rs. 10 lakhs to any individual against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds for subscribing to IPOs. Further, the Bank should not extend any credit or financing to Corporates for investment in other companies' IPOs and to NBFCs for further lending to individuals for IPOs.

Bank Finance to assist employees to buy shares of their own companies

2.104

(i) Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan (ESOP)/ reserved by way of employees' quota under IPO to the extent of 90% of the purchase price of the shares or Rs. 20.00 lakh, whichever is lower. 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' share under ESOPs/IPOs or from the secondary market irrespective of whether the advances are secured or unsecured. Follow – on Public Offers (FPOs) will also be included under IPO.

(ii) Banks should obtain declaration from the borrower indicating the details of the loan/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.

Advances to other borrowers against shares / debentures / bonds

2.105

(i) The question of granting advances against Primary Security of shares and debenture including promoters' shares to industrial, corporate or other borrowers should not normally arise except for secured loans granted towards working capital or for other productive purposes other than NBFCs. In such cases, Banks should accept shares only in dematerialised form. Banks may accept shares of promoters only in dematerialized form wherever demat facility is available. The question of granting advances against Primary Security of shares and debenture including promoters' shares to industrial, corporate or other borrowers should not normally arise except for secured loans granted towards working capital or for other productive purposes other than NBFCs. In such cases, Banks should accept shares only in dematerialised form. Banks may accept shares of promoters only in dematerialised form wherever demat facility is available.

(ii) Banks may obtain collateral security of shares and debentures by way of margin for a temporary period of one year from borrowers other than NBFCs who are 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 Banks have to satisfy themselves regarding the capacity of the borrower to raise the required funds and to repay the advance within the stipulated period.

Bank Loans for Financing Promoters Contribution

2.106 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 corporate 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 and as detailed in the loan policy of the bank, in addition to the general guidelines given in para 2.3.1.14 of the Master Circular on Loans and Advances – Statutory and Other restrictions dated July 1, 2015.

i) 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 RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015 on Exposure Norms.

iii) Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the loan policy of the banks. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

iv) 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.

v) With the approval of the Board of Directors, the banks should formulate internal guidelines with appropriate safeguards for this purpose.

vi) 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

Advances against Units of Mutual Funds

2.107 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 of mutual fund 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.

iv) Advance against units of mutual funds (except units of exclusively debt oriented funds) would attract the quantum and margin requirements as applicable to advance against shares and debentures. However, the quantum and margin requirement for loans/ advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves in accordance with their loan policy.

v) 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 the mutual funds or for the purchase of shares/ debentures/ bonds etc.

For exposure norms w.r.t. Advances against Mutual Funds, please refer to para 4.6 of the Master Circular on Exposure Norms dated July 1, 2015.

Margin Trading

2.108 Banks may extend finance to stockbrokers for margin trading. The Board of each bank should formulate detailed guidelines for lending for margin trading, subject to the following parameters:

(a) The finance extended for margin trading should be within the overall ceiling of 40% of net worth prescribed for exposure to capital market.

(b) A minimum margin of 50 per cent should be maintained on the funds lent for margin trading.

(c) 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.

(d) 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.

2.109 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. Banks should disclose the total finance extended for margin trading in the "Notes on Account" to their Balance Sheet.

Financing for Acquisition of Equity in Overseas Companies

2.110 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.

Refinance Scheme of Export Import Bank of India

2.111 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.

Arbitrage Operations

2.112 Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.

General guidelines applicable to advances against shares / debentures / bonds

2.113 Statutory provisions regarding the grant of advances against shares contained in Sections 19(2) and (3) and 20(1) (a) of the Banking Regulation Act 1949 should be strictly observed. Shares held in dematerialised form should also be included for the purpose of determining the limits under Section 19(2) and 19(3) ibid.

2.114 While considering grant of advances against shares / debentures banks must follow the normal procedures for the sanction, appraisal and post sanction follow-up.

2.115 Advances against the primary security of shares / debentures / bonds should be kept distinct and separate and not combined with any other advance.

2.116 Banks should satisfy themselves about the marketability of the shares / debentures and the net worth and working of the company whose shares / debentures / bonds are offered as security.

2.117 Shares/ debentures/ bonds should be valued at prevailing market prices when they are lodged as security for advances.

2.118 Banks should exercise particular care when advances are sought against large blocks of shares by a borrower or a group of borrowers. It should be ensured that advances against shares are not used to enable the borrower to acquire or retain a controlling interest in the company/ companies or to facilitate or retain inter-corporate investments.

2.119 No advance against partly paid shares shall be granted.

2.120 No loans to be granted to partnership/ proprietorship concerns against the primary security of shares and debentures.

2.121 Whenever the limit/limits of advances granted to a borrower exceeds Rupees ten lakhs, it should be ensured that the said shares / debentures / bonds are transferred in the bank's name and that the bank has exclusive and unconditional voting rights in respect of such shares. For this purpose the aggregate of limits against shares/ debentures/ bonds granted by a bank at all its offices to a single borrower should be taken into account. Where securities are held in dematerialised form, the requirement relating to transfer of shares in bank's name will not apply and banks may take their own decision in this regard.

2.122 Whenever the limit/limits of advances granted to a borrower exceeds Rupees ten lakhs, it should be ensured that the said shares / debentures / bonds are transferred in the bank's name and that the bank has exclusive and unconditional voting rights in respect of such shares. For this purpose the aggregate of limits against shares / debentures / bonds granted by a bank at all its offices to a single borrower should be taken into account. Where securities are held in dematerialised form, the requirement relating to transfer of shares in bank's name will not apply and banks may take their own decision in this regard. Banks should, however, avail of the facility provided in the depository system for pledging securities held in dematerialised form under which the securities pledged by the borrower get blocked in favour of the lending bank. In case of default by the borrower and on the bank exercising the option of invocation of pledge, the shares and debentures get transferred in the bank's name immediately.

2.123 Banks may take their own decision in regard to exercise of voting rights and may prescribe procedures for this purpose.

2.124 Banks should ensure that the scrips lodged with them as security are not stolen / duplicate / fake / benami. Any irregularities coming to their notice should be immediately reported to RBI.

2.125 Banks operating in India should not be a party to transactions such as making advances or issuing back-up guarantees favouring other banks for extending credit to clients of Indian nationality / origin by some of their overseas branches, to enable the borrowers to make investments in shares and debentures / bonds of Indian companies.

2.126 A uniform margin of 50% shall be applied on all advances against shares/financing of IPOs/issue of Guarantees. A minimum cash margin of 25% (within 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.

Advances against Fixed Deposit Receipts issued by Other Banks

2.127 There have been instances where fake term deposit receipts, purported to have been issued by some banks, were used for obtaining advances from other banks. In the light of these happenings, RBI has advised the banks to desist from sanctioning advances against FDRs, or other term deposits of other banks.

Advances to Agents/Intermediaries Based on Consideration of Deposit Mobilisation

2.128 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)

2.129 Banks cannot grant loans against CDs. Furthermore, they are also not permitted to buy-back their own CDs before maturity. However, these restrictions on lending and buy back in respect of CDs held by mutual funds are relaxed. While granting such loans to 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)

2.130 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.

Bank Finance to Non-Banking Financial Companies (NBFCs)

2.131 The RBI, vide its Master Circular No. DBR.BP.BC.No.5/21.04.172/ 2015-16 on Bank Finance to Non-Banking Financial Companies (NBFCs) dated July 1, 2015 provides as follows:

2.132 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.

2.133 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.

2.134 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.

2.135 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 406 of the Companies Act, 2013;
iii) Chit Fund Companies carrying on Chit Fund business as their principal business as per Explanation to Clause (vii) of Section 45-I(bb) of the Reserve Bank of India Act, 1934;
iv) Stock Broking Companies / Merchant Banking Companies registered under Section 12 of the Securities & Exchange Board of India Act; 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.

2.136 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 *bona fides* 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)

2.137 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). The computation of NOF will be as per definition of NOF as given in the explanation to Section 45-IA of the Reserve Bank of India Act, 1934.

Bridge loans / interim finance to NBFCs

2.138 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).

2.139 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

2.140 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

2.141 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

2.142 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

2.143 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.

(f) Banks offering factoring services may decide percentage of the invoice to be paid upfront based on their own assessment of the credit worthiness of the assignor / buyer, due diligence carried out by them and other commercial considerations.

(g) Factoring transactions on 'with recourse' basis shall be eligible for priority sector classification by banks, which are carrying out the business of factoring departmentally. The factoring transactions taking place through TReDS shall also be eligible for classification under priority sector upon operationalization of the platform. For detailed guidelines, refer RBI circular FIDD.CO.Plan.BC.10/04.09.01/2016-17 on "Priority Sector Lending status for Factoring Transactions"

Restrictions regarding investments made by banks in securities/ instruments issued by NBFCs

2.144 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).

2.145 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 NR(E) and FCNR(B) Deposits

2.146 Grant of advance against NR(E) and FCNR(B) deposits would be subject to the guidelines issued under Foreign Exchange Management Act, 1999.

Advances Against Bullion/Primary Gold

2.147 Banks are prohibited from granting any advance against bullion/ primary gold. However, specially minted gold coins sold by banks are not treated as "bullion" or "primary gold" and hence the same is acceptable as security upto 50 gms per customer. Such loans to be granted by the bank, may be covered under the policy framed by the bank's Board, in terms of RBI circular DBOD.No. BC. 138/21.01.023/94 dated November 22, 1994. Further, for cases wherein advances have been granted against the gold coins it should be ensure that the end use of 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

2.148 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.

Advances against Gold Ornaments & Jewellery

2.149 The RBI *vide* its Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/ 13.03.00/2015-16 dated July 1, 2015 provides that hallmarking of gold jewellery ensures the quality of gold used in the jewellery as to carat fineness and purity. Hence, banks find granting of advances against the security of such hallmarked jewellery safer and easier. Preferential treatment is given to loans against hallmarked jewellery which will also be in the long-term interest of consumer, lenders and the industry. Based on gold purity and content the bank decides on the margin and rates of interest.

Loan to Value Ratio for Loan against Gold Ornaments & Jewellery

2.150 The RBI vide its Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC. 10/13.03.00/2015-16 dated July 1, 2015 provides that loans (including bullet repayment loans) sanctioned by banks against pledge of gold ornaments and jewellery for non-agricultural purposes should not exceed 75 per cent of the value of gold ornaments and jewellery.

2.151 In order to standardize the valuation and make it more transparent to the borrower, gold ornaments and jewellery accepted as security / collateral will have to be valued at the average of the closing price of 22 carat gold for the preceding 30 days as quoted by the India Bullion and Jewellers Association Ltd. [Formerly known as the Bombay Bullion Association Ltd. (BBA)]. If the gold is of purity less than 22 carats, the bank should translate the collateral into 22 carat and value the exact grams of the collateral. In other words, jewellery of lower purity of gold shall be valued proportionately.

2.152 Loans extended against pledge of gold ornaments and jewellery for other than agricultural purposes, where both interest and principal are due for payment at maturity of the loan will be subject to the following conditions:

(i) Banks, as per their Board approved policy, may decide upon the ceiling with regard to the quantum of loan that may be granted against the pledge of gold jewellery and ornaments for non-agricultural end uses.

(ii) The period of the loan shall not exceed 12 months from the date of sanction.

(iii) Interest will be charged to the account at monthly rests and may be recognized on accrual basis provided the account is classified as 'standard' account. This will also apply to existing loans.

(iv) Such loans shall also be governed by other extant norms pertaining to income recognition, asset classification and provisioning which shall be applicable once the principal and interest become overdue.

Gold (Metal) Loans

2.153 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 conditions as specified by RBI's Master Circular RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on Loans and Advances- Statutory and Other restrictions.

2.154 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.

2.155 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.

2.156 Nominated banks are not permitted to enter into any tie up arrangements for retailing of gold / gold coins with any other entity including non-banking financial companies / co-operative banks / non-nominated banks.

Loans and advances to Micro and Small Enterprises (MSEs)

2.157 The Reserve Bank of India has issued Master Directions on Lending to Micro, Small & Medium Enterprises (MSME) sector vide Master Directions no.FIDD. MSME & NFS.12/ 06.02.31/2017-18 dated July 24, 2017, in which definition of MSME and common guidelines/instructions for lending to MSME section have been given.

Working Capital Finance to Information Technology and Software Industry

2.158 Following the recommendations of the "National Taskforce on Information Technology and Software Development", Reserve Bank has framed 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 promoter's 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 may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.

(iv) 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.

(v) 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

2.159 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 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.

2.160 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 1, 2015.

Stipulation of lock-in period for shares

2.161 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.

2.162 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.

2.163 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.

2.164 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. However, the Special Purpose Vehicles (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.

Financing Housing Projects

2.165 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.DBR.No.DIR.BC.13/ 08.12.001/2015-16 dated July 1, 2015 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.

2.166 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 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 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.

(v) In terms of the orders of the Delhi High Court, banks also cannot 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.

Loan to Value (LTV) ratio

2.167 In order to prevent excessive leveraging, the LTV ratio and risk weight and standard as set provisioning in respect of individual housing loans have been prescribed. Vide RBI circular dated June 7, 2017 revised LTV ratio is applicable for all loan sanctioned post June 7, 2017 is as under.

Category of loan	LTV ratio (%)	Risk Weight (%)
Upto ₹ 30 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above ₹ 30 lakh and upto ₹ 75 lakh	≤ 80	35
Above ₹ 75 lakh	≤ 75	50

2.168 The LTV ratios, Risk Weights and Standard Asset Provision set out in the circular DBR.BP.BC.No.44/08.12.015/ 2015-16 dated October 8, 2015, on the captioned subject, shall continue to apply to loans sanctioned up to June 6, 2017.

Category of loan	LTV ratio (%)	Risk Weight (%)
Upto ₹ 30 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above ₹ 30 lakh and upto ₹ 75 lakh	≤ 75	35
	> 75 and ≤ 80	50
Above ₹ 75 lakh	≤ 75	75

2.169 The LTV ratio should not exceed the prescribed ceiling in all fresh cases of sanction. In case the LTV ratio is currently above the ceiling prescribed for any reasons, efforts should be made to bring it within limits.

Waiver of EMI in case of regular payment of home loans

2.170 It has been observed that some banks have introduced certain incentive to home loans from regular payment of EMI/dues. As per the feature, the borrower gets waiver of some EMI amount either at the end of the loan or on some periodical basis. The auditor needs to ensure that the bank has made sufficient provision for future waiver of EMI in the books in the books.

Innovative Housing Loan Products – Upfront Disbursal of Housing Loans

2.171 It has been observed that some banks have introduced certain innovative Housing Loan Schemes in association with developers / builders, e.g. upfront disbursal of sanctioned individual housing loans to the builders without linking the disbursals to various stages of construction of housing project, interest / EMI on the housing loan availed of by the individual borrower being serviced by the builders during the construction period / specified period, etc. This might include signing of tripartite agreements between the bank, the builder and the buyer of the housing unit.

2.172 These loan products are popularly known by various names like 80:20, 75:25 Schemes. Such housing loan products are likely to expose the banks as well as their home loan borrowers to additional risks e.g. in case of disputes between individual borrowers and developers / builders, default / delayed payment of interest / EMI by the developer / builder during the agreed period on behalf of the borrower, non-completion of the project on time, etc. Further, any delayed payments by developers / builders on behalf of individual borrowers to banks may lead to lower credit rating / scoring of such borrowers by credit information companies (CICs) as information about servicing of loans gets passed on to the CICs on a regular basis. In cases where bank loans are also disbursed upfront on behalf of their individual borrowers in a lump-sum to builders / developers without any linkage to stages of construction, banks run disproportionately higher exposures with concomitant risks of diversion of funds.

2.173 In view of the higher risks associated with such lump-sum disbursal of sanctioned housing loans and customer suitability issues, banks are advised that disbursal of housing loans sanctioned to individuals should be closely linked to the stages of construction of the housing project / houses and upfront disbursal should not be made in cases of incomplete / under-construction / green field housing projects.

2.174 It is emphasized that banks while introducing any kind of product should take into account the customer suitability and appropriateness issues and also ensure that the borrowers / customers are made fully aware of the risks and liabilities under such products.

Retail loans

2.175 The banks generally provide other various retail advances namely:

- Home loans and loans against property.
- Vehicle loans.
- Personal loan.
- Consumer durable loans.
- Credit cards.

2.176 Generally, loans are either sourced through direct selling agents or through bank's own branches. The bank has a credit policy which defines process to be followed for sanction and disbursement of loan and the various documents required.

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

- Completely filled Loan Application Form with customers' signature.
- Income proof like Salary slip, financial statement, Income tax returns, Bank statement.
- Photograph.
- Business continuity proof. (e.g. Form D of Maharastra Shops and Establishment Act, Any other govt. certificate for doing business)
- Residence proof.
- Identification proof.
- Contact Point – Mobile No of applicants is mandatory.
- Age proof.
- PAN Card.

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

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

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

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

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

Financing of Infrastructure Projects

2.183 The RBI has revised the definition of Infrastructure Lending *vide* Master Circular on Loans and Advances – Statutory and Other Restrictions dated July 1, 2015 read with Circular No. RBI/2012 13/297/DBOD.BP.BC.No 58/08.12.014/ 2012-13 dated 20/11/2012 on "Second Quarter Review of Monetary Policy 2012-13 - Definition of 'Infrastructure Lending". RBI has periodically added certain sectors as infrastructure lending from time to time.

2.184 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'.

2.185 The definition of Infrastructure Lending would include credit facility extended by Lenders (i.e., Banks & Selected AIFIs) to a borrower for exposure in the various infrastructure sub-sectors as per paragraph 2.3.7.2 of Master Circular on Loans and Advances- Statutory and Other Restrictions dated July 1, 2015, read with Circular No. DBOD.BP.BC.No.66/08.12.2014/2013-14 on "Financing of Infrastructure – Definition of 'Infrastructure Lending'" dated November 25, 2013.

2.186 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, 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. Banks/FIs are, 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.

v. In few cases where the completion of the project gets delayed, the RBI vide its Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC. 2/21.04.048/2015-16 dated July 1, 2015 provides detailed guideline on the classification and provision for project loans. The RBI vide its Circular No. RBI/2016-17/122 DBR.No.BP.BC.34 /21.04.132/2016-17 provides guideline for project companies where change of ownership are happen/happening and date of commencement of commercial operation ('DCCO'). Detailed guidelines in this regard are given in Chapter 4 of Part III of this Guidance Note.

vi. The auditor should obtain the list of all outstanding project loans of the bank. The details should also include information about original DCCO and revision of DCCO, if any. The auditor should verify that the revision of the project DCCO is based on the technical and financial study and is approved by competent authority. The auditor should also verify the revision in DCCO, and check whether the same is permissible under the extent RBI guidelines. Auditor should apply professional judgement and skepticism while evaluating/ accessing and concluding on compliance of the said guidelines for deferment of DCCO and retaining standard/standard restructured classification. To verify compliance of the same, auditor shall obtain documentary evidences for e.g.: legal documents for Court cases, Lead engineers report/ Review note/ consortium meeting minutes specifying the event that is beyond promoter's control etc., as the case may be.

vii. RBI has issued clarification on their mail box on the assessment of project cost and revision in the project cost. RBI mail box clarification also provides guidance on classification of loan in case revision of project cost is above certain percentage of original project cost. The auditor should also ensure compliance with those clarification.

Types of Financing by Banks

2.187

(i) In order to meet financial requirements of infrastructure projects, banks may extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/ preference shares/ equity shares acquired as a part of the project finance package which is treated as "deemed advance" and any other form of funded or non-funded facility.

(ii) Take-out Financing Banks may enter into take-out financing arrangement with IDFC/ other financial institutions or avail of liquidity support from IDFC/ other FIs. Banks may also be guided by the instructions regarding take-out finance contained in Circular No.DBOD.BP.BC.144/21.04.048/2000 dated February 29, 2000.

(iii) Inter-institutional Guarantees: Banks are permitted to issue guarantees favouring other lending institutions in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project.

(iv) Financing promoter's equity: In terms of Circular No.DBOD.Dir.BC.90/ 13.07.05/98 dated August 28, 1998, Banks were 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. In view of the importance attached to the infrastructure sector, it has been decided that, under certain circumstances, an exception may be made to this policy for financing the acquisition of the promoters' shares in an existing company, which is engaged in implementing or operating an infrastructure project in India. The conditions, subject to which an exception may be made, are as follows:

- The bank finance would be only for acquisition of shares of existing companies providing infrastructure facilities. Further, acquisition of such shares should be in respect of companies where the existing foreign promoters (and/ or domestic joint promoters) voluntarily propose to disinvest their majority shares in compliance with SEBI guidelines, where applicable.
- The companies to which loans are extended should, *inter alia*, have a satisfactory net worth.

- The company financed and the promoters/ directors of such companies should not be a defaulter to banks/ FIs.
- In order to ensure that the borrower has a substantial stake in the infrastructure company, bank finance should be restricted to 50% of the finance required for acquiring the promoter's stake in the company being acquired.
- Finance extended should be against the security of the assets of the borrowing company or the assets of the company acquired and not against the shares of that company or the company being acquired. The shares of the Borrower Company / Company being acquired may be accepted as additional security and not as primary security. The security charged to the banks should be marketable.
- Banks should ensure maintenance of stipulated margins at all times.
- The tenor of the bank loans may not be longer than seven years. However, the Boards of banks can make an exception in specific cases, where necessary, for financial viability of the project.
- This financing would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.
- The banks financing acquisition of equity shares by promoters should be within the regulatory ceiling of 40 per cent of their net worth as on March 31 of the previous year for the aggregate exposure of the banks to the capital markets in all forms (both fund based and non-fund based).
- The proposal for bank finance should have the approval of the Board.

Income recognition

2.188 Provisions and regulations on Income recognition have been elaborately discussed in Chapter 4 of part III of Guidance Note.

Prudential Exposure Limits

Single and Group Borrower Limits[7]

2.189 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

[7] RBI vide its circular No. DBOD.No.BP.BC.96/21.06.102/2013-14 on *Guidelines on Management of Intra-Group Transactions and Exposures* providing guidelines on Intra-Group Transactions and Exposures (ITEs) for banks. The guidelines contain quantitative limits on financial ITEs and prudential measures for the non-financial ITEs to ensure that banks engage in ITEs in safe and sound manner in order to contain concentration and contagion risks arising out of ITEs. These guidelines l become effective from October 1, 2014.

exposure of a bank to individual borrowers and groups of borrowers in India. The Master Circular No. RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/ 2015-16 dated July 1, 2015 on “Exposure Norms”, lays down the ceiling on credit exposure to individual/group borrowers in relation to bank’s capital fund as defined under capital adequacy standards (Tier-I and Tier-II Capital). 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 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. 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.

2.190 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 (single as well as group) upto a further 5 per cent of capital funds..

2.191 With effect from May 29, 2008, the exposure limit in respect of single borrower has been raised to twenty five per cent 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. In addition to this, banks may in exceptional circumstances, consider enhancement of the exposure to the Oil Companies up to a further 5 per cent of capital funds.

2.192 Such exposures where the bank has exceeded the prudential exposure limit should be appropriately disclosed in the “Notes to Accounts” to the Balance Sheet.

Disinvestment Programme of the Government of India

2.193 On account of banks’ financing of acquisition of PSU shares under the Government of India disinvestment programmes, if any bank, is likely to exceed the regulatory ceiling of single / group borrower limit, RBI will consider relaxation on specific requests from banks in the single/group credit exposure norms on a case by case basis, provided that the bank’s total exposure to the borrower, net of its exposure due to acquisition of PSU shares under the Government of India disinvestment programme, should be within the prudential single/group borrower exposure ceiling prescribed by RBI.

Sector Specific Limit

2.194 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

2.195 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 / NBFC-AFC 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.

Bills Purchased/Discounted under Letter of Credit

2.196 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.

Unhedged Foreign Currency Exposure of Corporates

2.197 To ensure that each bank has a policy that explicitly recognises and takes account of risks arising out of foreign exchange exposure of their clients, foreign currency loans above US$ 10 million, or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures, should be extended by banks only on the basis of a well laid out policy of their Boards with regard to hedging of such foreign currency loans. Further, the policy for hedging, to be framed by their Boards, may consider, as appropriate for convenience, excluding the following:

- Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount.
- Where the forex loans are extended for meeting forex expenditure.

2.198 Banks may also consider stipulating a limit on unhedged position of corporates on the basis of bank's Board approved policy. In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.BC.85/21.06.200/2013-14 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure" dated January 15, 2014 and clarification DBOD.No.BP.BC.116/ 21.06.200/2013-14 dated June 3, 2014 providing requirements for exposures to entities with unhedged foreign currency exposure.

2.199 The auditor while carrying out the audit of the Unhedged Foreign Currency Exposure (UFCE), should ensure that the Bank has:-

- Obtained the UFCE information from all its branches (including foreign branches) in respect of large borrowers.
- Obtained a certificate in respect of UFCE from entities on a quarterly basis on self-certification basis, and which has preferably been internally audited by the entity concerned. However, at least on an annual basis, UFCE information should be audited and certified by the statutory auditors of the entity for its authenticity.
- Computed "Capital and Provisioning Requirements for Exposures to entities with UFCE" at least on a quarterly basis, as per the applicable RBI guidelines.

Lending for Real Estate

2.200 Banks are required to frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the banks' Boards. The disbursements in case of these loans should be made only after the borrower has obtained requisite clearances from the government authorities.

2.201 RBI has also required that the banks' Boards may also consider incorporation of aspects relating to adherence to National Building Code (NBC) in their policies on exposure to real estate. The information regarding the NBC can be accessed from the website of Bureau of Indian Standards (www.bis.org.in). Banks should also adopt the National Disaster Management Authority (NDMA) guidelines and suitably incorporate them as part of their loan policies, procedures and documentation.

Financing of Joint Ventures

2.202 Banks are allowed to extend credit/non-credit facilities (*viz*. letters of credit and guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad and step-down subsidiaries which are wholly owned by the overseas subsidiaries of Indian Corporates. Banks are also permitted to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods and services from India. The above exposure will, however, be subject to a limit of 20 percent of banks' unimpaired capital funds (Tier I and Tier II capital)and would be subject to the conditions laid down in this regard in the Master Circular on 'Loans and Advances – Statutory and Other Restrictions' dated July 1, 2015.

Limits on Banks' Exposure to Capital Markets

Statutory limit on shareholding in companies

2.203 No banking company is permitted to hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Banking Regulation Act, 1949. Shares held in demat form should also be included for the purpose of determining the exposure limit. This is an aggregate holding limit for each company.

Regulatory Limit

A. Solo Basis

2.204 The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth.

B. Consolidated Basis

2.205 The aggregate exposure of a consolidated bank to capital markets (both fund based and non-fund based) should not exceed 40 per cent of its consolidated net worth as on March 31 of the previous year. Within this overall ceiling, the aggregate direct exposure by way of the consolidated bank's investment in shares, convertible bonds/debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its consolidated net worth[8].

Sectoral Distribution

2.206 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.

2.207 Priority sector advances include:

- Advances for agriculture and other allied activities – However, RBI, *vide* its circular no. RPCD.CO.Plan.BC. 51 /04.09.01/2010-11 dated February 2, 2011 on "Classification of loans against gold jewellery" clarifies that loans sanctioned to NBFCs for on-lending to individuals or other entities against gold jewellery, are not eligible for classification under agriculture sector. Similarly, investments made by banks in securitised assets originated by NBFCs, where the underlying assets are loans against gold jewellery, and purchase/assignment of gold loan portfolio from NBFCs are also not eligible for classification under agriculture sector.

- RBI *vide* its master circular no FIDD.FID.BC.No.02/12.01.033/2015-16 dated July 1, 2015 has provided details on SHG- Bank linkage Programme. In order to enable the banks to report their SHG lending without difficulty, it was decided that the banks should report their lending to SHGs and/or to NGOs for on-lending to SHGs/members of SHGs under the new segment, *viz*. 'Advances to SHGs' irrespective of the purposes for which the members of SHGs have been disbursed loans. Lending to SHGs should be included

[8] Attention of the readers is drawn to Master Circular of RBI, DBR.No.Dir.BC.12/13.03.00/2015-16 dated 1 July 2015, for components of capital exposure, exclusions, method of computation of capital exposure for the purpose and Intra-day limits.

by the banks as part of their lending to the weaker sections (under priority section).

- Advances to minority communities.
- Advances to micro/small/medium scale enterprises[9].
- Advances to small road transport operators.
- Advances to retail traders and small business enterprises.
- Advances to professionals and self-employed.
- Advances sanctioned to State sponsored organisations for scheduled castes/scheduled tribes.
- Educational loans upto the prescribed limit – RBI, *vide* its circular no. RPCD.SME & NFS.BC.No. 69/06.12.05 /2009-10 dated April 12, 2010 on "Collateral Free Loans - Educational Loan Scheme", clarified that banks must not, mandatorily, obtain collateral security in the case of educational loans upto Rs. 4 lakh.
- Housing loans upto prescribed limits[10].
- Funds provided to RRBs.
- Micro credit[11].
- 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 (Swarna jayanti Gram swaraj Swarojgar Yojana)[12], SJSRY (Swarna jayanti Sahakari Rozgar Yojana).

[9] The RBI has issued a master circular no. FIDD.MSME & NFS. BC. No. 07/06.02.31/2015-16on "Lending to Micro, Small and Medium Enterprises (MSME) Sector" dated July 1, 2015. 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".

[10] Attention is also invited to circular no. DBOD.No.BP.BC. 69 /08.12.001/2010-11 dated December 23, 2010 on "Housing Loans by Commercial Banks – LTV Ratio, Risk Weight and Provisioning", circular no. RPCD.MSME & NFS.BC.No. 30 /06.11.01/ 2012-13 dated September 18, 2012 on "Scheme of 1% interest subvention on housing loans up to Rs. 15 lakh" and Master circular no. DBR. No.DIR.BC.13/08.12.001/2015-16 dated July 1, 2015 on "Housing Finance".

[11] 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".

[12] Attention is the readers is drawn to master circular No. FIDD.CO.Plan.BC.04/04.09.01/2015-16dated July 1, 2015 on "Priority Sector Lending - Special Programmes – Swarna jayanti Gram Swarozgar Yojana (SGSY)" and Circular No. RPCD.GSSD .BC.No.30 /09.01.01/2010 -11 dated December 15, 2010 on "Swarna jayanti Gram Swarozgar Yojana (SGSY) - Group Life Insurance Scheme". (Add circular related to NRLM as well)

2.208 Priority sector advances generally carry an interest rate, which is lower than the normal rate of interest on lending to other sectors. These advances are also known as DRI advances, i.e., advances on which differential rate of interest is applicable. Under the Reserve Bank of India's guidelines, a specified proportion of the total advances of banks are to be made to priority sectors necessarily. Depending upon the nature and type of facilities extended, the bank may get subsidy from the Government to fully or partly offset the shortfall in interest rate and/or get indemnified for bad debts for the whole or a portion of such advances.

2.209 RBI has issued guidelines for the targets and sub-targets set under priority sector lending for all scheduled commercial banks operating in India. For detailed information on the guidelines, refer RBI circular FIDD.CO.Plan.BC.54/04.09.01/2014-15 on "Priority Sector Lending – Targets and Classification".

2.210 Government of India vide Notification dated February 04, 2016 has specified "Dealing in Priority Sector Lending Certificates (PSLCs) in accordance with the Guidelines issued by Reserve Bank of India" as a form of business under Section 6 (1)(o) of the Banking Regulation Act, 1949. The purpose of PSLCs is to enable banks to achieve the priority sector lending target and sub-targets by purchase of these instruments in the event of shortfall and at the same time incentivize the surplus banks; thereby enhancing lending to the categories under priority sector. Refer RBI circular FIDD.CO.Plan.BC.23/04.09.01/2015-16 for detailed guidelines on PSLCs.

System of Base Rate and Interest Rate/ Marginal Cost of Funds based Lending Rate (MCLR)

2.211 The RBI *vide* its Circular No. DBR.No.Dir.BC.9/ 13.03.00/2015-16 dated April 1, 2015 and DBR.No.Dir.BC.67/13.03.00/2015-16 dated December 17, 2015 on "Interest Rates on Advances" required the banks to freely determine the lending rates on the advances as per their Board approved policy subject to the guidelines contained in the circular. The Base Rate system is aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. Accordingly, the following is the summary guidelines were issued by RBI for implementation by banks. For detailed guidelines, refer above mentioned RBI circulars:

- Banks were required to obtain the approval of their respective Boards for the Prime Lending Rate which was the minimum rate charged by them for the credit limits of over Rs 2 lakhs. In case of loans up to Rupees two lakh, it was decided to continue to protect these borrowers by prescribing the lending rates. With effect from April 29, 1998, it was decided that interest on Credit limit of Rs. 2 lakh and below shall not exceed PLR which was available to the best customer of the concerned bank. In order to enhance transparency in bank's pricing of their loan products as also to ensure that the PLR truly reflects the actual cost, in year 2003, it was decided to abolish the prescription of minimum lending rate for credit limits of over Rupees two lakh and banks were given the freedom to fix the lending rates for such credit limits subject to Benchmark Prime Lending Rate (BPLR) and spread guidelines. Banks were required to obtain the approval of their respective Boards for the BPLR, which would be the reference rate for credit limits of over Rs. 2 lakh. Each bank's BPLR had to be declared and be made uniformly applicable at all branches. BPLR continued to be the ceiling rate of interest for advances upto Rs. 2 lakh.

- Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. There can be only one Base Rate for each bank. Banks may choose any benchmark to arrive at the Base Rate 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 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. Banks are allowed to review Base Rate methodology after three years from date of its finalizationwith the approval of their Board of Directors/ ALCO.
- All rupee loans sanctioned and credit limits renewed w.e.f. April 1, 2016 will be priced with reference to the Marginal Cost of Funds based Lending Rate (MCLR) which will be the internal benchmark for such purposes. Audit teams should verify whether new loans sanctioned and credit limits renewed post April 1, 2016 is under the new MCLR regime.
- The MCLR will comprise of Marginal cost of funds, Negative carry on account of CRR, Operating costs and Tenor premium.

Spread

2.212

(i) Banks should have a Board approved policy delineating the components of spread charged to a customer. It should be ensured that any price differentiation is consistent with bank's credit pricing policy.

(ii) Bank's internal pricing policy must spell out the rationale for, and range of, the spread in the case of a given category of borrower, as also, the delegation of powers in respect of loan pricing. The rationale of the policy should be available for supervisory review.

(iii) The spread charged to an existing borrower should not be increased except on account of deterioration in the credit risk profile of the customer or change in the tenor premium. Any such decision regarding change in spread on account of change in credit risk profile should be supported by a full-fledged risk profile review of the customer. The change in tenor premium should not be borrower specific or loan class specific. In other words, the change in tenor premium will be uniform for all types of loans for a given residual tenor.

(iv) The guidelines contained in sub-paragraph (iii) above are, however, not applicable to loans under consortium/ multiple banking arrangements.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act, 2002

Securitisation of Standard Assets

2.213 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.

2.214 In order to further strengthen banks' ability to resolve their stressed assets effectively, RBI has issued revised guideline to improved framework governing sale of such assets by banks to SCs/RCs/other banks/Non-Banking Financial Companies /Financial Institutions etc. In order to enhance transparency in the entire process of sale of stressed assets, banks are required to do following:

- Identification of stressed assets beyond a specified value, as may be determined by bank's policy, for sale shall be top-down i.e., the head office/corporate office of the bank shall be actively involved in identification of stressed assets, including assets which are classified as Special Mention. Account, to be put on sale. Early identification will help in low vintage and better price realisation for banks;

- At least once in a year, preferably at the beginning of the year, banks shall, with the approval of their Board, identify and list internally the specific financial assets identified for sale to other institutions, including SCs/RCs;
- At a minimum, all assets classified as 'doubtful asset' above a threshold amount should be reviewed by the board/board committee on periodic basis and a view, with documented rationale, is to be taken on exit or otherwise. The assets identified for exit shall be listed for the purpose of sale as indicated above;
- Prospective buyers need not be restricted to SCs/RCs. Banks may also offer the assets to other banks/NBFCs/FIs, etc. who have the necessary capital and expertise in resolving stressed assets. Participation of more buyers will result in better price discovery;
- In order to attract a wide variety of buyers, the invitation for bids should preferably be publicly solicited so as to enable participation of as many prospective buyers as possible. In such cases, it would be desirable to use e-auction platforms. An open auction process, apart from attracting a larger set of borrowers, is expected to result in better price discovery. Banks should lay down a Board approved policy in this regard;
- Banks must provide adequate time for due diligence by prospective buyers which may vary as per the size of the assets, with a floor of two weeks;
- Banks should have clear policies with regard to valuation of assets proposed to be sold. In particular it must be clearly specified as to in which cases internal valuation would be accepted and where external valuation would be needed. However, in case of exposures beyond Rs.50 crore, banks shall obtain two external valuation reports;
- The cost of valuation exercise shall be borne by the bank, to ensure that the bank's interests are protected;
- The discount rate used by banks in the valuation exercise shall be spelt out in the policy. This may be either cost of equity or average cost of funds or opportunity cost or some other relevant rate, subject to a floor of the contracted interest rate and penalty, if any.

2.215 In order to make sure that sale of stressed assets by banks actually result in 'true sale' of assets and to create a vibrant stressed assets market, it has been decided to progressively restrict banks' investment in SRs backed by their own stressed assets.

i) With effect from April 1, 2017, where the investment by a bank in SRs backed by stressed assets sold by it, under an asset securitisation, is more than 50 percent of SRs backed by its sold assets and issued under that securitisation, the provisions held in respect of these SRs will be subject to a floor; this floor shall be progressive provisioning as per extant asset classification and provisioning norms, notionally treating book value of these SRs as the corresponding stressed loans, assuming these had remained, without recovery of principal, on the bank's books. In effect, provisioning requirement on SRs will be higher of the:

   a. provisioning rate required in terms of net asset value declared by the SCs/RCs; and

   b. provisioning rate as applicable to the underlying loans, assuming that the loans notionally continued in the books of the bank;

ii) With effect from April 1, 2018, the above threshold of 50 percent will stand reduced to 10 percent.

2.216 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 cannot be reversed and is kept to meet the shortfall/ loss on account of other non-performing assets.

E. Accounting and Auditing Aspects

Balance Sheet Disclosure

2.217 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.

A. (i) Bills purchased and discounted
   (ii) Cash Credits, Overdrafts and Loans repayable on demand
   (iii) Term loans

B. (i) Secured by tangible assets
   (ii) Covered by bank/government guarantees
   (iii) Unsecured

C. I. Advances in India
      (i) Priority sectors
      (ii) Public sector
      (iii) Banks
      (iv) Others
   II. Advances outside India
      (i) Due from banks
      (ii) Due from others
      (iii) Bills purchased and discounted
      (iv) Syndicated loans
      (v) Others

Classification Based on Nature of Advance (Section A)

2.218 Different classifications under section A will be as follows:

(a) In classification under section 'A', all outstandings – in India as well as outside India – less provisions made, will be classified under three heads.

(b) Outstandings in credit card operations should be shown as part of advances under the head 'cash credits, overdrafts and loans repayable on demand'.

(c) Term loans will be loans not repayable on demand and would include overdue instalments.

(d) All interest bearing loans and advances granted by the bank to its employees should be shown as part of advances.

Classification Based on Nature and Extent of Security (Section B)

2.219 Different classifications under section B will be as follows:

(a) All advances or part of advances, which are secured[13] by tangible assets,

[13] 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.

whether in India or outside India, should be shown under the heading 'secured by tangible assets'. Advances against book debts may be included under the head 'Secured by Tangible Assets', and presented in Schedule 9 (Advances) as follows:

"B Secured by Tangible Assets" (includes advances against book debt)

(b) Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC and ECGC are to be included under the head 'advances – covered by bank/government guarantees'.

(c) Unsecured advances will include advances not classified under (i) & (ii) of section B.

Classification based on Place of Making Advances (Section C)

2.220 a) Advances to sectors, which 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, 'Advances to Public Sector'.

b) Advances to Central and State Governments and other government undertakings including government companies and corporations which are, according to the statutes, to be treated as public sector companies, are to be included in the category 'Public Sector'.

c) All advances to the banking sector including co-operative banks will come under the head 'Banks'.

d) All the remaining advances will be included under the residual head 'Others'; typically this category will include non-priority advances to the private, joint and co-operative sectors.

Audit Approach and Procedures

2.221 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. 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.

2.222 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.

2.223 In carrying out 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 auditor can obtain the list of SMA 1 and SMA 2 borrowers from the bank and the same should also be considered for selection of problematic accounts. The extent of sample checking would 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.

2.224 Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc., should, generally, be included in audit sample. Besides this new advances sanctioned during the year should be included on selective basis in the sample.

2.225 In nutshell, auditor at branch may keep following in mind to plan comprehensive coverage of advances and for selection of sample

1. **Obtain top 10 exposure accounts:** It may be advisable for a branch auditor to visit the branch and ask the list of top 10 accounts/ exposures along with all the details such as status and security etc. before starting of the audit.

2. **Obtain the list of stressed accounts:** Stressed Accounts includes accounts classified as SMA 1 or SMA 2 of projects where implementation is delayed. The banks monitors stressed accounts on daily basis. The account that generally has overdue beyond 60 days or likely to slip to NPA at the quarter end is termed as stressed account (some banks may use different terminology). It is advisable to obtain such list of stressed accounts at least 15 days ahead of the closing date i.e. say stressed account list as on 15th March. This will provide the auditor a ready list of such accounts. The auditor then can scrutinise (based on materiality) to know whether the account has slipped or if not whether has been kept standard by unusual transaction that cannot be termed as business transaction. The RBI through its circulars has time and again been emphasising that stray credit at the quarter end need not qualify to keep account standard. We need to assess whether account is inherently weak. If so the same may have to be downgraded. As regards the partial recovery in overdue account (qualifying the criteria for classification of an account as NPA), such account cannot be upgraded unless overdue portion is recovered in entirety. As regards subsequent credit (after the date of balance sheet), the same will not improvise the classification of an advance.

3. **Obtain the list of restructured accounts:** As we are aware restructured account portfolio requires separate additional provisioning. It is necessary to obtain the list of such accounts and ensure whether the restructure is as per the RBI directives.

4. **Obtain the list of bi-lateral, CDR, SDR, S4A or 5/25 Accounts:** Please ensure the compliance with the RBI guidelines in respect of all such accounts.

5. **Obtain the list of unsecured exposures above Rs. 1 Cr.:** Unsecured exposure has significant impact on the bank, if slips to NPA. Many a times such accounts are reviewed in the traditional manner. These require close monitoring not only from the perspective of financial parameters of the

prudential guidelines but also non-financial parameters that give signals of the possible ill health. The banking industry (especially PSUs) has faced severe damages on account non-identification of such non-financial parameters.

6. **Early mortality cases:** Any advance slippage to NPA within 12 months of its introduction is called early mortality case. Early mortality cases invoke penalty to the sanctioning authorities. This will have to be checked to understand the reason for such happening to avoid such cases in future and also to find out whether there are any cases classified as performing on some untenable ground to push it beyond early mortality.

Evaluation of Internal Controls over Advances

2.226 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 by doing KYC compliance, proper credit appraisal etc. and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It 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.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. 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

2.227 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 or Buyer's Credit availed for procurement of material). The Bank should also insist on such information from borrowers. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks.

2.228 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.

2.229 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 regards the treatment of unpaid stocks while arriving at the drawing power available in the borrower accounts, wherein the thrust is avoidance of the double finance on the unpaid stock, if such stocks are taken as eligible for computation of drawing power. Thus, it would be unrealistic to assume that the composition of the stock items, the level of stock held and the portion of unpaid stock considered at the time of appraisal would be static and should be presumed to be at the same level for subsequent period. For the said reason, the drawing power needs to be recomputed based on variations, not only in composition and level of stock but also in the unpaid portion of stocks before the stipulated margin is applied as per the sanction terms of a working capital finance.

2.230 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.

2.231 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.

2.232 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 Buyer's Credit, LCs/ Guarantees/ Co-acceptances or otherwise) and margin as stipulated, is vital, particularly in cases of default, and in border-line cases where the health status of borrowers may be in question, to gauge slippages.

2.233 Due care is required to be exercised by the auditor in case of

- Documents retained in original at centralised offices where these are not available at the branches that are advised of drawing power limits; and
- consortium advances, where 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 verify that there is no slippage of the account into NPA classification.

Long Form Audit Report

2.234 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.

2.235 Observations relating to procedural significance should be mentioned in LFAR. Please note that the whole bank LFAR gets finalised within 60 days of signing of financial statements. Hence during finalisation CSA predominantly concentrates on main audit report submitted by the branch auditor. Any observation that requires to be dealt with during finalisation may miss the attention of CSA if the same is mentioned in LFAR alone. Such observations that need to be dealt with for finalisation of the banks financial statements should find place in main audit report along with appropriate MOC, if required.

Examining the Validity of Recorded Amounts

2.236 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.

2.237 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

2.238 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 special resolution of shareholders [in cases covered by section 180 (1)(c) of the Companies Act, 2013, etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. 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

2.239 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.

2.240 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

2.241 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. The audit procedure should be able to highlight disbursals from pre/freshly sanctioned limits made either to the same borrower or to group entities near the repayment dates of critical dues.

2.242 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.

2.243 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 as approved by Board of Directors of bank) or above for working capital from the banking system.

2.244 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.

2.245 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.

2.246 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.

2.247 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.

2.248 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

2.249 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.

2.250 An advance should be treated as secured to the extent of the value of the security on the reporting 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.

2.251 As mentioned earlier, the Reserve Bank has specified that advances against book debts may be included under the head 'secured by tangible assets'.

2.252 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) Advances covered by ECGC/DICGC,CGTS guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC/CGTS and kept in sundry creditors account pending adjustment should be deducted from advances.

(h) An account which is fully secured but the margin in which is lower than that stipulated by the bank should nevertheless be treated as fully secured for the purposes of balance sheet presentation.

(i) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as 'secured'.

(j) Documentary bills under delivery-against-acceptance terms which remain unaccepted 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.

(k) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.

(l) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.

(m) 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc. Moreover, 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. (Ref Master Circular No. RBI/2015-16/99DBR.BP.BC.No.23/21.04.018/2015-16 dated July 1 2015 on Disclosure in Financial Statements- Notes to Accounts)

2.253 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.

2.254 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;

   ii. advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and

   iii. Stocks hypothecated/pledged are paid stocks owned by the borrower.

(e) In 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.

2.255 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

2.256 The auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. The auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required and verify the same with Demat Statement.

2.257 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.

2.258 Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been paid in time by the borrower/bank.

Goods

2.259 In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank's security is only to the extent of the latter. Auditor should also verify that the Bank has system of maintenance of proper register in this regard as also system of scrutiny of stock/book debt statement furnished by the borrower.

2.260 The auditor should also check nature of goods hypothecated/pledged. If the goods are of perishable nature, it will not have market value.

2.261 In case of goods/book debts, movable assets hypothecated , auditor should also examine whether the Bank has system in place for periodical inspection of such goods/debts/assets and records of borrowers by its own officer or by external agencies like firm of Chartered Accountants. Whether proper register is maintained in this regard and timely action is taken whenever there is an adverse remark in the inspection report. Auditor should also check that there is adequate insurance cover in respect of goods /assets hypothecated and there is a bankers' clause in the policy.

2.262 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.

2.263 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. 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

2.264 The auditor may inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold. In context to the valuation, attention is also invited to the valuation norms as given in the RBI circular no. DBOD.No.BP.BC.27/21.04.048/2014-15 on "Loans against Gold Ornaments and Jewellery for Non-Agricultural End-uses" dated July 22, 2014.

2.265 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

2.266 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.

2.267 It should be verified whether the policies are assignable in bank's favour. In certain types of policies, the assignment to third party are restricted.

Bank's Own Deposit Certificates

2.268 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 master data.

Hire-purchase Documents

2.269 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

2.270 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.

2.271 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

2.272 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.[14] He should also examine the insurance policies.

2.273 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.

2.274 In case the bank has accepted third party property as a security. The

[14] Reference may be made in this regard to 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

2.275 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/Asset Quality Review/ Risk Based Supervision report.
- Concurrent /internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

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 should check whether the variations in provisions, etc., reported by RBI have been properly considered by the bank management. The statutory auditors should consider the issues emerging from recent RBI inspections and obtain an understanding of changes made by the banks pursuant to the inspection process to enhance their identification of NPA. Further, the audit procedures should be suitably re-designed to consider such issues.

Third Party Guarantees

2.276 The auditor should examine the guarantee bonds and the demand promissory notes in order to verify the third party liability. Auditor should satisfy that the guarantee is in force as at the date of the balance sheet. In 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 the acknowledgement to debt from the borrower as well as guarantor is obtained by the Bank.

Verification of Bills Purchased and Discounted

2.277 The auditor should familiarise with the guidelines issued by 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.

2.278 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.

2.279 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.

2.280 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.

2.281 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.

2.282 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 examined whether 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.

Verification of Buyer's Credit Transaction

2.283 Following documents are required to be verified by the statutory auditors during review of Buyers' Credit Transaction and its accounting treatment in the Indian Bank's books.

(a) (Loan) Agreement, if any, entered between the Indian importer (borrower), overseas bank (lender), the Indian bank (facilitator);

(b) Underlying documents for import of capital goods or raw materials;

(c) Maximum tenure of buyer's credit as per guidelines of RBI;

(d) SWIFT messages originated by overseas bank specifying the terms of Buyer's Credit;

(e) The calculation of contingent liability towards LoC/ LoU is inclusive of interest accrued on the Buyer's Credit as on financial statement date;

(f) Documentation / Agreement between overseas bank and Indian bank, and, any further confirmatory documents exchanged between overseas bank and Indian bank;

(g) Review of documents specifying right of recovery against borrower, in case if the borrower defaults in repayment of Buyer's Credit;

(h) Balance confirmations obtained from the overseas bank;

(i) Charge created in records of RoC related to the security offered for Buyer's Credit *vis-à-vis* disclosure of Buyer's Credit in the financials of borrowers as secured / unsecured loan;

(j) Acknowledgement of debt, if any, obtained from the borrower;

(k) The calculation of drawing power for working capital finance availed by the borrower is net of the Buyer's Credit;

(l) Form 15CA / Form 15CB compliance made by the borrower.

Other Aspects

2.284 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.

2.285 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'.

2.286 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.

2.287 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.

2.288 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.

2.289 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 and adequacy of its insurance cover along with Bank's name.
16. Timely submission of stock statement and other statements.
17. Analysis of stock statements *vis a vis* financial statements.

Drawing Power Calculation

2.290 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.

2.291 The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.

2.292 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.

2.293 It needs to be examined whether the drawing power is calculated as per the extant guidelines formulated by the bank, which should also be in line with RBI guidelines/directives. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power. As a general principle, and with the objective of avoidance of double financing, the unpaid stocks should not be considered while computing the DP available in the borrowal accounts.

2.294 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.

2.295 The drawing power needs to be verified carefully in case of working capital advances to entities engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be examined whether the mobilization advance being received by the contractors is reduced while calculating drawing power. Further is respect of certain businesses such as diamond merchants and jewellers, the auditor should exercise due caution while verifying realisable value of the inventory of precious metals, diamonds, jewellery etc. The auditor may also consider obtaining assistance of an expert in case circumstances so warrant.

2.296 In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks.

Lending under Consortium Arrangement / Multiple Banking Arrangements

2.297 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.

2.298 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.

2.299 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.

2.300 The auditor should check the compliance with RBI guidelines on unhedged foreign currency exposure. Self-declaration from the client or Independent auditors' certificate of foreign currency exposure should be obtained by the Bank. Such declaration/certificate can be cross checked with the computation of standard asset provisioning.

Retail Assets

2.301 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.

2.302 There may be a large number of accounts under retail assets, which have been restructured/rescheduled during respective years including repetitive rephasements. The process of the bank to report / record all such reschedulement/restructuring needs to be reviewed and adequacy of the same should be checked. In case of restructuring of consumer and personal advances, the same should immediately be treated as NPA. The accounts are treated as restructured when the bank, for economic or legal reasons relating to borrower's financial difficulty, grants to the borrower concessions that the bank would otherwise not consider. The HO of the bank should instruct properly to branches in this regard.

Restructuring of cases

2.303 RBI has given guidelines for treatment of restructured accounts in part B of the Master Circular on Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances dated July 1, 2015. The provisions of this Circular has been discussed in Chapter 4 of Part III of Guidance Note. The auditor should verify compliance with the requirements of the said circular.

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

2.304 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

2.305 In respect of sacrifice of interest, the auditor should examine whether:

(a) Interest sacrifice involved in the amount of interest has been provided for by debit to Profit & Loss account and held in a distinct account.

(b) Sacrifice is recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR/ Base Rate, term premium and the credit category of the borrower and the consequent shortfall in provision or reversal of the amount of excess provision has been held in the distinct account.

(c) In the event any security is taken against interest sacrifice, the same has been valued at Re.1/- till maturity of the security. As per RBI norms, the interest sacrifice in all the restructured cases needs to be worked out including for Working Capital Loans. In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components. The process of identifying such interest sacrifice in case of working capital loans needs to be looked upon in detail.

2.306 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.

Other Aspects

2.307 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 through the same to see whether these have been properly applied by the bank.

2.308 The Branch Auditor are advised to verify the advances based on the criteria for the selection as per "Illustrative list of Basis of selection of Advances accounts in case of Bank Branch Audit" as given in the CD.

III-3
Scrutiny of Advance Accounts Presented in Ind AS by Borrowers

Introduction

3.01 The Ministry of Corporate Affairs (MCA) on 6th April 2016 amended Schedule III of Companies Act 2013 to include general instructions for preparation of financial statements of a company whose financial statements are required to comply with Ind AS.

3.02 The amendment is applicable to following classes of companies from 1 April 2016

- Companies listed/ being listed and Net worth is Rs. 500 crore or more
- Unlisted Companies whose Net worth is Rs. 500 crore or more
- Holding/ Subsidiary/ Joint Venture or associate of above

3.03 From 1 April 2017, the amendment will also be applicable to following classes of companies:

- All other Companies listed/being listed
- Unlisted Companies whose Net worth is Rs. 250 crore or more and less than Rs. 500 crore.
- Holding/ Subsidiary/ Joint Venture or associate of above

3.04 The amendment divides Schedule III into two parts i.e. Division I and II. Division II covers the complete set of Financial Statements under Ind AS which include:

1. Balance Sheet
2. Statement of Profit and Loss divided in two parts as profit or Loss section and Other Comprehensive Income
3. Statement of changes in equity
4. Cash Flow Statement

5. Notes

3.05 Banks often refer to the Financial Statements of companies for credit decision regarding new lending, review and credit monitoring in the form of end use of funds, ratio analysis etc. The Financial statements are thus treated as Base Document for the purpose of Credit Appraisal, Review and monitoring. Since the accounting treatment, disclosures and formats of Financial statements have changed due to compliance with Ind AS, it is important for Banks to understand the intricacies of this changing reporting structure.

Major Financial Impacts (List is illustrative)

3.06

1. Property, Plant & Equipment (IND AS 16)

Key Area	Impact
For first time adoption three option of transition are available- a. **Recomputation of cost** as on transition date since inception b. **Fair Valuation** of PPE as on transition date c. **Carrying value** of PPE as of transition date as per Indian GAAP	• First two options will lead to changes in Debt equity ratio • In case of fair valuation, value adopted by the company *vis-a-vis* considered by the bank (for collateral security) needs to be cross referenced • It needs to be analysed whether fair value option has been availed and how it impacts the financial position and future cash flows.
Decommissioning, restoration and similar liabilities • To be recognised as part of the cost of an item of PPE • To be recognised as a liability in accordance with Ind AS 37.	Such accounting treatment will have following impact : • Increased depreciation • Increase in interest cost due to unwinding of discounted liability Whenever such type of provision is done, the nature and impact of such provision should be analyzed. Detailed calculation should be checked for analyzing the possible deviations.

2. Investment Property (IND AS 40)

Key Area	Impact
IND AS 40 requires separate disclosure in Balance sheet for assets which qualifies as Investment property as follows:	Information about assets held for capital appreciation/rental purposes will be separately available
• Fair value of Investment Properties	Such readily available information will be useful in assessing the real net worth of the company. Also, details of method used to calculate fair value will be useful in assessing the possible deviations in value.
• Revenue generating and non-revenue generating Investment properties with details of income and direct operating expenses.	This disclosure will give an idea of the income earning capacity. This may also give indication about the fair value of the property.
• Restrictions on realizability and contractual commitments	This information about all encumbrances will help in analyzing the practical usefulness of the property

3. Accounting for Government Grants and disclosure of Government Assistance (IND AS 20)

Key Area	Impact
Government grants are bifurcated in two categories: • Grants related to assets and • Grants related to income	It is pertinent to note that IND AS 20 does not recognize the concept of grant in the nature of promotors contribution. Thus, concept of capital reserve has been done away with.
Para 24 states that Government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet by setting up the grant as deferred income	Recognition of grant as operating income will increase the EBITDA
Disclosure regarding unfulfilled conditions and other contingencies attaching to government assistance that has been recognized	This disclosure requirement allows the stakeholders to assess the nature and impact of liabilities attaching the assistance received

4. Revenue (IND AS 18)

Key Area	Impact
Para 9 states that revenue shall be measured at the fair value of the consideration received or receivable. As a result • Revenue is to be presented gross of excise duty and • Revenue is to be presented net of incentives, quantity discounts, trade discounts, volume rebates, etc.	• Grossing up of excise duty • This will have an impact while comparing information with earlier periods • Reduction in revenue by large amounts where the company operates customer loyalty programs/discount coupons/gift vouchers, etc.
Para 11 states that when the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest	Whenever the sale is made at deferred credit terms, revenue will be reduced and will be recognized as interest in other income.

5. Inventories (IND AS 2)

Key Area	Impact
Para 36 of IND AS 2 requires disclosure of the amount of any write-down of inventories recognized as an expense in the period	The stakeholders will be able to analyze the quantum of the non moving inventories. This can be utilized while calculating drawing power

6. Events after the Reporting Period (IND AS 10)

Key Area	Impact
Para 12 states that If an entity declares dividends to holders of equity instruments (as defined in	This change will have huge impact on the retained earnings of many companies. Dividends recognized as liability will now be

Ind AS 32, Financial Instruments: Presentation) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period	added back to reserves which will largely impact the debt equity ratio.

7. Accounting Policies, Changes in Accounting Estimates and Errors (IND AS 8)

Key Area	Impact
Para 32 states that changes in the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets are to be regarded as changes in estimates	Earlier, change in the method of depreciation was considered as a change in accounting policy. However, IND AS 8 regards it as change in estimate. This change implies that the changes in depreciation method will have to be accounted for prospectively as against the earlier treatment of retrospective application. Such change is very important since it will restrict the companies from profit management by using changes in depreciation method as a tool.

8. Financial Instruments (IND AS 109, IND AS 32)

Key Area	Impact
Para 15 of IND AS 32 states that the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement	The definition of equity has wide impact on the various instruments issued by the company. This standard gives importance to substance over form. Thus, classification of an instrument into equity or liability is very crucial. Such classifications might change the entire composition of the balance sheet. This might have significant impact on the

and the definitions of a financial liability, a financial asset and an equity instrument	debt-equity ratio of the company as well as P&L. Real estate and start ups will be most affected
Foreign currency convertible bonds (FCCB)	Interest cost will be increased since in these cases the premium to be paid while redemption is to be factored at the time of issue of loan instrument itself.
Structured Instrument	Impact on the interest cost to a large extent Wherever instruments have been structured to provide for lower interest rates at the beginning and higher interest rates towards the end, such instruments will have to be fair valued w.r.t the prevailing market interest rates and accounting will have to be done accordingly.
Compound Financial instruments Para 28 of IND AS 32 states that the issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15	An instrument may contain an option to convert the debt instrument into equity. Here, since the instrument contain both the features of equity and debt, the amount needs to be bifurcated into equity and debt by computing the fair value of the equity portion.
Classification of investments For equity instruments not held for trading the standards provides two options – FVTOCI and FVTPL Investments held for trading will always be classified as FVTPL	The strategic investments made by the company will be classified as FVTOCI. The fluctuations in the fair value will not affect P&L but affect the reserves. The Bank can judge the group structure and its performance. All fluctuations in fair value will be accounted for in P&L. Careful study for the purpose of

	profitability is needed here by Banks.
<u>Loans extended with conversion option –</u> Such loans will always be classified as FVTPL since SPPI criteria is not met	Such accounting treatment will ensure the real value of loans extended in the balance sheet. Wherever the companies are loss making, fair value of loans advanced to such companies will be a crucial aspect
Fair valuation of startup companies – Crucial aspect	Since FVTPL instruments will have direct impact on P&L Wherever the companies have invested in startups, fair valuation of such investments will always be crucial. It would vary based on the business performance.
<u>Investments in mutual funds</u> – It will be classified as FVTPL instrument since SPPI criteria will not be met. Also, it will always be held for trading	P&L volatility will increase due to the fair valuation of investments on mutual funds.
<u>Classification of a liability/asset</u> An entity needs to classify a liability as financial or other liability as well as an asset as a financial or other asset The classification of liability/asset into financial or other is very important since the provisions of IND AS 109 applies to only financial liabilities/asset.	A financial liability/asset implies that the settlement will be either in cash or by transfer of other financial liability/asset. Other liabilities/asset implies settlement in other than cash mostly through delivery of services/goods. This classification to a large extent provides insight about the liabilities in monetary and non monetary terms Thus, the stakeholders might be able to approximate the cash flows of the company at a gross level.
Impact of expected credit loss model Para 5.5 of IND AS 109 requires impairment of financial assets based expected credit loss model. Two approaches have	The companies needs to evaluate the increases in credit risks associated with the financial assets and make loss allowance in the books of accounts wherever required. The stakeholders can enquire about the details of assessment made by the company

been specified : • General approach • Simplified approach	for evaluating the credit risks of the financial assets. Similarly such enquiries can be made for other major financial assets also.

9. Business Combinations (IND AS 103)

Key Area	Impact
No concept of appointed date or effective date	IND AS recognizes only the date when the control is obtained. This implies that agreements entered into will form basis of accounting.
Intangible assets needs to be carved out	All kinds of intangible assets to be identified separately from goodwill and accounted for in a business combination at fair value. This will provide real information about what the company is paying for. It will provide true value of goodwill after identifying all other intangibles
<u>Measurement at fair value</u> - The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values	This requirement ensures that the businesses are being acquired at real values. It will provide readily available data to stakeholders about the true values of businesses being acquired.

10. Disclosure Impacts

a. *Presentation of Financial Statements (IND AS 1)*

Key Area	Impact
<u>Capital Management</u> Para 134 states that an entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital	This is an important disclosure with regard to the capital management policy of the company. • This disclosure gives information about what are the objectives of the company w.r.t the capital requirements/adequacy • It describes the policies adopted by the

	company to achieve the objectives set by the company • Further, it also provides useful information about the steps which the company takes to adhere to the policies. The above information showcases the overall thought process of the company i.e. the policies adopted to maximize shareholder value, what kind of risks and how much risk the company is willing to take, the need for raising capital,

b. Operating segment (IND AS 108)

Key Area	Impact
New concept of Chief operating decision maker (CODM) introduced Operating segments to be disclosed based on how CODM reviews the operating results Apart from the segment disclosures, following entity wide disclosures are mandatory : • Information about products and services • Information about geographical areas • Information about major customers (revenue above 10%)	Major change in the disclosure requirements. Stakeholders will get to know how the businesses are getting managed, the overall decision making process and the allocation of resources of the company Information of revenues against each product/service offered by the company is useful for analyzing the major stream Information about exports and assets located outside India will provide information about the major area of operation of the company This will provide information about the concentration of the source of revenue of the company which enables to analyse the quantum of risks associated

c. Financial Instruments (IND AS 107)

Key Area	Impact
This standard requires wide disclosures in relation to	Such disclosures enable the stakeholders to analyze what kind of risk the company is

financial instruments. Some of them are as under : Disclosures regarding nature and extent of risks arising from financial instruments (Para 31-39): • Credit risk • Liquidity risk • Market risk	exposed to and the quantum of risk. This will enable to ascertain the possible impact on the profitability of the company. Credit risk disclosure enables the user of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows Liquidity risk disclosures enables the user of financial statements to understand the information such as maturity profile of the financial liabilities which gives an idea about the requirement of cash and it's sufficiency as well as information about policies to manage liquidity needs
Sensitivity Analysis of market risks (Para 40-42) • Foreign currency risks • Interest rate risks • Other price risks	Such information enables the stakeholders to analyse the exposure to each type of market risk and the possible volume of change that could affect the financial position of the company Further, the disclosures regarding how company manages such risks also provides useful information regarding the mitigation plan in case the risk materialize and also the sufficiency of such management All these disclosures regarding the risk exposure and management gives vast information and enables the stakeholders for internal credit rating purposes

III-4

Asset Classification, Income Recognition and Provisioning

Guidelines of the Reserve Bank of India on Income Recognition, Asset Classification, Provisioning and Other Related Matters

4.01 In its report submitted in 1992, the Committee on Financial System set up by the RBI under the Chairmanship of Mr. M. Narasimham made several recommendations concerning accounts of banks. The Committee recommended that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets should be done on the basis of objective criteria which would ensure a uniform and consistent application of norms. As regards provisioning, the Committee recommended that provisions should be made on the basis of classification of assets under different categories. Vide its Circular No. BP.BC.129/21.04.043-92 dated April 27, 1992, the Reserve Bank issued guidelines to be followed by all scheduled commercial banks (excluding regional rural banks) for income recognition, asset classification, provisioning and other related matters. These guidelines (commonly referred to as 'prudential guidelines' or 'prudential norms') have since been modified in several respects through various circulars of the Reserve Bank. The latest Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances". The salient points of the guidelines as presently in force are discussed below:

Non-Performing Assets

4.02 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

4.03 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.

4.04 Banks have been charging interest at monthly rests, from April 1, 2002. However, the banks should 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.

4.05 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 also be treated as 'out of order'. Further, any amount due to the bank under any credit facility is *'overdue'* if it is not paid on the due date fixed by the bank.

4.06 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.

(f) *Credit Card Accounts:* credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the statement as per Circular DBR.No.BP.BC.30/21.04.048/2015-16 dated July 16 2015. It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies (CIC) and for the purpose of levying of penal charges, *viz.,* late payment charges, etc., if any.

4.07 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.

4.08 The above norms should be made applicable to all direct agricultural advances as listed in the Master Direction on Lending to Priority Sector-Target and Classification dated July 7, 2016 (updated December 22, 2016). 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. In this context, attention of the Readers is also invited to Guidelines on Joint Lenders Forum and Corrective Action Plan providing the framework outlining a corrective action plan that will incentivise early identification of problem cases, timely restructuring of accounts which are considered to be viable, and taking prompt steps by banks for recovery or sale of unviable accounts.

Classification Norms relating to NPAs

Temporary Deficiencies

4.09 The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

(a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets, since current assets are first appropriated in times of distress. Drawing Power (DP) is required to be arrived at based on current stock statement. Proper computation of drawing power (as per Bank's policy) is imperative as the advances are to be checked with reference thereto. The auditor should review the Bank's policy for treatment of creditor's balances for computation of DP. As per Bank's policy, the creditors (for Goods) should be reduced from the stock and debtors within the stipulated period are considered while calculating the drawing power. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (circular no. No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association).

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

(c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

(d) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is 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/ adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of adhoc sanction will be treated as NPA.

Regularisation Near About Balance Sheet

4.10 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 about the manner of regularisation of the account to eliminate doubts on their performing status.

Cheque bounce

4.11 In case the account is regularised by making payment through cheque, the Auditor should review the actual realisation of cheques to assess the NPA classification. In case, the cheque is bounced, same should not be considered as credit in the Advance account for assessing the NPA classification.

Asset Classification to be Borrower-wise not Facility-wise

4.12 All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA/NPI, once any or a part of the facility/investment has become irregular.

4.13 In case debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning. The following provisions are given in the master circular in this regard:

(i) The bills discounted under LC favouring a borrower may not be classified as a Non-performing advance (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA.

(ii) The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for 90 days or more. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms. Accordingly, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might 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 (ii) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit / overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.

(iv) In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.

(v) As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed and held in a 'Suspense Account- Crystalised Receivables' in the same manner as done in the case of overdue advances.

(vi) Further, 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 above, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account. The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account. On payment of the overdues in cash, the balance in the 'Suspense Account-Crystalised Receivables' may be transferred to the ‘Profit and Loss Account’, to the extent payment is received.

(vii) If the bank has other derivative exposures on the borrower, it follows that the MTMs of other derivative exposures should also be dealt with / accounted for in the manner as described in para above, subsequent to the crystalised/settlement amount in respect of a particular derivative transaction being treated as NPA.

(viii) Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.

(ix) Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should be treated in the manner discussed above.

4.14 The Auditor needs to ensure that each customer of the bank is tagged under one single Customer ID in respect of all his/its accounts, including those in which credit facilities are granted, irrespective of their location , to enable the bank, (subject to the relaxations/exceptions for the time being applicable to any account/facility), to accord the same NPA classification status to the customer/borrower , based on the most adverse classification determined for any of his/its account/ facility. The auditor should also review the facilities enjoyed by such borrower’s related or group entities. The NPA classification so made does not automatically extend to such related or group entities, where the classification would have to be judged based on independently, i.e., at the entity level and not at a group level.

Non Financial Parameters

4.15 Normally NPA assessment is done based on record of recovery of dues in advances account. However there are many other non-financial parameters which also should be considered while assessing classification of NPA account such as:

- Inherent weakness in account
- Achievement of DCCO
- Failure to comply with key restructuring conditions
- Erosion in value of security

All above aspects are dealt with in detail in the following paragraphs of this chapter.

Advances to Primary Agricultural Credit Society (PACS)* Farmers Service Society *(FSS) ceded to Commercial Banks

4.16 In case of advances granted under the on-lending system, however, only the particular credit facility granted to PACSs or FSSs, which is in default for a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned subject to such conditions as specified in the RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances dated July 1, 2015. The other direct loans & advances, if any, granted by the bank to the member borrower of a PACS/ FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

Erosion in Value of Securities/ Frauds Committed by Borrowers

4.17 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 borrower 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.

(iii) Provisioning norms in respect of all cases of fraud:

a. The entire amount due to the bank (irrespective of the quantum of security held against such assets), or for which the bank is liable (including in case of deposit accounts), is to be provided for over a period not exceeding four quarters commencing with the quarter in which the fraud has been detected;

b. However, where there has been delay, beyond the prescribed period, in reporting the fraud to the Reserve Bank, the entire provisioning is required to be made at once. In addition, Reserve Bank of India may also initiate appropriate supervisory action where there has been a delay by the bank in reporting a fraud, or provisioning there against.

c. Where the bank chooses to provide for the fraud over two to four quarters and this results in the full provisioning being made in more than one financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year by credit to provisions. However, banks should proportionately reverse the debits to ‘other reserves’ and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

Government Guaranteed Advances

4.18 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

4.19 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.

4.20 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.

4.21 Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts. Advance against gold ornaments, government securities and all other securities are not covered by this exemption and should be classified as NPA as per the extant IRAC norms.However in respect of Jewel Loans taken for Agricultural Purposes, the classification has to be continued in accordance with Crop Seasons only.

Agricultural Advances Affected by Natural Calamities

4.22 Paragraph 4.2.13 of the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, *viz.,* conversion of the short term production loan into a term loan or reschedulement of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's latest Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" dated July 1, 2015 and guidelines contained in RBI FIDD.No.FSD.BC.01/05.10.001/2015-16 dated July 1, 2015 on "Guidelines for Relief Measures by Bank in Areas Affected by Natural Calamities". In such cases the NPA classification would be governed by such rescheduled terms. The Auditors are advised to obtain the latest decisions of State Level Banking Committee (SLBC) and the minutes of the SLBC meeting will be accessible in website.

4.23 In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remain overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not 'long duration" would be treated as "short duration" crops.

4.24 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

4.25 In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset. This classification cannot be upgraded by the bank unless the package of renegotiated terms has worked satisfactorily for a period of one year. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, the income recognition, asset classification norms would apply after a period of one year from the date of disbursement.

Transactions Involving Transfer of Assets through Direct Assignment of Cash Flows and the Underlying Securities

4.26 Originating Bank: The asset classification and provisioning rules in respect of the exposure representing the Minimum Retention Requirement (MRR) of the Originator of the asset would be as under:

a) The originating bank may maintain a consolidated account of the amount representing MRR if the loans transferred are retail loans. In such a case, the consolidated amount receivable in amortisation of the MRR and its periodicity should be clearly established and the overdue status of the MRR should be determined with reference to repayment of such amount. Alternatively, the originating bank may continue to maintain borrower-wise accounts for the proportionate amounts retained in respect of those accounts. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.

b) In the case of transfer of a pool of loans other than retail loans, the originator should maintain borrower-wise accounts for the proportionate amounts retained in respect of each loan. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.

c) If the originating bank acts as a servicing agent of the assignee bank for the loans transferred, it would know the overdue status of loans transferred which should form the basis of classification of the entire MRR/individual loans representing MRR as NPA in the books of the originating bank, depending upon the method of accounting followed as explained in para (a) and (b) above.

4.27 Purchasing Bank: In purchase of pools of both retail and non-retail loans, income recognition, asset classification and provisioning norms for the purchasing bank will be applicable based on individual obligors and not based on portfolio. Banks should not apply the asset classification, income recognition and provisioning norms at portfolio level, as such treatment is likely to weaken the credit supervision due to its inability to detect and address weaknesses in individual accounts in a timely manner. If the purchasing bank is not maintaining the individual obligor-wise accounts for the portfolio of loans purchased, it should have an alternative mechanism to ensure application of prudential norms on individual obligor basis, especially the classification of the amounts corresponding to the obligors which need to be treated as NPAs as per existing prudential norms. One such mechanism could be to seek monthly statements containing account-wise details from the servicing agent to facilitate classification of the portfolio into different asset classification categories. Such details should be certified by the authorized officials of the servicing agent. Bank's concurrent auditors, internal auditors and statutory auditors should also conduct checks of these portfolios with reference to the basic records maintained by the servicing agent. The servicing agreement should provide for such verifications by the auditors of the purchasing bank. All relevant information and audit reports should be available for verification by the Inspecting Officials of RBI during the Annual Financial Inspections of the purchasing banks.

4.28 The above guidelines prescribed for Originating Bank and Purchasing Bank do not apply to:

(a) Transfer of loan accounts of borrowers by a bank to other bank/FIs/NBFCs and vice versa, at the request/instance of borrower;

(b) Inter-bank participations;

(c) Trading in bonds;

(d) Sale of entire portfolio of assets consequent upon a decision to exit the line of business completely. Such a decision should have the approval of Board of Directors of the bank;

(e) Consortium and syndication arrangements and arrangement under Corporate Debt Restructuring mechanism;

(f) Any other arrangement/transactions, specifically exempted by the Reserve Bank of India.

Post Shipment Supplier's Credit

4.29 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.

4.30 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

4.31 Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under such an arrangement, the bank or financial institution financing infrastructure projects will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis. In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification will have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/ taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its takeover by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

Export Project Finance

4.32 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

4.33 Since income recognition is based on recoveries, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, except to the extent provided in Para 4.2.9 of the Master Circular dated July 1, 2015. Likewise, the availability of security and/or guarantee is not relevant for determining whether an account is an NPA or not.

Project Finance Under Moratorium Period

4.34 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

4.35 Interest bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from first due date onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

Partial Credit Enhancement to Corporate Bonds

4.36 In a waterfall mechanism, Credit Enhancement (CE) gets drawn only in a contingent situation of cash flow shortfall for servicing a debt / bond etc., and not in the normal course of business. Hence, such an event is indicative of financial distress of the project. Keeping this aspect in view, a drawn tranche of the contingent PCE facility will be required to be repaid within 30 days from the date of its drawal (due date). The facility will be treated as NPA if it remains outstanding for 90 days or more from the due date and provided for as per the usual asset classification and provisioning norms. In that event, the bank's other facilities to the borrower will also be classified as NPA as per extant guidelines.

NPA Management

4.37 The RBI has issued Master Circular dated July 1, 2015 on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. The Circular stresses the importance of effective mechanism and 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

4.38 Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise income on non-performing assets until it is actually realised.

4.39 If any advance including Bills purchased and discounted, becomes NPA, the entire interest accrued and credited to the income account in the past periods should be reversed if the same is not realised. Interest for the current year if recognised till the date of identification but not realised should also be reversed. Further,

i. Interest income on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

ii. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

iii. If Government guaranteed advances become NPA (subject to what is stated hereunder in respect of Central Govt. guaranteed accounts), the interest on such advances should not be taken to income account unless the interest has been realised.

Credit facilities backed by guarantee of the Central Government, though overdue, may be treated as NPA only when the Government repudiates its guarantee when invoked. Thus, where the guarantee is not invoked/repudiated, the related account cannot be classified as NPA and by implication, the advance is to be treated as "Standard" for the purpose of provisioning. This exemption from classification of such Central Government guaranteed advances as NPA is not for the purpose of recognition of income; and income is to be recognized only based on realisations made.

Reversal of Income

4.40 If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

4.41 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.

4.42 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

4.43 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

4.44 In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs (Appropriation of recoveries in NPAs)

4.45 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.

4.46 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

4.47 On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Classification of Advances

4.48 The guidelines require banks to classify their advances into four broad categories for the purpose of provisioning as follows:

(a) ***Standard assets***

4.49 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. However as per para 2.1 of the Circular on Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders Forum (JLF) and Corrective Action Plan (CAP) dated February 26, 2014, RBI has directed the banks to classify the standard accounts according to their overdue status under Special Monitoring Accounts popularly known as SMA. Under this

SMA Categories	Basis of Classification
SMA-0	No overdue but sign of incipient stress (as per annexure to the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015
SMA-1	Overdue between 30 -60 days
SMA-2	Overdue between 60-90 days

Such classification also serves to be useful for bank officers monitoring as well as audit perspective to check the transactions & methods of keeping these standard at the balance sheet date.

Demonetisation - Effect on Asset Classification

4.50 Consequent upon withdrawal of the legal tender status of the INR 500 and INR 1,000 notes w.e.f. November 8, 2016, the RBI had issued a notification dated November 21, 2016 providing an additional 60 days beyond what is applicable for the concerned regulated entity (RE) for recognition of a loan account as sub-standard in the following cases:

- Running working capital accounts (OD/CC)/crop loans, with any bank, the sanctioned limit whereof is Rs. 1 crore or less;
- Term loans, whether business or personal, secured or otherwise, the original sanctioned amount whereof is Rs. 1 crore or less, on the books of any bank or any NBFC, including NBFC (Micro Finance Institution). This shall include housing loans and agriculture loans;
- Loans sanctioned by banks to NBFC (MFI), NBFCs, Housing Finance Companies, and Primary Agriculture Credits and by State Cooperative Banks to District Control Co-operative Banks;
- The above guidelines will also be applicable to loans extended by DCCBs.

The above dispensation would be subject to following conditions:

The additional time given shall only apply to defer the classification of an existing standard asset as substandard and not for delaying the migration of an account across sub-categories of NPA.

(b) ***Sub-standard assets***

4.51 A sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

(c) ***Doubtful assets***

4.52 An asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Such an asset has all the inherent weaknesses as in a substandard asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

(d) ***Loss assets***

4.53 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.

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/presentation of advances altogether differently.

Guidelines on Restructuring of Advances by Banks

4.54 The RBI, vide its Master Circular No.DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 issued prudential guidelines on restructuring of advances by banks. The Guidelines also contain the organisational framework for restructuring of advances under consortium/ multiple banking/ syndication arrangements, i.e., the CDR mechanism.

4.55 In line with the recommendation of the Working Group under the Chairmanship of Shri B. Mahapatra, to review the existing prudential guidelines on restructuring of advances by banks/financial institutions, the extant incentive for quick implementation of restructuring package and asset classification benefits (paragraphs 4.224 to 4.226 (available on restructuring on fulfilling the conditions will however be withdrawn for all restructurings effective from April 1, 2015 with the exception of provisions related to changes in DCCO in respect of infrastructure as well as non-infrastructure project loans. It implies that with effect from April 1, 2015, a standard account on restructuring (for reasons other than change in Date of Commencement of Commercial Operations (DCCO)) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

4.56 The guidelines issued by the Reserve Bank of India on restructuring of advances (other than those restructured under a separate set of guidelines issued by the Rural Planning and Credit Department (RPCD) of the RBI on restructuring of advances on account of natural calamities) are divided into the following four categories:

- Guidelines on restructuring of advances extended to industrial units.
- Industrial units under the Corporate Debt Restructuring (CDR) Mechanism.
- Small and Medium Enterprises (SME).
- All other advances.

In these four sets of guidelines on restructuring of advances, the differentiations were broadly made based on whether a borrower is engaged in an industrial activity or a non-industrial activity. In addition, an elaborate institutional mechanism was laid down for accounts restructured under CDR Mechanism.

4.57 In the backdrop of extraordinary rise in restructured standard advances, these prudential norms were further revised by taking into account the recommendations of the Working Group under the Chairmanship of Shri B. Mahapatra, to review the existing prudential guidelines on restructuring of advances by banks/financial institutions. The details of the institutional / organizational framework for CDR Mechanism and SME Debt Restructuring Mechanism are given in Annex - 4 to the RBI's Master Circular on "Prudential

Norms on Income Recognition, Asset Classification and Provisioning to Advances" dated July 1, 2015 to be read along with circular no. DBOD.BP. BC.No.45/21.04.132/2014-15.

4.58 The CDR Mechanism (Annex - 4 of the Master circular) will 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 this purpose. Further, banks are also encouraged to strengthen the co-ordination among themselves in the matter of restructuring of consortium / multiple banking accounts, which are not covered under the CDR Mechanism.**Key Concepts**

4.59 Key concepts used in these guidelines are defined in Annex – 5 to the RBI's Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning to Advances" dated July 1, 2015.

General Principles and Prudential Norms for Restructured Advances

4.60 The principles and prudential norms laid down in below given paragraphs are applicable to all advances including the borrowers, who are eligible for special regulatory treatment for asset classification.

Eligibility criteria for restructuring of advances

4.61 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories. Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re- classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring/ rescheduling/ renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

4.62 Normally, restructuring cannot take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

4.63 No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action. Banks should accelerate the recovery measures in respect of such accounts. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include

- The Return on Capital Employed.
- Debt Service Coverage Ratio.
- Gap between the Internal Rate of Return.
- Cost of Funds and
- The amount of provision required in lieu of the diminution in the fair value of the restructured advance.

4.64 The viability should be determined by the banks based on the acceptable viability parameters and benchmarks for each parameter determined by them. The benchmarks for the viability parameters adopted by the CDR Mechanism are given in the Appendix to Part – B of this Master Circular on “”Prudential Norms on Income Recognition, Asset Classification and Provisioning and individual banks may suitably adopt them with appropriate adjustments, if any, for specific sectors while restructuring of accounts in non-CDR cases.

4.65 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 willful defaulters, especially in old cases where the manner of classification of a borrower as a willful defaulter was not transparent, and satisfy itself that the borrower is in a position to rectify the willful default. The restructuring of such cases may be done with Board's approval, while for such accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group only.

4.66 BIFR cases are not eligible for restructuring without their express approval. 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.

Miscellaneous

4.67 The banks should decide on the issue regarding convertibility (into equity) option as a part of restructuring exercise whereby the banks / financial institutions shall have the right to convert a portion of the restructured amount into equity, keeping in view the statutory requirement under Section 19 of the Banking Regulation Act, 1949, (in the case of banks) and relevant SEBI Regulations.

4.68 Conversion of debt into preference shares should be done only as a last resort and such conversion of debt into equity/preference shares should, in any case, be restricted to a cap (say 10 per cent of the restructured debt). Further, any conversion of debt into equity should be done only in the case of listed companies.

4.69 Acquisition of equity shares / convertible bonds / convertible debentures in companies by way of conversion of debt / overdue interest can be done without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached.

However, this will be subject to reporting of such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular Department of Supervision by Banks (DSB) Return on Asset Quality. Nonetheless, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.

4.70 Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities, prescribed by the RBI, subject to periodical reporting to the RBI in the aforesaid DSB return.

4.71 Banks may consider incorporating in the approved restructuring packages creditor's rights to accelerate repayment and the borrower's right to pre pay. Further, all restructuring packages must incorporate 'Right to recompense' clause and it should be based on certain performance criteria of the borrower. In any case, minimum 75 per cent of the recompense amount should be recovered by the lenders and in cases where some facility under restructuring has been extended below base rate, 100 per cent of the recompense amount should be recovered.

4.72 As stipulating personal guarantee will ensure promoters' "skin in the game" or commitment to the restructuring package, promoters' personal guarantee should be obtained in all cases of restructuring and corporate guarantee cannot be accepted as a substitute for personal guarantee. However, corporate guarantee can be accepted in those cases where the promoters of a company are not individuals but other corporate bodies or where the individual promoters cannot be clearly identified.

Disclosures

4.73 With effect from the financial year 2012-13, banks are required to disclose in their published annual Balance Sheets, under 'Notes on Accounts' information relating to number of accounts and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the format given in Annex – 6 to the RBI circular. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately. 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. The disclosure format prescribed in Annex-6, *inter-alia*, includes the following:

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.

4.74 This implies that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either *ab initio* or on upgradation from NPA category) revert to the normal level on account of satisfactory performance during the prescribed period, such advances should no longer be required to be disclosed by banks as restructured accounts in the "Notes on Accounts" in their Annual Balance Sheets. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions.

4.75 It has been reiterated that the basic objective of restructuring is to preserve economic value of units, not ever greening of problem accounts. This can be achieved by banks and the borrowers only by careful assessment of the viability, quick detection of weaknesses in accounts and a time-bound implementation of restructuring packages. (Text of RBI Master circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertains to Advances" for Annex 1 to 6 is given in CD.)

Guidelines on Joint Lenders Forum (JLF) and Corrective Action Plan (CAP)

4.76 These guidelines are applicable for lending under Consortium and Multiple Banking Arrangements (MBA) [except instructions in paragraphs 4.77, 4.111, 4.118 and 4.119 below and in case of dissemination of Information, which are applicable in all cases of lending], and should be read with prudential norms on ‘Restructuring of Advances by banks’ as contained in Part B of this Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/ 21.04.048/2015-16 dated July 1, 2015 issued prudential guidelines on restructuring of advances by banks.

Formation of Joint Lenders’ Forum

4.77 Bank is required to classify the loan accounts into 3 categories as special mention accounts as given below:

1) SMA-0: Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress as given in appendix to Part C of Master Circular no. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/ 2015-16 dated July 1, 2015.

2) SMA-1: Principal or interest payment overdue between 31-60 days.

3) SMA-2: Principal or interest payment overdue between 61-90 days.

Banks are required to report credit information, including classification of an account as SMA to CRILC (Central Repository of Information on Large Credits) on all their borrowers having aggregate fund-based and non-fund based exposure of Rs.50 million and above. Except the exemption granted for Crop loans, interbank exposure and exposure to NABARD, SIDBI, EXIM Bank and NHB from reporting as per Reserve Bank of India circular no. DBOD.BP.BC.No.45/21.04.132/2014-15 dated October 21, 2014.

4.78 Reserve Bank of India vide circular no. DBOD.BP.BC.No.45/21.04.132/ 2014-15 dated October 21, 2014 clarified that bank must report Cash credit (CC) and Overdraft (OD) accounts, including overdraft arising out of devolved LCs/Invoked guarantees to CRILC as SMA 2 when these are 'out of order' for more than 60 days. Similarly, bills purchased or discounted (other than those backed by LCs issued by banks) and derivative exposures with receivables representing positive mark to market value remaining overdue for more than 60 days should be reported to CRILC as SMA-2.

4.79 Further, Banks should continue to report the credit information and SMA status to CRILC on loans including loans extended by their overseas branches. However, formation of JLF will not be mandatory in cases of offshore borrowers which do not have any presence in India, either by way of a subsidiary, parent or a group entity. Further, the inclusion of offshore lenders as part of JLF shall not be mandatory. Formation of JLF will not be mandatory on reporting of investment portfolio as SMA, except in cases of bonds/debentures acquired on private placement basis or due to conversion of debt under restructuring of advances.

1) Banks should mandatorily form a committee to be called Joint Lenders' Forum (JLF) if the aggregate exposure (AE) [fund based and non-fund based taken together] of lenders in that account is Rs 1000 million and above and the account is reported by any of the lenders to CRILC as SMA-2.

2) Lenders also have the option of forming a JLF even when the AE in an account is less than Rs.1000 million and/or when the account is reported as SMA-0 or SMA-1.

4.80 Existing Consortium Arrangement for consortium accounts will serve as JLF with the Consortium Leader as convener, for accounts under Multiple Banking Arrangements (MBA), the lender with the highest AE will convene JLF. In case of a borrower's request for formation of JLF, the account should be reported as SMA-0 on such request to CRILC and the lender should form the JLF immediately if the AE is Rs 1000 million and above. The formation of JLF is optional for other cases of SMA-0 reporting.

4. 81 All the lenders should formulate and sign an Agreement (which may be called JLF agreement) incorporating the broad rules for the functioning of the JLF. The Indian Banks' Association (IBA) has prepared a Master JLF agreement and operational guidelines for JLF which can be adopted by all lenders. JLF formation and subsequent corrective actions will be mandatory in accounts having AE of Rs.1000 million and above, in other cases also the lenders will have to monitor the asset quality closely and take corrective action for effective resolution as deemed appropriate.

Corrective Action Plan (CAP) by JLF

4.82 The options under Corrective Action Plan (CAP) by the JLF would generally include –

a) Rectification: Obtaining a specific commitment from the borrower to regularise the account so that the account comes out of SMA status or does not slip into the NPA category. Commitment should be supported by identifiable cash flows without loss or sacrifice to existing lenders, additional funding through equity/strategic investors. These measures without any changes to the terms and conditions of the loan.

b) Restructuring: At this stage, commitment from promoters for extending their personal guarantees along with their net worth statement supported by copies of legal titles to assets may be obtained along with a declaration that they would not undertake any transaction that would alienate assets without the permission of the JLF.

c) Recovery: Once the first two options at (a) and (b) above are seen as not feasible, due recovery process may be resorted to. The JLF may decide the best recovery process to be followed, among the various legal and other recovery options available, with a view to optimising the efforts and results.

4.83 The decisions agreed upon by a minimum of 60% of creditors by value and 50% of creditors by number in the JLF would be considered as the basis for proceeding with the restructuring of the account, and will be binding on all lenders under the terms of the ICA (Inter creditor agreement). However, if the JLF decides to proceed with recovery, the minimum criteria for binding decision, if any, under any relevant laws/Acts would be applicable.

4.84 The JLF is required to arrive at an agreement on the option to be adopted for CAP within 45 days from (i) the date of an account being reported as SMA-2 by one or more lender, or (ii) receipt of request from the borrower to form a JLF, with substantiated grounds, if it senses imminent stress. The JLF should sign off the detailed final CAP within the next 30 days from the date of arriving at such an agreement.

4.85 If the JLF decides on option of rectification or restructuring given above, but the account fails to perform as per the agreed terms under the option, the JLF should initiate recovery.

4.86 **Joint Lenders' Forum Empowered Group (JLF – EG)**

A. Sometimes Boards of the banks find it difficult to approve the decisions taken by JLF as the JLFs do not have senior level representations from the participating lenders. In this regard, it is clarified that, although RBI has not explicitly prescribed the level of representation in its guidelines, banks are expected to depute sufficiently empowered senior level officials for deliberations and decisions in the meetings of JLF.

B. Nevertheless, it has been decided that JLF will finalise the CAP and the same will be placed before an Empowered Group (EG) of lenders, which will be tasked to approve the rectification/restructuring packages under CAPs. The JLF-EG shall have the following composition:

   i. A representative each of SBI and ICICI Bank as standing members;

ii. A representative each of the top three lenders to the borrower. If SBI or ICICI Bank is among the top three lenders to the borrower, then a representative of the fourth largest or a representative each of the fourth and the fifth largest lenders as the case may be;

iii. A representative each of the two largest banks in terms of advances who do not have any exposure to the borrower; and

iv. The participation in the JLF-EG shall not be less than the rank of an Executive Director in a PSB or equivalent.

The JLF convening bank will convene the JLF-EG and provide the secretarial support to it.

Restructuring under JLF

4.87 If the JLF decide to restructure as CAP, it can be referred to CDR cell or restructure the same independent of CDR mechanism. For restructuring process refer Master Circular no. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 along with clarification issued by Reserve bank of India circular no. DBOD.BP.BC.No.45/21.04.132/2014-15 dated October 21, 2014.

Restructuring of Doubtful accounts under JLF

4.88 In terms of paragraph 4.3.6 of the circular DBOD.BP.BC.No.97/ 21.04.132/2013-14 dated February 26, 2014, while generally no account classified as doubtful should be considered by the JLF for restructuring, in cases where a small portion of debt is doubtful i.e. the account is standard/sub-standard in the books of at least 90% of creditors (by value), the account may then be considered under JLF for restructuring.

4.89 In partial modification of the above, it has been decided that a JLF may decide on restructuring of an account classified as 'doubtful' in the books of one or more lenders similar to that of SMA2 and sub-standard assets, if the account has been assessed as viable under the Technology Economic Viability (TEV) and the JLF-EG concurs with the assessment and approves the proposal.

Asset Classification Norms

4.90 While a restructuring proposal is under consideration by the JLF/CDR, the usual asset classification norm would continue to apply. The process of re-classification of an asset should not stop merely because restructuring proposal is under consideration by the JLF/CDR.

4.91 The auditor should also verify whether that in case a standard asset has been restructured, it has been downgraded to "substandard" asset immediately. As mentioned in paragraph 20.2.3 in Part – B of this Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning, the special asset classification benefit as given below has been withdrawn for all restructurings with effect from April 1, 2015 with the exception of provisions related to changes in Date of Commencement of Commercial Operations (DCCO) in respect of infrastructure and non-infrastructure project loans.

4.92 Incentive for quick implementation of a restructuring package, the special asset classification benefit on restructuring of accounts as per extant instructions would be available for accounts undertaken for restructuring under these guidelines, subject to adherence to the overall timeframe for approval of restructuring package detailed in paragraphs 27.3 and 27.4 of Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 to be read along with Reserve bank of India circular no. DBOD.BP.BC.No.45/ 21.04.132/ 2014-15 dated October 21, 2014 and implementation of the approved package within 90 days from the date of approval. The asset classification status as on the date of formation of JLF would be the relevant date to decide the asset classification status of the account after implementation of the final restructuring package.

Strategic Debt Restructuring:

4.93 RBI circular DBOD.BP.BC.No.97/21.04.132/2013-14 dated February 26, 2014 on "Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)", wherein change of management was envisaged as a part of restructuring of stressed assets. Paragraph 5.3 of the circular states that the general principle of restructuring should be that the shareholders bear the first loss rather than the debt holders. With this principle in view and also to ensure more 'skin in the game' of promoters, JLF/Corporate Debt Restructuring Cell (CDR) may consider the following options when a loan is restructured:

- Possibility of transferring equity of the company by promoters to the lenders to compensate for their sacrifices;
- Promoters infusing more equity into their companies;
- Transfer of the promoters' holdings to a security trustee or an escrow arrangement till turnaround of company. This will enable a change in management control, should lenders favour it.

4.94 It has been observed that in many cases of restructuring of accounts, borrower companies are not able to come out of stress due to operational/ managerial inefficiencies despite substantial sacrifices made by the lending banks. In such cases, change of ownership will be a preferred option. Further, under JLF and CDR mechanism, the restructuring package should also stipulate the timeline during which certain viability milestones (e.g. improvement in certain financial ratios after a period of time, say, 6 months or 1 year and so on) would be achieved. The JLF must periodically review the account for achievement/non-achievement of milestones and should consider initiating suitable measures including recovery measures as deemed appropriate. With a view to ensuring more stake of promoters in reviving stressed accounts and provide banks with enhanced capabilities to initiate change of ownership in accounts which fail to achieve the projected viability milestones, banks may, at their discretion, undertake a 'Strategic Debt Restructuring (SDR)' by converting loan dues to equity shares, which will have the following features:

(i) At the time of initial restructuring, the JLF must incorporate, in the terms and conditions attached to the restructured loan/s agreed with the borrower, an option to convert the entire loan (including unpaid interest), or part thereof, into shares in the company in the event the borrower is not able to achieve the viability milestones and/or adhere to 'critical conditions' as stipulated in the restructuring package. This should be supported by necessary approvals/authorisations (including special resolution by the shareholders) from the borrower company, as required under extant laws/regulations, to enable the lenders to exercise the said option effectively. Restructuring of loans without the said approvals/authorisations for SDR is not permitted. If the borrower is not able to achieve the viability milestones and/or adhere to the 'critical conditions' referred to above, the JLF must immediately review the account and examine whether the account will be viable by effecting a change in ownership. If found viable under such examination, the JLF may decide on whether to invoke the SDR, i.e. convert the whole or part of the loan and interest outstanding into equity shares in the borrower company, so as to acquire majority shareholding in the company;

(ii) Provisions of the SDR would also be applicable to the accounts which have been restructured before the date of this circular provided that the necessary enabling clauses, as indicated in the above paragraph, are included in the agreement between the banks and borrower;

(iii) The decision on invoking the SDR by converting the whole or part of the loan into equity shares should be taken by the JLF as early as possible but within 30 days from the above review of the account. Such decision should be well documented and approved by the majority of the JLF members (minimum of 60% of creditors by value and 50% of creditors by number);

(iv) In order to achieve the change in ownership, the lenders under the JLF should collectively become the majority shareholder by conversion of their dues from the borrower into equity. However the conversion by JLF lenders of their outstanding debt (principal as well as unpaid interest) into equity instruments shall be subject to the member banks' respective total holdings in shares of the company conforming to the statutory limit in terms of Section 19(2) of Banking Regulation Act, 1949;

(v) Post the conversion, all lenders under the JLF must collectively hold 51% or more of the equity shares issued by the company;

(vi) The share price for such conversion of debt into equity will be determined as per the method given para 4.95

(vii) Henceforth, banks should include necessary covenants in all loan agreements, including restructuring, supported by necessary approvals/authorisations (including special resolution by the shareholders) from the borrower company, as required under extant laws/regulations, to enable invocation of SDR in applicable cases;

(viii) The JLF must approve the SDR conversion package within 90 days from the date of deciding to undertake SDR;

(ix) The conversion of debt into equity as approved under the SDR should be completed within a period of 90 days from the date of approval of the SDR package by the JLF. For accounts which have been referred by the JLF to CDR Cell for restructuring in terms of paragraph 4.2 of circular DBOD.BP.BC.No.97/21.04.132/2013-14 dated February 26, 2014 cited above, JLF may decide to undertake the SDR either directly or under the CDR Cell;

(x) The invocation of SDR will not be treated as restructuring for the purpose of asset classification and provisioning norms;

(xi) On completion of conversion of debt to equity as approved under SDR, the existing asset classification of the account, as on the reference date indicated at para 4.95(ii) below, will continue for a period of 18 months from the reference date. Thereafter, the asset classification will be as per the extant IRAC norms, assuming the aforesaid 'stand-still' in asset classification had not been given. However, when banks' holding are divested to a new promoter, the asset classification will be as per the para 4.94(xiii) below;

(xii) Banks should ensure compliance with the provisions of Section 6 of Banking Regulation Act and JLF should closely monitor the performance of the company and consider appointing suitable professional management to run the affairs of the company;

(xiii) JLF and lenders should divest their holdings in the equity of the company as soon as possible. On divestment of banks' holding in favour of a 'new promoter', the asset classification of the account may be upgraded to 'Standard'. However, the quantum of provision held by the bank against the said account as on the date of divestment, which shall not be less than what was held as at the 'reference date', shall not be reversed. At the time of divestment of their holdings to a 'new promoter', banks may refinance the existing debt of the company considering the changed risk profile of the company without treating the exercise as 'restructuring' subject to banks making provision for any diminution in fair value of the existing debt on account of the refinance. Banks may reverse the provision held against the said account only when all the outstanding loan/facilities in the account perform satisfactorily during the 'specified period' (as defined in the extant norms on restructuring of advances), i.e. principal and interest on all facilities in the account are serviced as per terms of payment during that period. In case, however, satisfactory performance during the specified period is not evidenced, the asset classification of the restructured account would be governed by the extant IRAC norms as per the repayment schedule that existed as on the reference date indicated at para 4.95(ii) below, assuming that 'stand-still' / above upgrade in asset classification had not been given. However, in cases where the bank exits the account completely, i.e. no longer has any exposure to the borrower, the provision may be reversed/absorbed as on the date of exit;

(xiv) The asset classification benefit provided at the above paragraph is subject to the following conditions:

a) The ‘new promoter’ should not be a person/entity/subsidiary/associate etc. (domestic as well as overseas), from the existing promoter/promoter group. Banks should clearly establish that the acquirer does not belong to the existing promoter group; and

b) The new promoters should have acquired at least 51 per cent of the paid up equity capital of the borrower company. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own at least 26 per cent of the paid up equity capital or up to applicable foreign investment limit, whichever is higher, provided banks are satisfied that with this equity stake the new non-resident promoter controls the management of the company.

c) *Vide* circular dated 10th November, 2016, it has been decided to modify paragraph (xiv)(b) of circular DBR.BP.BC.No.101/21.04.132/2014-15 dated June 8, 2015 and paragraph 7 of circular DBR.BP.BC.No.82 / 21.04.132/2015-16 dated February 25, 2016 as under:

“The new promoter should have acquired atleast 26 percent of the paid up equity capital of the borrower company and shall be the single

largest shareholder of the borrower company. Further, the new promoter shall be in 'control' of the borrower company as per the definition of 'control' provided in the Companies Act 2013 / regulations issued by the Securities and Exchange Board of India / any other applicable regulations / accounting standards as the case may be."

In terms of extant instructions, JLFs are required to adhere to certain prescribed timelines during SDR process. In partial modification of the extant instructions, it is advised that the JLF can have flexibility in the time taken for completion of individual activities up to conversion of debt into equity in favour of lenders (i.e. up to 210 days from the review of achievement of milestones/critical conditions) as per the SDR 4 package approved by JLF. It is also clarified that the benefit of 'stand-still' in asset classification will apply from the reference date itself. However, if the targeted conversion of debt into equity shares does not take place within 210 days from the review of achievement of milestones/critical conditions, the benefit will cease to exist. Thereafter, the loans will be classified as per the conduct of the account as per the extant Income Recognition, Asset Classification and Provisioning norms.

It is clarified that 'stand-still' clause only applies to asset classification and banks shall not recognize income on accrual basis if the interest is not serviced within 90 days from the due date.

Banks shall make disclosures on invocation of SDR in annual financial statements as per the format given.

4.95 The conversion price of the equity shall be determined as per the guidelines given below:

(i) Conversion of outstanding debt (principal as well as unpaid interest) into equity instruments should be at a 'Fair Value' which will not exceed the lowest of the following, subject to the floor of 'Face Value' (restriction under section 53 of the Companies Act, 2013):

a) Market value (for listed companies): Average of the closing prices of the instrument on a recognized stock exchange during the ten trading days preceding the 'reference date' indicated at (ii) below;

b) Break-up value: Book value per share to be calculated from the company's latest audited balance sheet (without considering 'revaluation reserves', if any) adjusted for cash flows and financials post the earlier restructuring; the balance sheet should not be more than a year old. In case the latest balance sheet is not available this break-up value shall be Re.1.

(ii) The above Fair Value will be decided at a 'reference date' which is the date of JLF's decision to undertake SDR.

4.96 The above pricing formula under Strategic Debt Restructuring Scheme has been exempted from the Securities and Exchange Board of India (SEBI)

(Issue of Capital and Disclosure Requirements) Regulations, 2009 subject to certain conditions, in terms of SEBI (Issue of Capital and Disclosure Requirements) (Second Amendment) Regulations, 2015 notified *vide* the Gazette of India Extraordinary Part–III–Section 4, published on May 5, 2015. Further, in the case of listed companies, the acquiring lender on account of conversion of debt into equity under SDR will also be exempted from the obligation to make an open offer under regulation 3 and regulation 4 of the provisions of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 in terms of SEBI (Substantial Acquisition of Shares and Takeovers) (Second Amendment) Regulations, 2015. This has been notified vide the Gazette of India Extraordinary Part–III–Section 4 published on May 05, 2015. Banks should adhere to all the prescribed conditions by SEBI in this regard.

4.97 In addition to conversion of debt into equity under SDR, banks may also convert their debt into equity at the time of restructuring of credit facilities under the extant restructuring guidelines. However, exemption from regulations of SEBI, as detailed in paragraph 4.96 above, shall be subject to adhering to the guidelines stipulated in the above paragraphs.

4.98 Acquisition of shares due to such conversion will be exempted from regulatory ceilings/restrictions on Capital Market Exposures, investment in Para-Banking activities and intra-group exposure. However, this will require reporting to RBI (reporting to DBS, CO every month along with the regular DSB Return on Asset Quality) and disclosure by banks in the Notes to Accounts in Annual Financial Statements. Equity shares of entities acquired by the banks under SDR shall be assigned a 150% risk weight for a period of 18 months from the 'reference date' indicated in paragraph 4.95(ii). After 18 months from the 'reference date', these shares shall be assigned risk weights as per the extant capital adequacy regulations.

4.99 Equity shares acquired and held by banks under the scheme shall be exempt from the requirement of periodic mark-to-market (stipulated vide Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks) for the 18 month period indicated at para 4.94(xi).

4.100 Conversion of debt into equity in an enterprise by a bank may result in the bank holding more than 20% of voting power, which will normally result in an investor-associate relationship under applicable accounting standards. However, as the lender acquires such voting power in the borrower entity in satisfaction of its advances under the SDR, and the rights exercised by the lenders are more protective in nature and not participative, such investment may not be treated as investment in associate in terms of paragraph 10.2.3 of Annexure to circular DBOD.No.BP.BC.89/21.04.018/2002-03 dated March 29, 2003 on 'Guidelines on Compliance with Accounting Standards (AS) by Banks'.

4.101 With reference to the provisions contained in circular DBR.BP.BC.No. 101/21.04.132/2014-15 dated June 8, 2015 on "Strategic Debt Restructuring", it is advised that in cases of failure of rectification or restructuring as a CAP as decided by JLF in terms of paragraph 3 of circular DBOD.BP.BC.No.97/ 21.04.132/ 2013-14 dated February 26, 2014, JLF will have the option to initiate

SDR to effect change of management of the borrower company subject to compliance with the conditions as stated above.

Audit Procedure for Accounts falling under CDR Programme

4.102 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.

4.103 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.,

4.104 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.

4.105 Auditor has to examine whether the 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

4.106 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.

4.107 The auditor should examine whether 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.

4.108 The auditor should also verify whether that in case a standard asset has been restructured it has been downgraded to “substandard” asset. The auditor should also verify whether the 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.

Guidelines on Scheme for Sustainable Structuring of Stressed Assets (S4A)

4.109

- Resolution of large borrowal accounts which are facing severe financial difficulties may, inter-alia, require co-ordinated deep financial restructuring which often involves a substantial write-down of debt and/or making large provisions.
- In order to ensure that adequate deep financial restructuring is done to give projects a chance of sustained revival, the Reserve Bank, after due consultation with banks, has decided to facilitate the resolution of large accounts, which satisfy the conditions set out in the following paragraphs.
- Eligible Accounts

For being eligible under the scheme, the account (In respect of Securitisation Companies/ Reconstruction Companies (SCs/RCs), only those accounts are eligible which, in addition to meeting the listed criteria, have been acquired against consideration in cash only, i.e. not by issuing any Security Receipts) should meet all the following conditions:

(i) The project has commenced commercial operations;

(ii) The aggregate exposure (including accrued interest) of all institutional lenders in the account is more than Rs.500 crore (including Rupee loans, Foreign Currency loans/External Commercial Borrowings);

(iii) The debt meets the test of sustainability as outlined in Debt Sustainability below.

- Debt Sustainability

  A debt level will be deemed sustainable if the Joint Lenders Forum (JLF)/Consortium of lenders/bank conclude through independent techno-economic viability (TEV) that debt of that principal value amongst the current funded/non-funded liabilities owed to institutional lenders can be serviced over the same tenor as that of the existing facilities even if the future cash flows remain at their current level. For this scheme to apply, sustainable debt should not be less than 50 percent of current funded liabilities. This is referred to as Part A in paragraph 2 of Sustainable Debt below.

- Sustainable Debt

1. The resolution plan may involve one of the following options with regard to the post-resolution ownership of the borrowing entity:

   (a) The current promoter continues to hold majority of the shares or shares required to have control;

   (b) The current promoter has been replaced with a new promoter, in one of the following ways:

      (i) Through conversion of a part of the debt into equity under SDR mechanism which is thereafter sold to a new promoter;

      (ii) In the manner contemplated as per Prudential Norms on Change in Ownership of Borrowing Entities (Outside SDR Scheme);

   (c) The lenders have acquired majority shareholding in the entity through conversion of debt into equity either under SDR or otherwise and

      (i) allow the current management to continue or

      (ii) hand over management to another agency/professionals under an operate and manage contract.

   Note: Where malfeasance on the part of the promoter has been established, through a forensic audit or otherwise, this scheme shall not be applicable if there is no change in promoter or the management is vested in the delinquent promoter.

2. In any of the circumstances mentioned above, the JLF/consortium/bank shall, after an independent TEV, bifurcate the current dues of the borrower into Part A and Part B as described below;

   (a) Determine the level of debt (including new funding required to be sanctioned within next six months and non-funded credit facilities crystallising within next 6 months) that can be serviced (both interest and principal) within the respective residual maturities of existing debt, from all sources, based on the cash flows available from the current as well as immediately prospective (not more than six months) level of operations. For this purpose, free cash flows (i.e., cash flow from operations minus committed capital expenditure) available for servicing debt as per latest audited/reviewed financial statement will be considered. Where there is more than one debt facility, the maturity profile of each facility shall be that which exists on the date of finalising this resolution plan. For the purpose of determining the level of debt that can be serviced, the assessed free cash flow shall be allocated to servicing each existing debt facility in the order in which its servicing falls due. The level of debt so determined will be referred to as Part A in these guidelines.

(b) The difference between the aggregate current outstanding debt, from all sources, and Part A will be referred to as Part B in these guidelines.

(c) The security position of lenders will, however, not be diluted and Part A portion of loan will continue to have at least the same amount of security cover as was available prior to this resolution.

- The Resolution Plan

  - The Resolution Plan shall have the following features:

    (a) There shall be no fresh moratorium granted on interest or principal repayment for servicing of Part A.

    (b) There shall not be any extension of the repayment schedule or reduction in the interest rate for servicing of Part A, as compared to repayment schedule and interest rate prior to this resolution.

    (c) Part B shall be converted into equity/redeemable cumulative optionally convertible preference shares. However, in cases where the resolution plan does not involve change in promoter, banks may, at their discretion, also convert a portion of Part B into optionally convertible debentures. All such instruments will continue to be referred to as Part B instruments in this circular for ease of reference.

  - Valuation and marking to market

For the purpose of this scheme, the fair value for Part B instruments will be arrived at as per the following methodologies:

(a) Equity - 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. Equity shares for which current quotations are not available or where the shares are not listed on the stock exchanges, should be valued at the lowest value arrived using the following valuation methodologies:

- o Break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest audited balance sheet (which should not be more than one year prior to the date of valuation). In case the latest audited balance sheet is not available the shares are to be valued at Re.1 per company. The independent TEV will assist in ascertaining the break-up value.

- o Discounted cash flow method where the discount factor is the actual interest rate charged to the borrower plus 3 per cent, subject to floor of 14 per cent. Further, cash flows (cash flow available from the current as well as immediately prospective (not more than six months) level of operations) occurring within 85 per cent of the useful economic life of the project only shall be reckoned.

(b) Redeemable cumulative optionally convertible preference shares/ optionally convertible debentures - The valuation should be on discounted cash flow (DCF) basis. These will be valued with a discount rate of a minimum mark up of 1.5 per cent over the weighted average actual interest rate charged to the borrower for the various facilities. Where preference dividends are in arrears, no credit should be taken for accrued dividends and the value determined as above on DCF basis should be discounted further by at least 15 per cent if arrears are for one year, 25 per cent if arrears are for two years, so on and so forth (i.e., with 10 percent increments).

- Where the resolution plan does not involve a change in promoter or where existing promoter is allowed to operate and manage the company as minority owner by lenders, the principle of proportionate loss sharing by the promoters should be met. In such cases, lenders shall, therefore, require the existing promoters to dilute their shareholdings, by way of conversion of debt into equity /sale of some portion of promoter's equity to lenders, at least in the same proportion as that of part B to total dues to lenders. JLF/Consortium/bank should also obtain promoters' personal guarantee in all such cases, for at least the amount of Part A.

- The upside for the lenders will be primarily through equity/quasi equity, if the borrowing entity turns around. The terms for exercise of option for the conversion of preference shares/debentures to equity shall be clearly spelt out. The existing promoter or the new promoter, as the case may be, may have the right of first refusal in case the lenders decide to sell the share, at a price beyond some predetermined price. The lenders may also include appropriate covenants to cover the use of cash flows arising beyond the projected levels having regard to quasi-equity instruments held in Part B.

- Other important principles for this scheme are the following:

  (a) The JLF/Consortium/bank shall engage the services of credible professional agencies to conduct the TEV and prepare the resolution plan. While engaging professional agencies, the JLF/Consortium/bank shall ensure that the agency is reputed, truly independent/free from any conflict of interest, has proven expertise and will be in a position to safeguard the interest of lenders while preserving the economic value of the assets.

  (b) The resolution plan shall be agreed upon by a minimum of 75 percent of lenders by value and 50 percent of lenders by number in the JLF/ consortium/ bank.

  (c) At individual bank level, the bifurcation into Part A and part B shall be in the proportion of Part A to Part B at the aggregate level.

- Overseeing Committee

a) An Overseeing Committee (OC), comprising of eminent persons, will be constituted by IBA in consultation with RBI. The members of OC cannot be changed without the prior approval of RBI.

b) The resolution plan shall be submitted by the JLF/consortium/bank to the OC.

c) The OC will review the processes involved in preparation of resolution plan, etc. for reasonableness and adherence to the provisions of these guidelines, and opine on it.

d) The OC will be an advisory body.

- Asset Classification and Provisioning

(A) Where there is a change of promoter–

In case a change of promoter takes place, i.e. a new promoter comes in, the asset classification and provisioning requirement will be as per the 'SDR' scheme or 'outside SDR' scheme as applicable.

(B) Where there is no change of promoters –

(i) In view of the need to provide reasonable time to the overseeing committee to review the processes involved in the resolution plan, the Asset classification as on the date of lenders' decision to resolve the account under these guidelines (reference date) will continue for a period of 180 days from this date. This standstill clause is permitted to enable JLF/consortium/bank to formulate the resolution plan, submit the same to the overseeing committee formed under the guidelines and implement it.

Banks should normally submit the resolution plan to the overseeing committee within 90 days from the reference date. It is expected that the overseeing committee would review the processes involved in preparation of resolution plan, etc. for reasonableness and adherence to the provisions of these guidelines, and convey its final opinion on it within a period of 45 days. Subsequently, banks shall implement the resolution plan within the next 45 days. However, banks will have flexibility on the above time lines, within the overall period of 180 days. If the resolution plan is not implemented within this period, the asset classification will be as per the extant asset classification norms, assuming there was no such ‘stand-still’. It is clarified that ‘stand-still’ clause only applies to asset classification and banks shall not recognize income on accrual basis if the interest is not serviced within 90 days from the due date;

(ii) In respect of an account that is ‘Standard’ as on the reference date, the entire outstanding (both Part A and part B) may be treated as 'Standard' subject to provisions made upfront by the lenders being at least the higher of 40 percent of the amount held in part B or 20 percent of the aggregate outstanding (sum of Part A and part B). For this purpose, the provisions already held in the account can be reckoned. These provisions may be reversed one year after the date of implementing the resolution plan or one year after completion of the longest pre-existing moratorium, whichever is later, subject to satisfactory performance of Part A and Part B during this period.

(iii) In respect of an account that is classified as a non-performing asset as on the reference date, the Part B instruments shall continue to be classified as non- performing investment and provided for as a non-performing asset as per extant prudential norms, as long as such instruments remain in Part B. The sustainable portion (Part A) may optionally be treated as 'Standard' upon implementation of the resolution plan by all banks, subject to provisions made upfront by the lenders being at least the higher of 50 percent of the amount held in part B or 25 percent of the aggregate outstanding (sum of Part A and part B). For this purpose, the provisions already held in the account can be reckoned.

(iv) In all cases, lenders may upgrade Part B to standard category and reverse the associated enhanced provisions after one year of satisfactory performance of Part A loans. In case of any pre-existing moratorium in the account, this upgrade will be permitted one year after completion of the longest such moratorium, subject to satisfactory performance of Part A debt during this period.

However, in all cases, the required MTM provisions on Part B instruments must be maintained at all times. The transition benefit available in terms of paragraph 9(B)(vi) can however be availed.

Banks shall make disclosures in their annual financial statements on application of the Scheme for Sustainable Structuring of Financial Assets, as per the format in the Appendix. These disclosures shall be made with respect to the accounts under the observation period specified at (iv) above.

Disclosures on the Scheme for Sustainable Structuring of Stressed Assets (S4A), as on (INR Crore)

No. of accounts where S4A has been applied	Aggregate amount outstanding	Amount outstanding		Provision Held
		In Part A	In Part B	
Classified as Standard	XXXXX	XXXXX	XXXXX	XXXXX
Classified as NPA	XXXXX	XXXXX	XXXXX	XXXXX

(v) Any provisioning requirement on account of difference between the book value of Part B instruments and their fair value as indicated in para 7.2 ibid, in excess of the minimum requirements prescribed as per the above para (ii) and (iii), shall be made within four quarters commencing with the quarter in which the resolution plan is actually implemented in the lender's books, such that the MTM provision held is not less than 25 percent of the required provision in the first quarter, not less than 50 percent in the second quarter and so on. For this purpose, the provision already held in the account can be reckoned.

(vi) If the provisions held by the bank in respect of an account prior to this resolution are more than the cumulative provisioning requirement prescribed in the applicable sub-paragraphs above, the excess can be reversed only after one year from the date of implementation of resolution plan (i.e. when it is reflected in the books of the lender, hereinafter referred to as 'date of restructuring'), subject to satisfactory performance during this period.

(vii) The resolution plan and control rights should be structured in such a way so that the promoters are not in a position to sell the company/firm without the prior approval of lenders and without sharing the upside, if any, with the lenders towards loss in Part B.

(viii) If Part A subsequently slips into NPA category, the account will be classified with slippage in category with reference to the classification obtaining on the reference date and necessary provisions should be made immediately.

(ix) Where a bank/NBFC/AIFI chooses to make the prescribed provisions/write downs over more than one quarter and this results in the full provisioning/write down remaining to be made as on the close of a financial year, banks/NBFCs/AIFIs should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided/not written down at the end of the financial year, by credit to specific provisions. However, bank/NBFC/AIFI should proportionately reverse the debits to ‘other reserves’ and complete the provisioning/write down by debiting profit and loss account, in the subsequent quarters of the next financial year. Banks shall make suitable disclosures in Notes to Accounts with regard to the quantum of provision made during the year under this scheme and the quantum of unamortised provisions debited to ‘other reserves’ as at the end of the year.

- Mandatory Implementation

  Once the resolution plan prepared/presented by the lenders is ratified by the OC, it will be binding on all lenders. They will, however, have the option to exit as per the extant guidelines on Joint Lenders’ Forum (JLF) and Corrective Action Plan (CAP).

Timelines for Stressed Assets Resolution

4.110 RBI Circular DBR.BP.BC.No.67/21.04.048/2016-17 dated May 05, 2017 describes the timelines for stressed assets resolution.

- "Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)" aims at early identification of stressed assets and timely implementation of a corrective action plan (CAP) to preserve the economic value of stressed assets. In order to ensure that the CAP is finalised and formulated in an expeditious manner, the Framework specifies various timelines within which lenders have to decide and implement the CAP. The Framework also contains disincentives, in the form of asset classification and accelerated provisioning where lenders fail to adhere to the provisions of the Framework. Despite this, delays have been observed in finalising and implementation of the CAP, leading to delays in resolution of stressed assets in the banking system

- CAP can also include resolution by way of Flexible Structuring of Project Loans, Change in Ownership under Strategic Debt Restructuring, Scheme for Sustainable Structuring of Stressed Assets (S4A), etc.

- Lenders must scrupulously adhere to the timelines prescribed in the Framework for finalising and implementing the CAP. To facilitate timely decision making, it has been decided that, henceforth, the decisions agreed upon by a minimum of 60 percent of creditors by value and 50 percent of creditors by number in the JLF would be considered as the basis for deciding the CAP, and will be binding on all lenders, subject to the exit (by substitution) option available in the Framework. Lenders shall ensure that their representatives in the JLF are equipped with appropriate mandates, and that decisions taken at the JLF are implemented by the lenders within the timelines.

- It shall be noted that
  - (i) the stand of the participating banks while voting on the final proposal before the JLF shall be unambiguous and unconditional;
  - (ii) any bank which does not support the majority decision on the CAP may exit subject to substitution within the stipulated time line, failing which it shall abide the decision of the JLF;
  - (iii) the bank shall implement the JLF decision without any additional conditionalities; and
  - (iv) the Boards shall empower their executives to implement the JLF decision without requiring further approval from the Board.

Accelerated Provision Norms

4.111 In cases where banks fail to report SMA status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts or evergreen the account, banks will be subjected to accelerated provisioning for these accounts and/or other supervisory actions as deemed appropriate by RBI. The current provisioning requirement and the revised accelerated provisioning in respect of such non performing accounts are provided in para 31.1 of Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/ 21.04.048/ 2015-16 dated July 1, 2015.

4.112 Further, any of the lenders who have agreed to the restructuring decision under the CAP by JLF and is a signatory to the ICA and DCA, but changes their stance later on, or delays/refuses to implement the package, will also be subjected to accelerated provisioning requirement as indicated at para 31.1 of the aforementioned Master Circular, on their exposure to this borrower i.e., if it is classified as an NPA. If the account is standard in those lenders' books, the provisioning requirement would be 5%.

4.113 Presently, asset classification is based on record of recovery at individual banks and provisioning is based on asset classification status at the level of each bank. However, if lead bank or the bank with second largest AE as per Reserve bank of India circular no. DBOD.BP.BC.No.45/21.04.132/2014-15 dated October 21, 2014 fail to convene the JLF or fail to agree upon a common CAP within the stipulated time frame, the account will be subjected to accelerated provisioning as indicated at para 31.1 of the aforementioned Master Circular , if it is classified as an NPA. If the account is standard in those lenders' books, the provisioning requirement would be 5%.

4.114 If an escrow maintaining bank under JLF/CDR mechanism does not appropriate proceeds of repayment by the borrower among the lenders as per agreed terms resulting into down gradation of asset classification of the account in books of other lenders, the account with the escrow maintaining bank will attract the asset classification which is lowest among the lending member banks but will also be subjected to corresponding accelerated provision instead of normal provision. Further, such accelerated provision will be applicable for a period of one year from the effective date of provisioning or till rectification of the error, whichever is later.

Duration of application of extant penal provisions (5% in case of Standard account and accelerated provision in case of NPAs)

4.115 Penal provisions are applicable under certain cases vide circular DBOD.BP.BC.No.97/21.04.132/ 2013-14 dated February 26, 2014. While the duration of such penal provision has been specified in case of an escrow account maintaining bank which does not appropriate proceeds of repayment by the borrower among the lenders as per agreed terms resulting into down gradation of asset classification of the account in books of other lenders, the duration has not been prescribed in other cases. Banks are advised that the penal provisions in the other cases under the Framework will be applicable for the following durations:

Sl. No.	Reason for Penal Provision	Duration
(i)	Banks fail to report SMA status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts or	From the date of imposition of penal provision as advised by RBI Inspection/Statutory Auditor till one year or rectification of

	evergreen the account.	defect, whichever is later.
(ii)	Lenders who have agreed to the restructuring decision under the CAP by JLF and are signatories to the ICA and DCA, but change their stance later on, or delay/refuse to implement the package.	
(iii)	Lenders fail to convene the JLF or fail to agree upon a common CAP within the stipulated time frame.	
(iv)	Accelerated provision for existing loans/exposures of banks to companies having director/s (other than nominee directors of government/financial institutions brought on board at the time of distress), whose name/s appear more than once in the list of wilful defaulters.	From the date of notification as wilful defaulter in the list of wilful defaulters till the removal of the name from the list.

Disagreement on restructuring as CAP and Exit Option

4.116 In terms of para 10.3 of circular DBOD.BP.BC.No.45 / 21.04.132 / 2014-15 dated October 21, 2014 banks, irrespective of whether they are within or outside the minimum 75 per cent and 60 per cent, can exercise the exit option for providing additional finance only by way of arranging their share of additional finance to be provided by a new or existing creditor.

4.117 It has been brought to notice that sometimes disagreement arises among lenders on deciding the CAP on rectification or restructuring, resulting in delay in initiating timely corrective action. Although co-operation among lenders for deciding a CAP by consensus is desirable for timely turn-around of a viable account, it is also important to enable all lenders to have an independent view on the viability of account and consequent participation in rectification or restructuring of accounts, without allowing them to free ride on efforts made by others. In view of this, it has been decided that dissenting lenders who do not want to participate in the rectification or restructuring of the account as CAP, which may or may not involve additional financing, will have an option to exit their exposure completely by selling their exposure to a new or existing lender(s) within the prescribed timeline for implementation of the agreed CAP. The exiting lender will not have the option to continue with their existing exposure and simultaneously not agreeing for rectification or restructuring as CAP. The new lender to whom the exiting lender sells its stake may not be required to commit any additional finance, if the agreed CAP involves additional finance. In such cases, if the new lender chooses to not to participate in additional finance, the share of additional finance pertaining to the exiting lender will be met by the existing lenders on a pro-rata basis.

Wilful Defaulter and Non-Cooperative Borrower

4.118 The provisioning in respect of existing loans/exposures of banks to companies having director/s (other than nominee directors of government/financial institutions brought on board at the time of distress), whose name/s appear more than once in the list of wilful defaulters, will be 5% in cases of standard accounts; if such account is classified as NPA, it will attract accelerated provisioning as indicated at para 31.1 of Master Circular on Prudential Norms. This is a prudential measure since the expected losses on exposures to such borrowers are likely to be higher. It is reiterated that no additional facilities should be granted by any bank/FI to the listed wilful defaulters, in terms of paragraph 2.5 (a) of Master Circular on Wilful Defaulters dated July 1, 2015.

4.119 With a view to discouraging borrowers/defaulters from being unreasonable and non-cooperative with lenders in their *bona fide* resolution/recovery efforts, banks may classify such borrowers as non-cooperative borrowers, after giving them due notice if satisfactory clarifications are not furnished. Banks will be required to report classification of such borrowers to CRILC. Further, banks will be required to make higher/accelerated provisioning in respect of new loans/exposures to such borrowers as also new loans/exposures to any other company promoted by such promoters/ directors or to a company on whose board any of the promoter / directors of this non-cooperative borrower is a director. The provisioning applicable in such cases will be at the rate of 5% if it is a standard account and accelerated provisioning as per para 31.1 of Master Circular on Prudential Norms, if it is an NPA. Reporting of non-cooperative borrower has to be read along with Reserve Bank of India circular no. DBR.No.CID.BC.54/20.16.064/2014-15.

Relief for MSME borrowers registered under GST

4.120 The RBI has issued a circular dated February 07, 2018 granting relief for MSME Borrowers registered under GST, thus, the auditors needs to be vigilant as regards the applicability of the said circular and eligibility of the borrower. This circular applies only to borrowers which are classified as micro, small and medium enterprise under the MSMED Act, 2006. The exposure of banks to such borrowers would be classified as standard assets subject to conditions specified in the circular:

1. The borrower is registered under the GST regime as on January 31, 2018;
2. The aggregate exposure including non-fund-based facilities of banks and NBFCs, to the borrower does not exceed Rs. 25 crores as on January 31, 2018.

   Thus, the overall exposure of the borrower (including that of multiple banking, consortium banking) as on January 31, 2018 should not exceed Rs. 25 crores, i.e. the overall exposure of the borrower to banks and NBFCs combined should not exceed the cap of Rs. 25 crores.

Further, it is to be noted that as per RBI Master Circular on Exposure Norms – 'Exposure' shall include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The sanctioned limits or outstandings, whichever are higher, shall be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure.

3. The borrower's account should be standard account as on August 31, 2017.

   It would be pertinent to note that some banks may be following a system of marking of accounts as NPA in the system as at quarter-end instead of marking the accounts on on-going basis. However, the borrower account needs to be tested for classification purpose as on August 31, 2017 and in case if such account is a NPA account as per the extant of IRAC norms specified by RBI as on August 31, 2017, irrespective of the account being marked or not by the bank, such accounts will not be eligible for relief granted by this circular;

4. The amount from the borrower, overdue as on September 01, 2017 and payments from the borrower due between September 01, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due date.

   As per para 2.3 of Master Circular of RBI on IRAC norms – 'any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank'. Thus, the extension period of 180 days granted for the repayment of the overdue amount as on September 01, 2017 as well as the amounts due between the specified period is restricted to the extent of 180 days from the respective 'due date'. The words 'overdue' as well as 'due date' mentioned in the said clause are significant, since both are applicable in case of facilities other than CC/OD like Term Loan, Bill Discounting, etc. only and thus, are not relevant as far as CC/OD facilities are concerned as CC/OD accounts per se do not have the concept of 'overdue' but have concept of 'overdrawn' and, there is no 'due date' concept w.r.t. CC/OD account. Further, it is to be noted that a CC/OD account would qualify to be a NPA if the account remains 'out of order' as indicated in para 2.2 of the Master Circular of the RBI on IRAC Norms. Thus, the said extension granted is confined to the facilities which are other than CC/OD.

5. A provision of 5% shall be made against such exposures which are not classified as NPA (due to the relaxation as provided above), which otherwise would have been classified as NPA as per usual IRAC norms (of accounts overdue beyond 90 days period).
6. The additional time provided is for the purpose of asset classification only and not for income recognition.

Thus, if an account is otherwise eligible to be classified as NPA as per usual IRAC norms (of accounts overdue beyond 90 days period) but is classified as PA based on the above-mentioned relaxation granted, the income is required to be recognised on realisation basis and not on accrual basis.

Resolution of Stressed Assets – Revised Framework w.e.f. February 12, 2018

4.121 The RBI has issued a circular dated February 12, 2018 about 'Resolution of Stressed Assets – Revised Framework', wherein the existing provisions w.r.t. stress assets have been revised in entirety with discontinuation of various enabling provisions for retention of class of assets (under Corrective Action Plan (CAP), Strategic Debt Restructuring (SDR), Scheme for Sustainable Structuring of Stressed Assets (S4A). All accounts including the one where any of the schemes have been invoked but not yet implemented, shall be governed by revised framework.

4.122 RBI had put a comma for restructuring by discontinuing special regulatory treatment for Asset classification from 31 March 2015. However, the introduction / continuation of schemes like CAP, SDR, S4A, etc. allowed banks to keep accounts standard after restructuring. With the new guidelines issued on February 12, 2018, the RBI has overhauled the restructuring framework by discontinuing prevalent restructuring schemes like CAP, SDR, S4A, etc. The new framework goes one step ahead as it aims at resolution of stressed asset and not just restructuring. With the enactment of Insolvency & Bankruptcy Code, 2016 (IBC), the process of resolution in case of failure of restructuring can be expedited.

4.123 The key highlights of the Resolution of Stressed Assets – Revised Framework are as under;

1. Early identification and reporting of stress

a. Lenders shall identify emerging stress in loan accounts and categorise the same as under:

SMA Sub - Categories	Basis for classification – Principal or interest payment or any other amount wholly or partly overdue between
SMA – 0	1 – 30 days
SMA – 1	31 – 60 days
SMA – 2	61 – 90 days

b. The lenders to report credit information and SMA classification of all borrower entities in default with aggregate exposure of Rs.5 crore and above to CRILC

2. Implementation of resolution plan (RP)

a. All lenders should put Board approved policies for resolution of stressed assets under this framework with timelines.
b. Lenders (singly or jointly) shall initiate steps to cure the default.
c. The resolution plan may involve any of the following actions
    i. Regularisation of the account by payment of all overdues by borrower entity
    ii. Sale of exposures to other entities / investors

   iii. Change in ownership
   iv. Restructuring

d. RP shall be clearly documented by all lenders irrespective of (and including no) change in terms and conditions.

3. Implementation Conditions for RP

a. Borrower entity is no longer in default with any of the lenders
b. Resolution plan involves restructuring
   i. Completion of documentation by all lenders
   ii. New capital structure and / or revised terms and conditions of existing loans get reflected in books of all lenders and borrower.
c. RPs involving restructuring / change in ownership where exposure is Rs.100 crores and above:
   i. Independent Credit Evaluation (ICE) by authorized Credit rating agencies (CRA) of residual debt
   ii. Exposure of Rs. 500 Crore and above, ICE from two CRAs & that not more than Rs.500 Crore, ICE from one CRA
   iii. RP 4 or better shall be considered for implementation.
   iv. If ICE from more than one CRA all CRA should give RP4 or better
   v. Payment to CRA should be made by lenders (instead of borrower as per earlier norms)
   vi. ICE is applicable for all large accounts immediately (i.e., from February 12, 2018) irrespective whether restructuring is carried out before March 01, 2018.

4. Timelines for Large Accounts to be referred under IBC
    i. Aggregate exposure of Rs. 2000 crores and above on or after March 01, 2018 (reference date)
    ii. Resolution initiated in new or existing framework or restructured standard account, RP shall be implemented as per following timelines:
        i) Default on 1 March 2018 within 180 days
        ii) Default after 1 March 2018, within 180 days from default
    iii. If, RP not implemented within timeline then insolvency application under Insolvency and Bankruptcy Code, 2016 (IBC)within 15 days from date of expiry of timeline
    iv. RP implemented no default within specified period (one year from end of moratorium period or date by which 20% of principal and capitalised interest is repaid, whichever is later).
    v. If default during specified period referred file insolvency petition within 15 days of default
    vi. Default after specified period to be considered as Fresh default
    vii. Aggregate Exposure below 2000 crore & not less than Rs. 100 crore separate guidelines to be issued.
    viii. Borrower under Specific instructions by RBI, earlier instructions continue.

5. Prudential Norms applicable to any restructuring (whether under IBC or outside IBC framework:

i. During process of RP, usual asset classification norms continue to apply;
ii. Restructuring – Standard advance to be downgraded as NPA. NPA remain in existing bucket.
iii. Ageing criteria as per Extant norms continues.
iv. Upgraded based on
    i) Satisfactory performance during 'specified period'.
    ii) Aggregate Exposure of Rs.100 crore and above, satisfactory performance and Credit rating of BBB- or better at the end of specified period from CRA.
    iii) Aggregate Exposure of Rs.500 crore and above, credit rating by two CRAs and all ratings should be BBB- or better.
v. Default during specified period then NPA date will be reckoned as per pre-restructuring repayment schedule.
vi. Provisioning as per Extant IRAC norms.
vii. Existing restructured accounts as per norms applicable to existing restructuring schemes.
viii. Additional Finance – Classified as "Standard" during specified period. In case of default or non-upgradation as per restructured debt.
ix. Income recognition: For Restructured Standard asset, income would be recognized on Accrual basis and for Additional Finance to restructured NPA and Restructured NPA, income would be recognized on Cash basis, except in case wherein the restructuring is accompanied by change in ownership.

6. Conversion of principal into Debt / Equity & unpaid interest into FITL, Debt or Equity Instrument

   i. Asset classification – Same as per restructured account

   ii. Valuation

      i) Equity : Marked to Market , if quoted. Otherwise breakup value as per previous year balance sheet. If previous year balance sheet portfolio is valued at Re.1. No set off for depreciation with appreciation in other shares.

III. Unrealised income recognition

   ii) FITL / Debt : On sale or redemption

   iii) Unquoted Equity : On sale

   iv) Quoted equity : Market value of equity on date of upgradation not exceeding unrealized income.

7. Change in ownership

   In case of change in ownership, Advance can be classified as standard, if

   i. Acquirer is not a person disqualified as per IBC
   ii. New promoter holds 26% equity and largest shareholder
   iii. New promoter shall be in control of borrowing entity
   iv. RP implemented as per existing guidelines

   Such accounts, will continue to be classified as standard based on satisfactory performance during specified period. In case of default, the facilities would be classified as Sub standard and future upgradation would be contingent on implementation of fresh RP.

Provision held cannot be reversed till demonstration of satisfactory performance during specified period.

8. Sale & Leaseback transaction as restructuring will be treated as restructuring in case of debt of buyer and seller, if
   i. Seller is in financial difficulty; and,
   ii. More than 50% revenue of buyer from leased asset to seller; and,
   iii. 25% or more loan by buyer for purchase of asset are funded by lenders of seller

9. Refinancing of Exposure in foreign or Indian Currency

   Foreign Currency / Export Advances for the purpose of repayment of rupee loan to be treated as restructuring, if borrower is in financial difficulty and
   i. Foreign currency borrowing from Indian Banking System or based on BGs, LCs Letter of comfort from Indian banking System; or,
   ii. Rupee loans for refinancing

In case of extension of DCCO, the existing IRAC norms are applicable.

Upgradation of Loan Accounts Classified as NPAs

4.124 (i) If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as ‘standard’ accounts. Upgradation is allowed only if the account reaches “no overdues” status. This should not be misunderstood with “overdues brought within 90 days”. Upgradation of a restructured/ rescheduled/CDR accounts is governed by the restructuring / reschedulement/CDR norms as discussed later in the Chapter.

(ii) Auditor has to verify that any upgrading of accounts classified as ‘Sub-Standard’ or ‘Doubtful’ category wherein restructuring / re phasement of principal or interest has taken place should be upgraded to the ‘Standard Asset’ category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this period of one year should be recovered and there should be no overdues to make it eligible for upgradation. If the amount which has become due during this one year period is on a lower side *vis a vis* total amount outstanding, the other aspects of the account, *viz* financial performance, availability of security, operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.

(iii) Recovery in an advance which was rescheduled cannot give the advance a better classification than the previous one. NPA accounts can be upgraded to Performing Accounts, provided all overdue are adjusted

(iv) Upgradation within the NPA category is not permitted i.e. a Doubtful account cannot be made Sub-standard even if the overdue are reduced to less than 12 months.

Provisioning for Loans and Advances

4.125 The RBI's Master Circular of July 1, 2015 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances contains the principles to be followed by the bank in calculating the provisions required for the NPAs in conformity with the prudential norms. The circular also requires the bank to take into consideration aspects such as time lag between an account becoming an NPA, its recognition as such, realisation of security and the erosion over time in the value of security charged to the bank, while calculating the required amount of provision. The specific requirements of the Master Circular in respect of provisioning are as follows:

(a) ***Loss assets***

4.126 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***

4.127 The provisioning for doubtful assets under loans and advances is as under:

(i) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. Auditor should verify whether that the security is considered based on the latest information available with the bank. DICGC/ECGC cover is also taken into account (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***

4.128 A general provision of 15% on total outstanding should be made without making any allowance for DICGC/ECGC cover and securities available. Unsecured exposures, which are identified, as sub-standard would attract an additional provision of 10%. (i.e., total 25% of total outstanding). However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows. Unsecured exposure' is defined as an exposure (including all funded and non-funded exposures) where realisable value of the tangible security properly charged to the bank, as assessed by bank/approved valuers/RBI inspectors, is not more than 10%, *ab initio*, of the outstanding exposure. ‘Security’ means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc.

4.129 In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the following

RBI requirements are applicable from the financial year 2009-10 onwards:

a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.

b) However, banks may treat annuities under build-operate-transfer (BOT) model in respect of road / highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

c) It is noticed that most of the infrastructure projects, especially road/highway projects are user-charge based, for which the Planning Commission has published Model Concession Agreements (MCAs). These have been adopted by various Ministries and State Governments for their respective public-private partnership (PPP) projects and they provide adequate comfort to the lenders regarding security of their debt. In view of the above features, in case of PPP projects, the debts due to the lenders may be considered as secured to the extent assured by the project authority in terms of the Concession Agreement, subject to the following conditions

i) User charges / toll / tariff payments are kept in an escrow account where senior lenders have priority over withdrawals by the concessionaire;

ii) There is sufficient risk mitigation, such as pre-determined increase in user charges or increase in concession period, in case project revenues are lower than anticipated;

iii) The lenders have a right of substitution in case of concessionaire default;

iv) The lenders have a right to trigger termination in case of default in debt service; and

v) Upon termination, the Project Authority has an obligation of (i) compulsory buy-out and (ii) repayment of debt due in a pre-determined manner.

In all such cases, banks must satisfy themselves about the legal enforceability of the provisions of the tripartite agreement and factor in their past experience with such contracts.

d) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc., has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

4.130 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***

4.131 The bank is required to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. The general provision towards standard assets as per Master Circular is as follows:

a) Farm Credit to Agricultural and Small and Micro Enterprises (SMEs) sectors - 0.25%.

b) Advances to Commercial Real Estate (CRE) sector – 1.00%.

c) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent.

   For this purpose, CRE-RH would consist of loans to builders/developers for residential housing projects (except for captive consumption) under CRE segment. Such projects should ordinarily not include non-residential commercial real estate. However, integrated housing projects comprising of some commercial space (e.g. shopping complex, school, etc.) can also be classified under CRE-RH, provided that the commercial area in the residential housing project does not exceed 10% of the total Floor Space Index (FSI) of the project. In case the FSI of the commercial area in the predominantly residential housing complex exceeds the ceiling of 10%, the project loans should be classified as CRE and not CRE-RH.

d) Housing loans extended at teaser rates– 2.00%- The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain ‘standard’.

e) In terms of RBI Circular No. RBI/2016-17/317-DBR.BP.BC.No. 72/08.12.015/2016-17 dated June 7,2017, the bank should make standard asset provision of 0.25% on individual housing loan sanctioned on or after 7th June 2017. In respect of individual housing loan sanctioned before that date provisions @ 0.40% is required to be made on standard assets in terms of Circular No. DBR.BP.BC.No.44/ 08.12.015/ 2015-16 dated October 8, 2015.

f) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

As per para 17.4.1 of IRAC Norms, with effect from April 1, 2016 provision on new restructured standard accounts would be made at 5 per cent. The phased manner plan for increase in the provision to 5 per cent was in existence till March 31, 2016.

All other loans and advances not included in (a), (b), (c), (d) and (e) above - 0.40%.

4.132 It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular on Lending to Micro, Small & Medium Enterprises (MSME) Sector.

4.133 While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning, *vis-a-vis* the position as on any previous date, should be determined on an aggregate basis. If the provisions required to be held on an aggregate basis are less than the provisions held as on November 15, 2008, the provisions rendered surplus should not be reversed to P&L account but should continue to be maintained at the level, existed as on November 15,

2008. In case of shortfall determined on aggregate basis, the balance should be provided for by debit to P&L account.

4.134 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.

4.135 Banks shall make additional provision of 2% (in addition to country risk provision that is applicable to all overseas exposures) against standard assets representing all exposures to the step-down subsidiaries of Indian companies, to cover the additional risk arising from complexity in the structure, location of different intermediary entities in different jurisdictions exposing the Indian company, and hence the bank, to greater political and regulatory risk. All the step-down subsidiaries, including the intermediate ones, must be wholly owned subsidiary of the immediate parent company or its entire shares shall be jointly held by the immediate parent company and the Indian parent company and / or its wholly owned subsidiary. The immediate parent should, wholly or jointly with Indian parent company and / or its wholly owned subsidiary, have control over the step-down subsidiary.

4.136 A high level of unhedged foreign currency exposures of the entities can increase the probability of default in times of high currency volatility. Hence, banks are required to estimate the riskiness of unhedged position of their borrowers as per the instructions contained in RBI circular

DBOD.No.BP.BC.85/21.06.200/2013-14 dated January 15, 2014 and circular DBOD.No.BP.BC.116/21.06.200/2013-14 dated June 3, 2014 and make incremental provisions on their exposures to such entities:

Likely Loss / EBID (%)	**Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning**
Upto 15 per cent	0
More than 15 per cent and upto 30 per cent	20 bps
More than 30 per cent and upto 50 per cent	40 bps
More than 50 per cent and upto 75 per cent	60 bps
More than 75 per cent	80 bps

Provisioning requirements for derivative exposures

4.137 Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

Provisioning Norms for Leased Assets

4.138

i) Substandard assets

  a) 15 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms ‘net investment in the lease’, ‘finance income’ and ‘finance charge’ are as defined in ‘AS 19 Leases’ issued by the ICAI.

  b) Unsecured lease exposures which are identified as ‘substandard’ would attract additional provision of 10 per cent, i.e., a total of 25 per cent.

ii) Doubtful and

iii) Loss assets

This is same as for Loan Assets.

Provisioning Coverage Ratio

4.139

i. Provisioning Coverage Ratio (PCR) is essentially the ratio of provisioning to gross non-performing assets and indicates the 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.

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 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" dated July 1, 2015; 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. As a countercyclical measure, vide RBI circular No. DBOD.No.BP. 95/21.04.048/2013-14 on "Utilisation of Floating Provisions/Counter Cyclical Provisioning Buffer" dated February 7, 2014 banks were permitted to utilise upto 33 per cent of countercyclical provisioning buffer / floating provisions held by them as on March 31, 2013, for making specific provisions for non-performing assets, as per the policy approved by their Board of Directors

d. banks are required to build up 'Dynamic Provisioning Account' during good times and utilize the same during downturn. Under the proposed framework, banks are expected to either compute parameters such as probability of default, loss given default, etc. for different asset classes to arrive at long term average annual expected loss or use the standardized parameters prescribed by RBI towards computation of Dynamic Provisioning requirement. Dynamic loan loss provisioning framework is expected to be in place with improvement in the system. Meanwhile, banks should develop necessary capabilities to compute their long term average annual expected loss for different asset classes, for switching over to the dynamic provisioning framework.

iii. 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

4.140 While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities the bank should follow the AS 19 on "Leases" issued by ICAI in accounting for lease transactions.

Provisioning for Certain Specific Types of Advances

4.141 The guidelines also deal with provisioning for certain specific types of advances as follows.

Advances Guaranteed by ECGC

4.142 In the case of advances guaranteed by ECGC, provision should be made only for the balance in excess of the amount of such guarantee. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then provision should be made. (For examples on calculation of the provision, refer the Master Circular on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2015)

Advance covered by guarantees of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH)

4.143 In case the advance covered by CGTMSE or CRGFTLIH guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non- performing advances. For illustrative examples of provisioning in case of advances covered by CGTSI guarantee, refer the paragraph 5.9.5 of the Master Circular No. on Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2015.

4.144 After statutory audit, RBI conducts annual financial inspection of banks. Auditors may go through the divergence reported by RBI, if any, in terms of classification as well as provisioning and whether the same divergence has been appropriately addressed /clarified, by Banks. Accordingly auditor would be well advised to consider these aspects while take final view on classification /provisioning of such accounts.

Treatment of interest suspense account

4.145 Amounts held in Interest Suspense Account should not be reckoned as part of provisions. Amounts lying in the Interest Suspense Account should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

Disclosures

4.146 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".

Provisioning Norms

Normal provisions

4.147 Banks will hold provision against these advances as per the existing provisioning norms.

Income Recognition

4.148 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.

Reserve for Exchange Rate Fluctuations Account (RERFA)

4.149 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

4.150 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

4.151 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).

4.152 Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction company (RC) –

(i) When a bank / FI sells its financial assets to SC/ RC, on transfer the same will be removed from its books.

(ii) If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year. Banks can also use countercyclical / floating provisions for meeting any shortfall on sale of NPAs i.e., when the sale is at a price below the net book value (NBV).

However, for assets sold on or after February 26, 2014 and upto March

31, 2015, as an incentive for early sale of NPAs, banks can spread over any shortfall, if the sale value is lower than the NBV, over a period of two years. This facility of spreading over the shortfall will be subject to necessary disclosures in the Notes to Account in Annual Financial Statements of the banks. The RBI vide Notification dated May 21, 2015 had decided to extend this dispensation for assets sold on or after March 31, 2015 and up to March 31, 2016

Further RBI has vide notification DBR.No.BP.BC.102/21.04.048/2015-16 dated June 13, 2016 has decided to extend the dispensation of amortising the shortfall up to March 31, 2017. However for the assets sold from the period April 1, 2016 to March 31, 2017, banks will be allowed to amortise the shortfall over a period of only four quarter from the quarter in which the sale took place.

Further, where a bank chooses to make the necessary provisions over more than one quarter and this results in the full provisioning remaining to be made as on the close of a financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year, by credit to specific provisions. However, banks should proportionately reverse the debits to ‘other reserves’ and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

Banks shall make suitable disclosures in Notes to Accounts with regard to the quantum of provision made during the year to meet the shortfall in sale of NPAs to SCs/RCs and the quantum of unamortised provision debited to 'other reserves' as at the end of the year.

(iii) For assets sold on or after February 26, 2014, banks can reverse the excess provision on sale of NPAs, if the sale value is for a value higher than the NBV, to its profit and loss account in the year the amounts are received. However, banks can reverse excess provision arising out of sale of NPAs only when the cash received (by way of initial consideration and / or redemption of SRs / PTCs) is higher than the net book value (NBV) of the asset. Further, reversal of excess provision will be limited to the extent to which cash received exceeds the NBV of the asset. With regard to assets sold before February 26, 2014, excess provision, on account of sale value being higher than NBV, should not be reversed but should be utilized to meet the shortfall/ loss on account of sale of other financial assets to SC/RC.

(iv) When banks/ FIs invest in the security receipts/ pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks / FIs at the lower of:

- the redemption value of the security receipts/ pass-through certificates, and
- the NBV of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with in the same manner as at (ii) and (iii) above.

4.153 All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/ RC in which banks/ FIs invest will be in the nature of non SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/ FI's investment in debentures/ bonds/ security receipts/PTCs issued by SC/ RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/ FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

4.154 Banks'/ FIs' investments in debentures/ bonds/ security receipts/PTCs issued by a SC/RC will constitute exposure on the SC/RC. As only a few SC/RC are being set up now, banks'/ FIs' exposure on SC/RC through their investments in debentures/ bonds/security receipts/PTCs issued by the SC/ RC may go beyond their prudential exposure ceiling. In view of the extra ordinary nature of event, banks/ FIs will be allowed, in the initial years, to exceed prudential exposure ceiling on a case-to-case basis.

4.155 Banks/ FIs, which sell their financial assets to an SC/ RC, shall be required to make the disclosures in the Notes on Accounts to their Balance sheets. For guidelines on the presentation of the disclosures, refer para 6.6 of the master circular BR.No.BP.BC.2/21.04.048/2015-16 - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

4.156 Prudential Guidelines on provisioning in case of Revitalising Stressed Assets in the Economy.

Pursuant to the RBI notification DBR.BP.BC.No.82/ 21.04.132 / 2015-16 dated February 25, 2016 on Review of Prudential Guidelines- Revitalising Stressed Assets in the Economy, the classification of the advances and provisioning thereon will be as follows:

Category A-

In case the lender agreed to Corrective Action Plan (CAP) in the Joint Leander Forum (JLF) meeting and also conveyed final approval to the CAP within the stipulated period.

Asset classification- As per the extant asset classification norms

Provisioning- As per the extant provisioning norms.

Category-B

In case the lender agreed to CAP as approved in the JLF meeting but conveyed final approval and signed off the detailed final CAP after the stipulated period but within the prescribed implementation period.

Asset classification: Lowest asset classification of the borrower among all the JLF lenders. **Provisioning-** A penal provisioning of 10 per cent in addition to provisioning applicable as per Lowest asset classification of the borrower with any JLF lender, for one year from the date of sign off of CAP.
Category-C In case the lender agreed to CAP, as approved, in the JLF meeting but failed to convey final approval and sign off the detailed final CAP within prescribed implementation period. **Asset classification:** Lowest asset classification of the borrower among all the JLF lenders. **Provisioning:** A penal provisioning of 15 per cent in addition to provisioning applicable as per Lowest asset classification of the borrower with any JLF lender, for one year from the date of sign off of CAP. As the prescribed implementation period is over, the lender has to compulsorily abide by the terms of the approved CAP.

4.157 RBI vide their circular dated 1 September 2016 has issued guidelines on Sale of Stressed Assets by Banks. In terms of these guidelines, the Board of the bank need to lay down detailed policies and guidelines on sale of stressed assets to SC/ RC which should, *inter alia*, cover the following aspects:

i. Financial assets to be sold.

ii. Norms and procedure for sale for such financial assets.

iii. Valuation procedure to be followed to ensure that the realisable value of financial assets is reasonably estimated.

iv. Delegation of powers of various functionaries for taking decision on the sale of the financial assets; etc.

Auditors need to ensure that the Bank comply with the RBI Guidelines issued on 1 September vide circular number RBI/2016-17/56 DBR.No.BP.BC.9/ 21.04.048/2016-17. In addition to the existing disclosure, Banks need to comply with the disclosure requirement in this circular.

4.158 *Disclosure Requirements*

A. Details of financial assets sold to SC/RC: (Amounts in Rupees crore)

1. No. of accounts sold
2. Aggregate outstanding (net of provisions)
3. Aggregate consideration received
4. Additional consideration realized in respect of accounts transferred in earlier years
5. Aggregate gain / loss over net book value

B. Details of Book Value of investments in Security receipts (Amounts in Rupees crore)

1. Book Value of investments in Security receipts - Backed by NPA's sold by bank as underlying
2. Book Value of investments in Security receipts – Backed by NPA's sold by other banks / financial institutions/ non – banking financial companies as underlying
3. Totals of above

Other Aspects

4.159 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

4.160 RBI mandates banks to hold floating provisions in respect of "Advances" as well as "Investments" separately. The Master Circular of July 1, 2015 on Prudential Norms 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.

4.161 It is 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, Market and Credit. Under general category, there can be 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 category would include events such as a general melt down in the markets, which affects the entire financial system. Among the credit category, only exceptional credit losses would be considered as an extra-ordinary circumstance.

4.162 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. 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.

Additional Provisions for NPAs at higher than prescribed rates

4.163 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. The additional provisions for NPAs, like the minimum regulatory provision on NPAs, may be netted off from gross NPAs to arrive at the net NPAs.

Loss Assets

4.164 Every bank should have board approved policy for classification of advance account as Loss Asset. The Auditor should review the policy and ensure that all important criteria for classification of account as Loss Asset is covered in policy.

Further, the Bank should consistently apply policy to all advance accounts and in case of any deviation same also need to be approved by board. The auditor should ensure compliance with policy of classification of account as Loss Asset.

Write-off of NPAs

4.165 The banks should either make full provision as per the guidelines or write off the advances and claim the tax benefits as are applicable, by evolving appropriate methodology in consultation with their auditors/tax consultants. Recoveries made in such accounts should be offered for tax purposes as per the rules. Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of loss assets 100% provision shall be made.

Guidelines on Sale/Purchase of NPAs

4.166 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.

4.167 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.

4.168 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.

4.169 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.

4.170 A bank may purchase/sell nonperforming financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the nonperforming financial assets should be transferred to the purchasing bank. Selling bank shall ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank and after the sale there should not be any known liability devolving on the selling bank.

4.171 Banks should ensure that subsequent to sale of the non-performing financial assets to other banks. They do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

4.172 Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing banks, the selling banks would have to bear a part of the shortfall. Further, NPAs can be sold to other banks only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

4.173 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.

4.174 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.

4.175 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.

4.176 Prudential norms for banks for the purchase/sale transactions issued by RBI, from time to time, should be adhered to.

4.177 As per the Master Circular on Prudential Norms on Advances dated July 1, 2015, if the sale is in respect of Standard Asset and the sale consideration is higher than the book value, the excess provisions may be credited to Profit and Loss Account. Excess provisions which arise on sale of NPAs can be admitted as Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted

Assets. Accordingly, these excess provisions that arise on sale of NPAs would be eligible for Tier II status.

Asset Classification Norms

4.178 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

4.179 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

4.180 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

4.181 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

4.182 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

4.183 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

4.184 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 non-performing financial assets purchased:

(Amounts in Rupees crore)

1. (a) No. of accounts purchased during the year

   (b) Aggregate outstanding

2. (a) Of these, number of accounts restructured during the year

   (b) Aggregate outstanding

B. Details of nonperforming financial assets sold:

(Amounts in Rupees crore)

1. No. of accounts sold
2. Aggregate outstanding
3. Aggregate consideration received
4. Additional consideration realized in respect of accounts transferred in earlier years
5. Aggregate gain / loss over net book value

C. Details of Book Value of investments in Security receipts (Amounts in Rupees crore)

1. Book Value of investments in Security receipts - Backed by NPA's sold by bank as underlying
2. Book Value of investments in Security receipts – Backed by NPA's sold by other banks / financial institutions/ non – banking financial companies as underlying
3. Totals of above

The purchasing bank shall furnish all relevant reports to RBI, Credit Information Company which has obtained Certificate of Registration from RBI and of which the bank is a member etc. in respect of the nonperforming financial assets purchased by it.

Auditor's Report in case of Bank Borrowers

4.185 The RBI *vide* its circular no. DBOD.No. CAS(COD)BC.146/27-77 dated December 22, 1977 had prescribed that all borrowers having credit limit of Rs.10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. Further the RBI vide its circular DBOD.No.BP.BC.33/21.04.018/2002-03 dated October 21, 2002 has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

Sale/ Purchase of NPAs

4.186 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.

4.187 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.

4.188 In case of sale of an NPA, the auditor should also examine that:

(i) on the sale of the NPA, the same has been removed from the books of the account.

(ii) the short fall in the net book value (NBV) has been charged to the profit and loss account.

(iii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss on account of sale of other non-performing financial assets.

4.189 Similarly, in case of purchase of NPAs, the auditor should verify that:

(i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the selling bank.

(ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.

(iii) for the purpose of capital adequacy, banks has assigned 100% risk weights to the NPAs purchased from other banks.

Verification of Provision for Non-performing assets

4.190 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 familiarise himself fully with the norms prescribed by RBI in this regard. 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. Provisions of section 15 of the Banking Regulation Act, 1949, which applies to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks, the bank concerned should make adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

4.191 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.

4.192 As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the satisfaction of Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

4.193 The statutory auditors should consider the issues emerging from recent RBI inspections and obtain an understanding of changes made by the banks pursuant to the inspection process to enhance their identification of NPA. Further, the audit procedures should be suitably re-designed to consider such issues. It is to be examined whether 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 sample of loans selected during the statutory audit should have greater considerations of large corporate borrowers in Special Mention Accounts II (SMA-II) Category, projects where implementation is delayed and accounts subjected to any form of restructuring. The date of NPA is of significant importance to determine the classification and hence specific care be taken in this regard. The regularisation and / or closure of account subsequent to the date of balance sheet will not have any impact on improvisation of the classification of advance as on the date of NPA.

Projects under Implementation

4.194 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

4.195 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.

4.196 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

4.197(i) A loan for an infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(ii) A loan for an infrastructure project will be classified as NPA if it fails to commence commercial operations within two years from the original DCCO, even if it is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(iii) If a project loan classified as 'standard asset' is restructured any time during the period up to two years from the original date of commencement of commercial operations (DCCO), in accordance with the provisions of Part B of this Master Circular, it can be retained as a standard asset if the fresh DCCO is fixed within the following limits, and further provided the account continues to be serviced as per the restructured terms.

(a) Infrastructure Projects involving court cases

Up to another 2 years (beyond the existing extended period of 2 years i.e. total extension of 4 years), in case the reason for extension of date of commencement of production is arbitration proceedings or a court case.

(b) Infrastructure Projects delayed for other reasons beyond the control of promoters

Up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years), in other than court cases.

(iv) It is re-iterated that the dispensation is subject to adherence to the provisions regarding restructuring of accounts as contained in the Master Circular which would *inter alia* require that the application for restructuring should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.

The other conditions applicable would be:

a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond two years from the original DCCO, considering the high risk involved in such restructured accounts.

b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Particulars	Provisioning Requirement
If the revised DCCO is within two years from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond two years and upto four years or three years from the original DCCO, as the case may be, depending upon the reasons for such delay	Project loans restructured with effect from June 1, 2013: 5.00 per cent – From the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later Stock of project loans classified as restructured as on June 1, 2013: • 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14) • 4.25 per cent - with effect from March 31, 2015 (spread over the

four quarters of 2014-15)

- 5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

The above provisions will be applicable from the date of restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later.

(v) For the purpose of these guidelines, mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of two years from the original DCCO. In such cases the consequential shift in repayment period by equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO would also not be considered as restructuring provided all other terms and conditions of the loan remain unchanged.

(vi) In case of infrastructure projects under implementation, where Appointed Date (as defined in the concession agreement) is shifted due to the inability of the Concession Authority to comply with the requisite conditions, change in date of commencement of commercial operations (DCCO) need not be treated as 'restructuring', subject to following conditions:

a. The project is an infrastructure project under public private partnership model awarded by a public authority;

b. The loan disbursement is yet to begin;

c. The revised date of commencement of commercial operations is documented by way of a supplementary agreement between the borrower and lender; and

d. Project viability has been reassessed and sanction from appropriate authority has been obtained at the time of supplementary agreement.

Change in Ownership

4.198

i. In order to facilitate revival of the projects stalled primarily due to inadequacies of the current promoters, if a change in ownership takes place any time during the periods quoted in paragraphs 4.2.15.3 of the circular or before the original DCCO, banks may permit extension of the DCCO of the project up to two years in addition to the periods quoted at paragraph 4.2.15.3 of the circular as the case may be, without any change in asset classification of the account subject to the conditions stipulated in the following paragraphs. Banks may also consequentially shift/extend repayment schedule, if required, by an equal or shorter duration.

ii. In cases where change in ownership and extension of DCCO (as indicated in paragraph 4.2.15.5 (i) of the circular) takes place before the original

DCCO, and if the project fails to commence commercial operations by the extended DCCO, the project will be eligible for further extension of DCCO in terms of guidelines quoted at paragraph 4.2.15.3 of the circular. Similarly, where change in ownership and extension of DCCO takes place during the period quoted in paragraph 4.2.15.3 (i) of the circular, the account may still be restructured by extension of DCCO in terms of guidelines quoted at paragraph 4.2.15.3 (ii) of the circular, without classifying the account as non-performing asset.

iii. The provisions of paragraphs 4.2.15.4 (i) and 4.2.15.4 (ii) of the circular are subject to the following conditions:

a. Banks should establish that implementation of the project is stalled/affected primarily due to inadequacies of the current promoters/management and with a change in ownership there is a very high probability of commencement of commercial operations by the project within the extended period;

b. The project in consideration should be taken-over/acquired by a new promoter/promoter group with sufficient expertise in the field of operation. If the acquisition is being carried out by a special purpose vehicle (domestic or overseas), the bank should be able to clearly demonstrate that the acquiring entity is part of a new promoter group with sufficient expertise in the field of operation;

c. The new promoters should own at least 51 per cent of the paid up equity capital of stake in the acquired project. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own atleast 26 per cent of the paid up equity capital or up to applicable foreign investment limit, whichever is higher, provided banks are satisfied that with this equity stake the new non-resident promoter controls the management of the project;

d. Viability of the project should be established to the satisfaction of the banks;

e. Intra-group business restructuring/mergers/acquisitions and/or takeover/acquisition of the project by other entities/subsidiaries/ associates etc. (domestic as well as overseas), belonging to the existing promoter/promoter group will not qualify for this facility. The banks should clearly establish that the acquirer does not belong to the existing promoter group;

f. Asset classification of the account as on the 'reference date' would continue during the extended period. For this purpose, the 'reference date' would be the date of execution of preliminary binding agreement between the parties to the transaction, provided that the acquisition/takeover of ownership as per the provisions of law/regulations governing such acquisition/takeover is completed within a period of 90 days from the date of execution of preliminary binding agreement. During the intervening period, the usual asset classification norms would continue to apply. If the change in ownership is not completed within 90 days from the preliminary binding agreement, the 'reference date' would be the effective date of acquisition/takeover as per the provisions of law/regulations governing such acquisition/takeover;

g. The new owners/promoters are expected to demonstrate their commitment by bringing in substantial portion of additional monies required to complete the project within the extended time period. As such, treatment of financing of cost overruns for the project shall be subject to the guidelines prescribed in paragraph 13 of the circular. Financing of cost overrun beyond the ceiling prescribed in paragraph 13 of the circular would be treated as an event of restructuring even if the extension of DCCO is within the limits prescribed above;

h. While considering the extension of DCCO (up to an additional period of 2 years) for the benefits envisaged hereinabove, banks shall make sure that the repayment schedule does not extend beyond 85 per cent of the economic life/concession period of the project; and

i. This facility would be available to a project only once and will not be available during subsequent change in ownership, if any.

iv. Loans covered under this guideline would attract provisioning as per the extant provisioning norms depending upon their asset classification status.

Project Loans for Non-Infrastructure Sector

4.199(i) A loan for a non-infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (iv) below.

(ii) A loan for a non-infrastructure project will be classified as NPA if it fails to commence commercial operations within one year from the original DCCO, even if is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (iv) below.

(iii) In case of non-infrastructure projects, if the delay in commencement of commercial operations extends beyond the period of one year from the date of completion as determined at the time of financial closure, banks can prescribe a fresh DCCO, and retain the "standard" classification by undertaking restructuring of accounts in accordance with the provisions contained in this Master Circular, provided the fresh DCCO does not extend beyond a period of two years from the original DCCO. This would among others also imply that the restructuring application is received before the expiry of one year from the original DCCO, and when the account is still "standard" as per the record of recovery.

The other conditions applicable would be:

a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond one year from the original DCCO, considering the high risk involved in such restructured accounts.

b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Particulars	Provisioning Requirement
If the revised DCCO is within one year from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond one year and upto two years from the original DCCO prescribed at the time of financial closure	Project loans restructured with effect from June 1, 2013: 5.00 per cent – From the date of restructuring for 2 years Stock of Project loans classified as restructured before June 01, 2013: • 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14) • 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)

- 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

The above provisions will be applicable from the date of restructuring for 2 years.

(iv) For this purpose, mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of two years from the original DCCO. In such cases the consequential shift in repayment period by equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO would also not be considered as restructuring provided all other terms and conditions of the loan remain unchanged.

Other Issues

4.200(i) All other aspects of restructuring of project loans before commencement of commercial operations would be governed by the provisions of Part B of Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances. Restructuring of project loans after commencement of commercial operations will also be governed by these instructions.

(ii) Any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project, would not be treated as restructuring if:

  (a) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.

  (b) The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.

  (c) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCO.

  (d) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

(iii) Project loans for Commercial Real Estate

CRE projects mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of one year from the original DCCO and there is no change in other terms and conditions except possible shift of the repayment schedule and servicing of the loan by equal or shorter duration compared to the period by which DCCO has been extended. However, the asset classification benefit would not be available to CRE projects if they are restructured.

(iv) Multiple revisions of the DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will be treated as a single event of restructuring provided that the revised DCCO is fixed within the respective time limits stipulated at paragraphs 4.2.15.3 (iii) and 4.2.15.4 (iii) of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2015 and all other terms and conditions of the loan remained unchanged.

(v) Banks, if deemed fit, may extend DCCO beyond the respective time limits stipulated at paragraphs 4.2.15.3 (iii) and 4.2.15.4 (iii) of the Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2015; however, in that case, banks will not be able to retain the 'standard' asset classification status of such loan accounts.

(vi) In all the above cases of restructuring where regulatory forbearance has been extended, the Boards of banks should satisfy themselves about the viability of the project and the restructuring plan.

4.201 (i) The RBI vide its Circular No. RBI/2014-15/182 DBOB. No.BP.BC.33/21.04.048/2014-15 dated August 14, 2014 on "Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances – Project under Implementation" mentions that banks have represented to RBI that in respect of funding of cost overruns, which may arise on account of extension of DCCO within the above (i.e.;

two years and one year for infrastructure and non-infrastructure projects from original DCCO date with other terms and conditions remain unchanged), time limits may be allowed without treating the loans as restructured.

(ii) In cases where banks have specifically sanctioned a 'standby facility' at the time of initial financial closure to fund cost overruns, they may fund cost overruns as per the agreed terms and conditions.

(iii) In cases Where the initial financial closure does not envisage such financing of cost overruns, based on the representations from banks, it has been decided to allow banks to fund cost overruns, which may arise on account of extension of DCCO within the time limits quoted at paragraph (i) above, without treating the loans as 'restructured asset' subject to the following conditions:

(a) Banks may fund additional 'Interest during Construction', which may arise on account of delay in completion of a project;

(b) Other cost overruns (excluding Interest during Construction) up to a maximum of 10% of the original project cost

(c) Debt Equity Ratio as agreed at the time of initial financial closure should remain unchanged subsequent to funding cost overruns or improve in favour of the lenders and the revised Debt Service Coverage Ratio should be acceptable to the lenders

(d) Disbursement of funds for cost overruns should start only after the Sponsors/Promoters bring in their share of funding of the cost overruns; and

(e) All other terms and conditions of the loan should remain unchanged or enhanced in favour of the lenders.

Flexible structuring of Long Term Project Loans to Infrastructure and Core Industries

4.202 (i) In view of the challenges faced by Banks, the RBI has clarified in its circular no. DBOD.No.BP.BC.24/21.04.132/2014-15 on Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries dated July 15, 2014, that it has no objection to banks' to fix longer amortisation period for loans to projects in infrastructure and core industries sectors, say 25 years, based on the economic life or concession period of the project, with periodic refinancing, say every 5 years. For details refer to the circular.

(ii) The RBI has further clarified in its circular no. DBOD.No.BP.BC.24/ 21.04.132/2014-15 Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries dated December 15, 2014 that the flexible structuring of existing loans will be allowed in addition to new loans as per the norms given in the circular.

(iii) For detailed guidelines on the Flexible structuring of Long Term Project Loans, refer para 10 and 11 of the master circular DBR.No.BP.BC.2/21.04.048/2015-16 - Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

Income recognition

4.203(i) Banks may recognise income on accrual basis in respect of the projects under implementation, which are classified as 'standard'.

(ii) Banks should not recognise income on accrual basis in respect of the projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. Consequently, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s). As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

a) Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

b) Conversion into equity, debentures or any other instrument: The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realization basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

Provisioning norms on restructured advances

Normal provisions

4.204(i) Banks will hold provision against the restructured advances as per the extant provisioning norms.

(ii) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

(iii) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

(iv) The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under :

- 3.50 per cent - with effect from March 31, 2014. (spread over the four quarters of 2013-14)
- 4.25 per cent - with effect from March 31, 2015. (spread over the four quarters of 2014-15)
- 5.00 per cent - - with effect from March 31, 2016.(spread over the four quarters of 2015-16)

Provision for diminution in the fair value of restructured advances-

4.205

(i) Reduction in the rate of interest and/or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR or Base Rate[15] (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR or base rate (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to be followed consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect

[15] 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'.

the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

ii) There could be divergences in the calculation of diminution of fair value of accounts by banks. For example, divergences could occur if banks do not appropriately factor in the term premium on account of elongation of repayment period on restructuring. In such a case the term premium used while calculating the present value of cash flows after restructuring would be higher than the term premium used while calculating the present value of cash flows before restructuring.

Further, the amount of principal converted into debt/equity instruments on restructuring would need to be held under AFS and valued as per usual valuation norms. Since these instruments are getting marked to market, the erosion in fair value gets captured on such valuation. Therefore, for the purpose of arriving at the erosion in the fair value, the NPV calculation of the portion of principal not converted into debt/equity has to be carried out separately. However, the total sacrifice involved for the bank would be NPV of the above portion plus valuation loss on account of conversion into debt/equity instruments.

Auditor should therefore verify that Bank has correctly captured diminution in fair value of restructured accounts as it will have a bearing not only on the provisioning required to be made by them but also on the amount of sacrifice required from the promoters

Auditors should also verify that there is no any effort on the part of banks to artificially reduce the net present value of cash flows by resorting to any sort of financial engineering. Auditor should also verify that there is a proper mechanism in place of checks and balances to ensure accurate calculation of erosion in the fair value of restructured accounts.

4.206 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 4.205(i) 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.

4.207 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.

4.208 The diminution in the fair value may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR or base rate (whichever is applicable to the borrower), term premium and the credit category of the borrower.

Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

4.209 If due to lack of expertise / appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, the banks has the option of notionally computing the amount of diminution in the fair value and providing therefor, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore.

4.210 The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

Risk-Weights

4.211 The RBI circular also provides that:

a. Restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points.

b. With a view to reflecting a higher element of inherent risk which may be latent in entities whose obligations have been subjected to restructuring / rescheduling either by banks on their own or along with other bankers / creditors, the unrated standard / performing claims on corporates should be assigned a higher risk weight of 125% until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest / principal falls due under the revised schedule.

c. For details on risk weights, Master Circular RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/2015-16 dated July 1, 2015 on 'Basel III Capital Regulations' may be referred.

Prudential Norms for Conversion of Principal into Debt / Equity

Asset classification norms

4.212 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

4.213 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

4.214 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

4.215 These instruments should be held under AFS and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any) which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available, the shares are to be valued at Re. 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Re. 1. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments

Asset classification norms

4.216 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

4.217 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.

4.218 The unrealised income represented by FITL / Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)".

4.219 In the case of conversion of unrealised interest income into equity, which is quoted, interest income can be recognized after the account is upgraded to standard category at market value of equity, on the date of such upgradation, not exceeding the amount of interest converted into equity.

4.220 Only on repayment in case of FITL or sale / redemption proceeds of the debt / equity instruments, the amount received will be recognized in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

Valuation & Provisioning norms

4.221 Valuation and provisioning norms would be as per para 4.215 above. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

Special Regulatory Treatment for Asset Classification

4.222 The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated in para 18 of the Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2015, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 20.2 of the above mentioned master circular. 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.

The asset classification of these three categories accounts as well as that of other accounts which do not comply with the conditions enumerated in para 20.2 of the aforesaid Master Circular, are governed by the prudential norms in this regard described in para 17 of the Master Circular.

Elements of special regulatory framework

4.223 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

4.224 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 120 days from the date of receipt of application by the bank in cases other than those restructured under the CDR Mechanism.

Asset classification benefits

4.225 Subject to the compliance with the undernoted conditions in addition to the adherence to the prudential framework laid down in para 17 of the Master Circular DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015:

(i) In modification to para 17.2.1 of aforesaid Master Circular, an existing 'standard asset' will not be downgraded to the sub-standard category upon restructuring.

(ii) In modification to para 17.2.2 of aforesaid Master Circular, 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.

4.226 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 Annex – 5 of the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015. The condition of being fully secured by tangible security will not be applicable in the following cases:

   (a) MSE 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.

ii) The unit becomes viable in 8 years, if it is engaged in infrastructure activities, and in 5 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 Directors of the banks should prescribe the maximum period for restructured advance keeping in view the safety and soundness of the advances.

iv) Promoters' sacrifice and additional funds brought by them should be a minimum of 20 per cent of banks' sacrifice or 2 per cent of the restructured debt, whichever is higher. This stipulation is the minimum and banks may decide on a higher sacrifice by promoters depending on the riskiness of the project and promoters' ability to bring in higher sacrifice amount. Further, such higher sacrifice may invariably be insisted upon in larger accounts, especially CDR accounts. The promoters' sacrifice should invariably be brought upfront while extending the restructuring benefits to the borrowers. The term 'bank's sacrifice' means the amount of 'erosion in the fair value of the advance'; or "total sacrifice", to be computed as per the methodology enumerated in para 4.205(i) and (ii) above.

(Prior to May 30, 2013, if banks were 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. However, in such cases, if 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 as given in para 17.2 of aforesaid Master Circular.

v) 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.

vi) The restructuring under consideration is not a 'repeated restructuring' as defined in para (v) of Annex - 5 of the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015.

4.227 As per para 20.2.3 of the Master Circular dated July 1, 2015 the extant incentive for quick implementation of restructuring package and asset classification benefits (paragraphs 4.224 to 4.226 (available on restructuring on fulfilling the conditions will however be withdrawn for all restructurings effective from April 1, 2015 with the exception of provisions related to changes in DCCO in respect of infrastructure as well as non-infrastructure project loans. It implies that with effect from April 1, 2015, a standard account on restructuring (for reasons other than change in DCCO and) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

4.228 Accelerated Provisioning

In cases where banks fail to report SMA status to the accounts to CRILIC or resort to methods with the intent to conceal the actual status of the accounts or evergreen the accounts, banks will be subjected to accelerated provisioning for these accounts as under:

Asset Classification	**Period as NPA**	**Current Provisioning**	**Revised accelerated provisioning (%)**
Sub Standard (Secured)	Upto 6 months 6 months to 1 year	15 15	15 (no change) 25
Sub Standard (unsecured *ab initio*)	Upto 6 months 6 months to 1 year	25(other than infrastructure loans) 20 (infrastructure loans) Same as above	25 40
Doubtful I	2^{nd} year	25(secured portion)	40

		100(unsecured portion)	100
Doubtful II	3rd & 4th year	40(secured portion) 100 (unsecured portion)	100 for both secured and unsecured portion
Doubtful III	5 year onwards	100	100

The auditor should check bank's process to identify SMA accounts and reporting of same. If report is generated from system, parameters considered for identification of SMA accounts and system controls to be checked.

Integration of SMA identification system with Core banking system to be checked and to ensure that there is no manual intervention which may result in intentional concealment of data.

Relevant access controls and modification rights in system need to be checked.

4.229 The accelerated provisioning requirement as above is not only for non reporting or delayed reporting or wrong reporting of SMA status bit also for delay/refusal in implementation of package already agreed by lender under CAP by JLF.

PART - IV

IV-1

Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice

1.01 Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice constitutes one of the important items of balance sheet of a bank. Of these items, only a few select branches in each bank handle the transactions relating to money at call and short notice.

Balance Sheet Disclosure

1.02 The Third Schedule to the Banking Regulation Act, 1949, requires the following disclosures to be made in the Schedule 6 & Schedule 7 of 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-Schedule 6

I. Cash in hand (including foreign currency notes)

II. Balance with Reserve Bank of India
- (i) in Current Account
- (ii) in Other Accounts

Balances with Banks and Money at Call and Short Notice-Schedule 7

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

Balances with Reserve Bank of India, Balances with Other Banks

1.03 Banks maintain accounts with RBI and other Banks for Banking Operations however only select branches maintain account with RBI. The branches also maintain accounts with other banks for banking operations.

Money at Call and Short Notice

1.04 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' or 'call money' means deals in overnight funds, 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 notice money market are scheduled commercial banks (excluding RRBs), co-operative banks (other than land development banks) and primary dealers (PDs), both as borrowers and lenders. Non-bank institutions (other than PDs) are not permitted to participate in call/notice money market. Scheduled commercial banks usually borrow from this market to meet the requirements relating to cash reserve ratio 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.

1.05 RBI vide its Master Direction no. RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17 dated July 7, 2016 on "Money Market Instruments: Call/ Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)" provides the detailed guidelines on the prudential limits in respect of both outstanding and lending transactions in call/notice money market for scheduled commercial banks, co-operative banks and PDs. The eligible participants are free to decide the interest rates in call/notice money market. Computation of interest payable would be based on the methodology given in handbook of market practices brought out by the Fixed Income Money Market and Derivates Association of India (FIMMDA) and the eligible participants may adopt the documentation suggested by FIMMDA from time to time. The Call/Notice Money transactions can be executed either on NDS-Call, a screen–based, negotiated, quote-driven electronic trading system managed by the Clearing Corporation of India (CCIL), or over the counter (OTC) through bilateral communication. NDS-Call (a screen–based, negotiated, quote-driven system), do not require separate reporting, however, it is mandatory that all OTC deals should be reported within 15 minutes on NDS-Call reporting platform irrespective of the size of the deal.

Audit Approach and Procedures

Cash

1.06 The auditor should carry out verification of the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible. In few banks, the branch deposits a large portion of its cash balance with the RBI or the State Bank of India or any other bank on the closing day, in such cases, the auditor must request the branch to provide sufficient appropriate evidence for the same.

1.07 Care should be taken to ensure that if cash is kept separately in different departments or at different locations (e.g., at extension counters, onsite ATMs linked with the branch, all the balances are verified by the auditor simultaneously. The auditor should also ensure that there is no movement of cash till such cash is physically verified.

1.08 The auditor should evaluate the effectiveness of the system of internal controls in branch regarding daily verification of cash, maintenance of cash balance registers and vault register, custody of cash, custody of vault keys, daily cash holding and retention limit of the branch, etc. The auditor should examine/inquire whether there is a global (insurance) policy taken for safety of cash from theft or burglary and such policy is effective as on reporting date. This would be relevant for a bank as a whole and there would not be any insurance policy available at the branch level, however, the branch auditor should seek a Xerox copy of the same from the Head office. The Central Statutory Auditor should also make an analysis of the quantum of cash holding and whether the insurance cover is adequate. This will also be important from the perspective of reporting in Long Form Audit Report (LFAR) under (I) Assets-Cash.

1.09 For physically verifying the cash-on-hand, the auditor may proceed as below:

(a) Physically verify the cash-on-hand available at the branch. 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. The processed and unprocessed notes should be separately kept and the denomination of the same should be separately mentioned in the cash balance register.

(b) Obtain a certificate from the bank indicating denomination-wise cash balance as on the date of verification.

1.10 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.

1.11 The cash balance as physically verified should be agreed with the balance shown in the cash book and the books of account. When the physical verification of cash is carried out by the auditor before or after the date of the balance sheet, the auditor should perform the additional audit procedure to reconcile the results of verification with the cash balance as at the balance sheet date.

1.12 Foreign currency notes should also be verified at the time of physical verification of cash. The auditor should also ensure that these notes are 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.

1.13 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 an 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 on closing day, but should take sufficient safeguards to ensure that currency chest balance is not mixed up in the cash balances produced 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. The auditor should also examine whether the system is such that the transactions relating to deposits into and withdrawals from, currency chest are recorded appropriately. 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.

1.14 In terms of the Master Direction No RBI/DCM/2017-18/59 Master Direction DCM(CC) No.G - 2/03.35.01/2017-18 dated October 12, 2017 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 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.

1.15 All currency chest transactions (deposits into /withdrawals from currency chest) at the respective branch, 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; 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. However, in case of wrong reporting representations for waiver will not be considered.

1.16 The said directions cover:

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.

1.17 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 on 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.

1.18 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.

1.19 The auditor should examine whether 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.

1.20 RBI Master Circular No. RBI/2017-18/3DCM(NE)No.G-1/08.07.18/2017-18 dated July 03, 2017 on “Facility for Exchange of Notes and Coins” 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, "Soiled/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. The auditor should also inquire about the service charges levied by the bank on Exchange of soiled notes as per RBI Notification No. RBI/2016-17/15 DCM (NE) No.120/08.07.18/2016-17 dated July 14, 2016 to identify the revenue leakage in the bank.

1.21 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 No. RBI/2017-18/26 DCM (FNVD) G – 4/16.01.05/2017-18 dated July 20, 2017 on "Detection and Impounding of Counterfeit Notes" which provides operational guidance on detection and impounding of Counterfeit notes. The Government of India has framed Investigation of High Quality Counterfeit Indian Currency Offences Rules, 2013 under Unlawful Activities (Prevention) Act (UAPA), 1967. The Third Schedule of the Act defines High Quality Counterfeit Indian Currency Note. Activity of production, smuggling distribution and circulation of High Quality Counterfeit Notes has been brought under the ambit of UAPA, 1967.

1.22 Increasingly banks are entering into an agreement with third party vendors for management of their ATM operations. These vendors collect amount from banks and are responsible for loading amount in the ATM. They are also responsible for collecting amount (deposited by customers) from ATM and depositing it with bank. The auditor should verify an agreement entered with these vendors. The auditors should also understand the process of providing, collecting and reconciliation etc. with these vendors and test controls in the process.

At each period end, the auditor should send independent balance confirmation to these vendors about balance held by them and should verify reconciliation statements.

1.23 Also in respect of ATM operations, banks are centralizing the process of monitoring ATM balance. This division monitors balance as per the books and balance as per ATM machine (commonly termed as Switch balance) and their reconciliation and ensuring timely adjustment of reconciling entries. The auditor should understand the process of monitoring of balance, reconciliation etc. and based on the risk assessment should understand controls in the process and strategy of testing these controls.

1.24 Where ATMs are operated by bank themselves, auditor should verify the cash at ATMs also and tally the same with books of accounts. At each reporting period end, the auditor should obtain the reconciliation statement and should verify the reconciliation statement.

Balance With RBI

1.25 In a bank, only a few select branches are designated to have accounts

(Deposit/Current) with the RBI, the main account generally being with the Treasury Branch. The procedures of confirmation/reconciliation are not different as compared to accounts and balances with other banks and need to be followed except the confirmations.

1.26 It is relevant to point out that, amongst others, currency chest operations involve entries in the accounts maintained with RBI. Where currency chest is attached to the branch maintaining RBI account, all deposits into and withdrawals from the currency chest trigger a debit /credit to the account maintained at the Branch itself. Other branches of the bank having currency chests but not maintaining the RBI Account would be linked to such Branch and would be required to transmit information forthwith for all deposits into/withdrawal from the attached currency chest through Inter branch mechanism. The effect of such entries is required to be considered in the RBI account on a value date basis.

1.27 The auditor of the Branch maintaining the RBI account should follow direct confirmation procedures of the balances in the RBI account and examine the reconciliation to ensure that all transactions originating in the account statement of the RBI are duly responded on value date basis.

1.28 The auditor should enquire into the reasons/justification for 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.

Balance With Banks (Other than Reserve Bank of India)

1.29 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 books of accounts for the year have been considered. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc., are not made separately in the statement of account.

(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.

1.30 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.

1.31 In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. Balances in deposit accounts are usually (though not necessarily) in round figures. Where such balances are in odd figures, the auditor should enquire whether the account concerned is actually of the nature of a deposit account. The auditor should also ensure that interest on such deposits have been recorded on time proportion basis and interest have been recorded till the closing day.

1.32 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.

1.33 Increasingly banks are automating the process of reconciliation with other banks. In case of system process, the auditor should understand the system, system controls and manual controls. The auditor should also assess the system access control and program change controls of the reconciliation system. (Also refer chapter 3, Special Considerations in a CIS Environment of Part II of Guidance Note).

Money at Call and Short Notice

1.34 The auditor needs to enquire whether the bank has an approved risk policy of lending money at call or short notice and the same has been adhered before lending money at call or short notice. This would be more relevant at the head office rather than at the branch level.

1.35 The auditor should examine whether there is 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 lending in inter-bank call money market, should also be examined.

1.36 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/account tally with the control accounts as per the general ledger. The auditor 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.

1.37 Like deposits with banks, money at call and short notice are also usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

1.38 The auditor should also verify that borrowing or 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.

1.39 The auditor needs to verify monies at call to banks, whether they are fresh or roll over of the old transactions and ascertain whether any provision or write off is required.

1.40 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, 1971.

1.41 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 by confirming the same from the opposite party.

IV-2
Fixed Assets and Other Assets

Fixed Assets

2.01 Fixed assets comprise premises and other fixed assets such as furniture and fixtures, motor vehicles, office equipments, computers, intangible assets such as application software and other computer software, etc.

2.02 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.

2.03 As far as maintenance of records relating to fixed assets is concerned, practices vary among banks. In some banks, the offices acquiring the fixed assets have to maintain proper records including the provision of depreciation thereon whereas in case of some banks, the same is being done at the Head Office. In such a case, the acquisitions, disposals, etc. are advised by the branch/other office concerned to the head office through the inter-branch accounting mechanism. A variant of this practice involves the recording of depreciation by branches and other offices based on the advice received from the head office. In recent times, some of the banks have installed Fixed Asset Management Software and the information relating to purchase, sale of fixed assets and depreciation thereon (in some cases) is accounted for with the help of such software. This is usually done at a centralized HO level and reports are generated at branches and/or regional/zonal offices. In some cases, passing of entries of certain types of IT assets, like computers, printers, ATMs etc., are centralized at the HO. However, physical records need to be updated at branches. Also branches need to update records/inform HO in case there has been physical movement of assets from one branch/location to another including in case of transfers at staff quarters or disposal. At the branch level, an auditor needs to conduct a physical verification of all assets particularly those acquired during the year and match the same with fixed asset management system (manual or electronic). Discrepancies, noticed if any, on such verification should have been properly dealt with in the books.

Balance Sheet Disclosure

2.04 The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, *viz.,* Premises and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs) issued by the Institute of Chartered Accountants of India (ICAI).

2.05 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'.

2.06 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.

2.07 No rates of depreciation on fixed assets have been prescribed by the Banking Regulation Act, 1949. The provisions of the Schedule II to the Companies Act, 2013, should, therefore, be kept in mind in this respect especially in so far as the banking companies are concerned. Disclosure is mandatory in respect of the method adopted to compute the revalued amounts, the nature of the indices used, the year of any appraisal made and whether an external valuer was involved in case the assets are stated at revalued amounts. The Banking Regulation Act, 1949 requires that the auditor should examine whether the rates of depreciation are appropriate in the context of the expected useful lives of the respective fixed assets. Depreciation rates must be reconfirmed with the accounting policy of the bank. In respect of computers and data processing equipments, RBI has directed that depreciation should be provided over three year period. With respect to fixed assets held at foreign offices/branches, depreciation policy should be consistent with that followed by the bank as a whole and to the extent not contradictory with the local laws and regulations. Further, as per note 4 of Schedule II of the Companies Act, 2013, useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately, in other words component accounting with respect to fixed assets would be mandatory effective from financial year 2015-16 onwards.

2.08 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.

2.09 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

2.10 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

2.11 As per RBI Circular no. DBOD.BP.BC.24/21.04.048 dated March 30, 1999, credit card outstanding is not to be included under ‘Other Assets’. Instead, they have to be shown as part of advances.

2.12 As per RBI circular DBOD.BP.BC.83/21.01.002/2000-01 dated February 28, 2001, all loans and advances given to staff, which are non-interest bearing should be included in item 'Others' under 'Other Assets' and should not be reflected as ‘Advances’.

Audit Approach and Procedures

Fixed Assets

2.13 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.

2.14 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. In cases where, for any reason acquisition of fixed asset is shown in suspense account then the branch cannot classify the asset in the Balance Sheet under this head unless the asset is put to use or ready for use, as the case may be, and all internal formalities are completed. A long standing suspense entry of this type should be properly dealt with by the auditor and may need to be escalated to the statutory central auditors if the amount involved is material.

Premises

2.15 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.

2.16 In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance residual life. It would be appropriate to segregate the cost/value of the land from the building/superstructures to ensure that depreciation/amortisation is appropriately considered in case of leasehold premises.

2.17 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).

2.18 Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item under the head 'fixed assets' or under the head 'other assets'. It should be verified that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as "premises under construction". In such cases even if all the bills/ documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

2.19 As per the AS-10 (Revised), Property, Plant & Equipment, the banks can adopt the policy to follow Cost Model or Revaluation Model for Premises or any other class of Property, Plant & Equipment (PPE). The auditor should inquire about the policy followed by the bank and verify the accounting treatment more specifically with reference to revaluation model. The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

2.20 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

2.21 The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of movable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/internal/concurrent audit team. The auditor should also examine whether discrepancies have been properly dealt in the books of account and adequate provision in respect of any damaged assets has been made – as per the physical verification of fixed assets reports available on record.

2.22 Banks incur substantial expenditure on computer hardware and software. Computer hardware qualifies the definition of a property, plant and equipment' as given in AS 10 (Revised), "Property, Plant and Equipment" . Computer software that is essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. The expenditure incurred on acquisition and installation of the hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalised in accordance with the principles laid down in AS 10(Revised) and depreciated over the remaining useful life of the hardware. Hardware and software are susceptible to faster rate of technical obsolescence; hence the auditor must take into consideration this fact while verifying the provision for depreciation on these assets. The same, however, should not be depreciated for a period of more than three years.

2.23 Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". The treatment of expenditure on application software, whether acquired from outside or developed in-house, would also be similar. However, in estimating the useful life of application software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS 26, according to which expenditure incurred during the research phase should not be capitalised as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to Paragraph 44 of the said Standard. Further, due care should be taken in verifying the date of capitalization and date on which asset was put to use/ ready for intended use, particularly in case of implementation of application software and system. While conducting the audit of intangible assets, the auditor should also consider the guidelines issued by RBI by way of Circular No.DBOD.No.BP.BC.82/21.04.018/2003-04, dated April 30, 2004.

2.24 In case of banking companies, the auditor needs to verify that the requirements of Schedule II to the Companies Act, 2013 are also complied with including identification of components wherever applicable. Banks may acquire software at considerable expenditure. The system of recording this expenditure as part of the fixed assets (so that it may be depreciated) or to defer expenditure (for amortisation over its useful life) may be reviewed. The Bank's Accounting Policy in this regard must be enquired into, and a note kept on record. Non-provision for this intangible asset will not attract the provisions of Section 15 of the Banking Regulation Act, 1949 as per a notification specifically issued by the Government of India.

2.25 At times, though depreciation has been fully provided on certain types of assets, however, they continue to be in use. In such cases the auditor should verify that the bank's policy in this regard has been followed.

2.26 Many a times, fixed assets like furniture, office equipments, etc., are transferred from one branch to another. The auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers. In recent times, the fixed asset management softwares are in use. The auditor has to examine the reasonableness of the internal controls with respect to recording such inter branch transfer of assets.

2.27 It should be examined whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For example, items like safe deposit vaults should not be clubbed together with the office equipments or the theft alarm system of the bank.

2.28 In respect of fixed assets sold during the year, a copy of the sale deed, if any, and receipt of the sale value should be examined by the auditor. In such a case, it should also be seen that the original cost and accumulated depreciation on the assets sold have been correctly adjusted. Profit earned or loss incurred on such sales should also be checked.

2.29 In case of sale/disposal/scrapping of fixed assets, the auditor should examine whether there is an adequate control system in place and the same has been adhered to. The auditor should also ensure that proper accounting for the same has been done.

2.30 The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly. According to AS 10(Revised), "Property, Plant & Equipment", such expenditure should be added to the book value of the fixed asset concerned only if it increases the future benefits from the asset beyond its previously assessed standard of performance.

2.31 The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers' ins/outs, are tallied. A broad check on the depreciation amount *vis-a-vis* the gross block of assets must be reviewed with special emphasis on the computer hardware/software.

Leased Assets

2.32 RBI's Circular No. DBOD No.FSC.BC.70/24.01.001/99 dated July 17, 1999 deals with accounting and provisioning norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases". Assets given on Lease need to be separately shown in the same manner as other assets.

Impairment of Assets

2.33 AS 28, "Impairment of Assets" prescribes the procedures that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount. An asset is treated as 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 enterprise to recognise an impairment loss. This Standard also prescribes when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets. This Standard requires that an enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss, if recognised, shall be debited to the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exists, the loss should first be debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same should be debited to profit and loss account. RBI's circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- Banks may also take into account the following specific factors while complying with the Standard:
    - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value of assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.

- In addition to the assets of banks which are specifically identified above, *viz.,* financial assets, inventories, investment, loans and advances etc to which the Standard does not apply, the Standard would apply to financial lease assets and non-banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

Other Assets

2.34 The branch auditor may carry out the audit of various items appearing under the head 'Other Assets' in the following manner.

Inter-Office Adjustments

2.35 Inter Office Adjustments/Inter Branch Account is dealt separately in Chapter 12 of Part IV of Guidance Note on "Inter-office Transactions".

Interest Accrued

2.36 The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks normally debit the borrower's account with interest due on the borrowers repayment cycle date, there would usually be an amount of interest accrued but not due on advances on balance sheet date. On the other hand, interest on government securities, debentures, bonds, etc., which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. The auditor should examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/discounted. Several times the interest accrued on such advances is manually computed by the Branch and the auditors should check the workings thoroughly so as to avoid any income leakages. As far as possible, the detailed break up of the loan portfolio and the interest accrual should be obtained and the same should agree with the general ledger balance. This would ensure completeness of the interest accrual of advances. The auditor should also examine the interest accrued on advances by re-computing it on a test check basis by referring to the loan parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the loan agreements. This would ensure the completeness of the interest accrual on advances. In the current banking scenario the interest accrual setup is automated system driven for most banks and the auditor should verify the in– built logic and controls of the system.

2.37 The auditor should examine whether only such interest as can be realised in the ordinary course of business should be shown under this head.

This is based on the principle, recognised in AS 9, "Revenue Recognition" that revenue cannot be recognised if there is a significant uncertainty about its collectability; as also with instructions given by RBI to the effect that interest be not recorded as income in respect of Non Performing assets. Interest accrued in the current year in respect of accounts identified as NPAs must be reversed to Income and derecognised and cannot be the subject matter of a provision. Dividends recognised as income but not received may be included in the residuary sub-head of 'Others'. Dividends and interest on investments would be recognised in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

Tax Paid in Advance/Tax Deducted at Source

2.38 Generally, this item is dealt at the head office only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services if handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to examine whether the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

2.39 At Head Office, the availability of all the TDS Certificates, submission of the same with Income Tax Department/claim of the same in Income Tax returns filed should be checked to verify the justification of the claim towards such certificates. The auditor should also verify the online tax credit from the Income Tax website with the TDS/advance tax recorded in the books and ask for a reconciliation of the same. Income recognized in the books could also be cross verified by this analysis. If there is any TDS, the auditor needs to enquire as to the income to which it pertains so that the bank claims it in its assessments.

Stationery and Stamps

2.40 Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller's cheques, gift cheques, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to misappropriation of the most valuable physical asset of a bank, *viz*., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in his

LFAR.

2.41 As per RBI instructions, the item "Stationery and Stamps" should include only exceptional items of expenditure on stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. The valuation of such items is suggested to be at cost without any element of escalation/appreciation. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

2.42 The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse. 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

2.43 Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

2.44 While examining this item, the auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however acquired (i.e. whether acquired by way of satisfaction of claims or otherwise), except such as required for its own use, for any period exceeding seven years from the date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years.

2.45 Except when held for its own use, AS 10 (Revised), "Property, Plant & Equipment", would not be applicable on those fixed assets which are held with the bank in satisfaction of claim. At the date of acquisition, the assets should be recorded at amount lower of the net book value of the advance or net realisable value of asset acquired. At each balance sheet date, net realisable value of such assets may be re-assessed and necessary adjustments may be made.

2.46 The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. The auditor should verify that the ownership of the property is legally vested in the bank's name. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

Others

2.47 This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below.

Non-Interest Bearing Staff Advances

2.48 The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the bank's policy in this regard. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be examined whether the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

2.49 Banks grant unsecured advances to staff like festival/drought relief/housing advances etc. due to the employer- employee relationship where normally lien is marked on the terminal benefits of the employee; but advances against FDRs and other securities etc. are also given. While distinction needs to be made between advances given by the bank as an "employer" and as "banker", the RBI's latest applicable circular needs to be kept in view as regards disclosure requirement of advances in the latter category i.e. as banker.

Security Deposits

2.50 Security deposits with various authorities (e.g., on account of telephone, electricity, etc.,) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. The auditor should verify that the deposits have not become due as per the terms and conditions. If it is so, then the recoverability of the same needs to be looked into in detail and appropriate provision should be suggested against the amount where recovery is in doubt.

2.51 The auditor, based on the materiality, should send independent balance confirmation for security deposit at period end and should document the reason in the case of any differences. Verification of all security deposits given during the year should be conducted and that of older deposits can be done on a test check basis.

Suspense Account

2.52 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, the suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

(i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;

(ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;

(iii) amounts of losses on account of frauds awaiting adjustment.

2.53 RBI has also suggested a quick audit of entries in Suspense Account and the status thereof to be reported in terms of its circulars dated 6.7.95/18.8.95 and reference may also to be made to the RBI Circular DBOD.BP.BC.4/21.04.018/2003-04 dated 19.7.03.

2.54 The auditor should pay special attention to any unusual items in suspense account since these are prone to fraud risk. The auditor should obtain the management policy for provision/write off for old outstanding items. He should obtain from the management, details of old outstanding entries/age-wise balances along with narrations in suspense account. The auditor should also verify the reasons for such delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/written off. All items of more than 6 months in suspense accounts need special attention of the auditor. The auditor has to certify all the suspense account entries through a separate certificate in the annual closing sets.

Prepaid Expenses

2.55 The auditor should verify prepaid expenses in the same manner as in the case of other entities. The auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. The auditor should particularly examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.

Miscellaneous Debit Balances on Government Account

2.56 Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. In many cases, the accounting for this is outside the core banking solution and needs the special attention of the auditor. The auditor should review the ageing statements pertaining to these items. He should particularly examine the recoverability of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant guidelines, terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for /written off as the case may be in the accounts.

2.57 The residual item of “Others” in “Other Assets” generally constitutes a significant amount in the Balance Sheet of the bank. The Head Office auditors should obtain the head wise details of the same along with the previous year figures. The age-wise details of the major outstanding should also be obtained. Further, the major variance as compared to the previous year figures should also be enquired into and reasons for the same should be recorded and reviewed. In case any amount seems doubtful of recovery, appropriate provisions against the same should be made.

IV-3

Borrowings and Deposits

Borrowings

3.01 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

3.02 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 1 Capital

1) Perpetual Non-Cumulative preference shares (PNCPS)

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.

3.03 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.

3.04 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 RBI include refinance obtained by the bank from the RBI. Similarly, borrowings from other banks include refinance obtained by the bank from commercial banks, co-operative banks, etc. Refinance obtained by the bank from EXIM Bank, NABARD, SIDBI and other similar institutions and agencies is to be included under 'borrowings from other institutions and agencies'. This head will also include the bank's liability against participation certificates on non-risk sharing basis issued by it to participating banks.

3.05 Credit balances, if arising, in NOSTRO accounts represent Deposits repayable on demand as also VOSTRO Accounts which are akin to Current account balances and do not constitute borrowings unless an overdraft/borrowing facility is obtained and evidenced on record.

3.06 '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.

3.07 Money at call or short notice taken by the bank is also shown under this head. RBI through its "Master Circular no. RBI/2015-16/55 FMRD.DIRD. 01 /14.01.001/2015-16 on "Call-Notice Money Market Operations" dated July 1, 2015 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.

Certificates of deposits are to be treated (at the discounted value at the year-end), as deposits and not as borrowings.

Inter Bank Liabilities (IBL)

3.08 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 the asset side. More particularly, uncontrolled IBL may have systemic implications, even if, the individual counterparty banks are within the allocated exposure.

3.09 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 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 dated 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 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

3.10 Deposits represent the most important source of funds for banks.

Deposits are received from a large number of constituents, generally in small amounts.

Balance Sheet Disclosure

3.11 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

3.12 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

3.13 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. Further it includes overdue/matured deposits, credit balance in overdraft account, deposits payable at call, in operating current account, VOSTRO account, merchant bankers and similar deposits, Interest accrued and due on deposits and excluding margins by way of book adjustments if any against bill purchased and discounted.

3.14 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 that can be withdrawn by the account holder at any one time.
- There is no restriction on the number of transactions in the account during any period of time.
- No interest is payable on this deposit except where it may be specifically permitted by the bank / RBI.

Savings Bank Deposits

3.15 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.

3.16 The salient features of this type of accounts are:

- Banks place restrictions on the maintenance of minimum balance (separate for accounts with cheque book facility and those without cheque book facility), amount of funds that can be withdrawn by the account holder at any point of time. Beyond this cut-off level, banks require the depositors to give notice of a specified period for withdrawal of the amount.
- Banks also place restrictions on the number of withdrawals from the account during a stated period of time, usually one year. For the number of withdrawals beyond this number, banks have the right to levy service charges. The intention behind putting this restriction is to ensure that the savings bank accounts (on which the account holder is entitled to payment of interest) are used to promote genuine savings and are not used as substitutes for current accounts (on which the account holder usually does not get interest).
- Interest is payable as per the RBI guidelines in force. In the past, interest was paid annually but now, banks pay interest at quarterly / half-yearly intervals on daily outstanding balances. Depending on the practice adopted by each bank provision for the balance period up to the year-end may be made at branches/Head Office.
- Interest on savings bank accounts is required to be calculated on a daily product basis in terms of Para 3.2.1 of the RBI Master Circular DBR.No.Dir.BC. 7/13.03.00/2015-16 dated 1-7-2015; and the banks have been given freedom to fix the rate of interest on savings accounts.

3.17 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. Removing of "Specimen signature" cards from active cards can be one of the controls.

Term Deposits

3.18 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.

3.19 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 chooses amount of deposit each time based on their convenience.

3.20 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. Further, issuance of CDs will attract stamp duty. In this regard, the RBI has issued Master Circular No. RBI/2015-16/57 FMRD.DIRD. 03 /14.01.003/2015-16 on "Guidelines for Issue of Certificates of Deposit" dated July 1, 2015. CDs may be issued at a discount on face value. The rate of interest thereon is negotiable with the depositor and may vary on a daily basis. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year. Banks are allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank/FI is free to determine the discount / coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. CDs can be issued in Demat or in physical form, and in the latter case must be issued on security paper stationery, in denomination of Rs. 1 lac (for a single subscriber) or in multiple of Rs 1 lac and without the benefits of repatriation if issued to NRI. Other than for NRIs, CDs are transferrable by endorsement and delivery.

3.21 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.

3.22 In respect of term deposits, banks issue Deposit Receipts. These receipts are not negotiable, and therefore, deposits cannot be transferred without the consent of the bank. Certificates of deposits are, however, transferable. CDs held in physical form are transferable by endorsement and delivery. CDs in dematerialised form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for CDs. Banks / FIs cannot grant loans against CDs. Furthermore, premature buyback is not permitted and no loans can be taken against CDs. However, the Reserve Bank may relax these restrictions for temporary periods through a separate notification.

3.23 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.

3.24 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. 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 rate of interest same as saving bank rate is provided on the same as per RBI Guidelines.

3.25 Pro-rated expenditure by way of discounts up to the year end on each certificate must be accrued / adjusted and included under the head "Other Liabilities", as the terms of issue warrant that the proceeds be paid only on maturity.

3.26 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.

3.27 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. RBI/2015-16/40 DBR.No.Dir.BC.8/13.03.00/2015-16 dated July 1, 2015 on "Interest rates on deposits held in FCNR (B) Accounts", provides guidance on the interest rates on deposits held in FCNR(B) accounts. The Circular further prohibit banks to:

i. accept or renew a deposit over five years;

ii. discriminate in the matter of rate of interest paid on the deposits, between one deposit and another accepted on the same date and for the same maturity, whether such deposits are accepted at the same office or at different offices of the bank, except on the size group basis. 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 accounts***

- Non-interest bearing – No credit facilities against the security of the balances.
- 100% of inward remittance for Status Holder Exports, professional service rendered in personal capacity.
- 100% of EOU, STP and EHTP, 50% for other payments received from a unit DTA for goods supplied to SEZ.

(d) ***Non-resident 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. RBI/2015-16/39 DBR.No.Dir.BC.7/13.03.00/2015-16 dated July 1, 2015 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.

Further, paragraph 3.16 of aforesaid Master Circular 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.
- 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.

Accounting

3.28 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. Banks will maintain "CD Redemption Account" represented by specific ISIN.

Combinations of Demand and Term Deposits

3.29 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.

Unclaimed Deposits/ Inoperative Accounts

3.30 As per RBI Circular no. DBOD No. Leg.BC.34/ 09.07.005/2008-09 dated August 22, 2008 on "Unclaimed Deposits/inoperative accounts in Banks", a bank is required to make an annual review of accounts in which there are no operations (other than crediting of periodic interest or debiting of service charges) for more than one year. A savings as well as current account should be treated as inoperative/ dormant if there are no transactions in the account for over a period of two years. In case any reply is given by the account holder giving the reasons for not operating the account, banks should continue classifying the same as an operative account for one more year within which period the account holder may be requested to operate the account. However, in case the account holder still does not operate the same during the extended period, banks should classify the same as inoperative account after the expiry of the extended period. If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest. In terms of Foreign Exchange Management (Crystallization of Inoperative Foreign Currency Deposits) Regulations, 2014 and vide Notification No. FEMA 10A/2014-RB dated March 21, 2014, issued under Foreign Exchange Management Act (FEMA), 1999 relating to inoperative foreign currency deposits, directions have been issued under Sections 10(4) and 11(1) of FEMA; and as per

Clause 2.7 of the RBI Master Circular DBOD.No.Dir.BC.14/13.03.00/2014-15 dated 1-7-2014, inoperative deposits having a fixed term and those with no fixed term maturity, after the expiry of a three month notice upon completion of three years, will get crystallized into Rupees.

Depositor Education and Awareness Fund (DEAF) Scheme 2014

3.31 Reserve Bank of India vide its circular no. DBOD. DEAF Cell. BC. No. 101/ 30.01.002/2013-14 dated March 21, 2014 namely "The Depositor Education and Awareness Fund Scheme, 2014 - Section 26A of Banking Regulation Act, 1949" has laid down certain guidelines with respect to the said fund. Under the provisions of Section 26A of the Banking Regulation Act, 1949 the amount to the credit of any account in India with any bank which has not been operated upon for a period of ten years or any deposit or any amount remaining unclaimed for more than ten years shall be credited to the Fund, within a period of three months from the expiry of the said period of ten years. The Fund shall be utilised for promotion of depositors' interest and for such other purposes which may be necessary for the promotion of depositors' interests as specified by RBI from time to time. The depositor would, however, be entitled to claim from the bank the deposit or any other unclaimed amount or operate the account after the expiry of ten years, even after such amount has been transferred to the Fund. The bank would be liable to pay the amount to the depositor/claimant and claim refund of such amount from the Fund.

3.32 All such unclaimed liabilities (where amount due has been transferred to DEAF) may be reflected as "Contingent Liability – Others, items for which the bank is contingently liable" under Schedule 12 of the annual financial statements. Banks are also required to disclose the amounts transferred to DEAF under the notes to accounts.

Reserve Bank of India (Gold Monetization Scheme) Direction, 2015

3.33 The RBI issued Master Direction No.DBR.IBD.No.45/23.67.003/2015-16 dated 22-10-2015 to all Scheduled Commercial Banks that decide to implement the Scheme*(excluding Regional Rural Banks),* requiring such banks that decide to implement the Scheme (Designated Bank), to formulate a comprehensive policy with approval of their respective boards.

3.34 The Gold Monetization Scheme, 2015 (GMS) which includes the Revamped Gold Deposit Scheme (R-GDS) and Revamped Gold Metal Loan Scheme (R-GML) was intended to mobilise gold held by households and institutions to facilitate its use for productive purposes, and to reduce country's reliance on the import of gold.

3.35 Designated Banks are authorised to accept deposits, the principal and interest of which, under the scheme, shall be denominated in gold. Such deposits can be accepted from eligible persons viz., Resident Indians (Individuals, HUFs, Trusts including Mutual Funds/Exchange Traded Funds registered under SEBI (Mutual Fund) Regulations and Companies. Joint deposits of two or more eligible depositors can be made on the same basis as other joint deposit accounts and with nomination facility. The Broad features of the Gold Monetization Scheme are summarised in ***Appendix XIV*** of the Guidance Note.

Procedural Aspects

3.36 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. 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.

Know Your Customer Requirements (KYC)

3.37 Reserve Bank of India *vide* its master circular no. RBI/2015-16/42 DBR.AML.BC.No.15/14.01.001/2015-16 dated July 1, 2015 on "Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating Financing of Terrorism (CFT)/Obligation of banks and financial institutions under PMLA, 2002" has laid down certain guidelines to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. The guidelines prescribed in this circular, popularly known as KYC guidelines, also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently.

These guidelines contain detailed requirements for banks in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

Audit Approach and Procedures

Borrowings

3.38 Where borrowings are shown by branch, the auditor must ensure that the borrowings/refinance

i) is separately disclosed as required by law;

ii) balance confirmation certificates are obtained in evidence of borrowings from each lender; and

iii) the nature and extent of security is determined and disclosed.

3.39 The auditor should understand process of new borrowing, repayment of borrowings and test controls around these processes.

3.40 Borrowings from RBI, other banks/financial institutions, etc., should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, application form, sanction letter, agreements, interest rate, security, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties / lenders may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of Standard on Auditing (SA) 505, "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

3.41 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.

3.42 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.

3.43 The auditor should similarly examine the relevant correspondence or other documents to verify whether the branch has been authorised by the head office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation.

3.44 The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

3.45 In case of borrowing through bonds and debentures, generally banks appoint the registrar for maintenance of records of borrowing such as bond holders etc. The auditor can obtain the balance confirmation from registrar of the bonds including other parameters of borrowing at each period end.

Deposits

3.46 In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

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

Current Accounts

3.47 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.

3.48 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.

3.49 The auditor should examine whether the debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'Advances'.

3.50 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

3.51 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.

3.52 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 accounts can be obtained in selected sample and auditor can verify the calculation. In case of manual branches the calculation can be verified as per the work sheets.

3.53 As in the case of current accounts, the auditor should pay special attention to inoperative savings bank accounts.

Term Deposits

3.54 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.

3.55 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.

3.56 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 also examine whether the proper provision for interest payable on deposits is made.

3.57 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.

3.58 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.

3.59 If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest as given in Para 3.4 of the Master Circular on Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts.

Deposits Designated in Foreign Currencies

3.60 In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year

i) For deposits up to one year, at the applicable rate without any compounding effect.

ii) In respect of deposits for more than 1 year, the interest on FCNR (B) deposits should be calculated at intervals of 180 days each and thereafter for remaining actual number of days, till normal maturity.

Further, in case of conversion of FCNR (B) deposits into NRE deposits or vice versa before maturity has been subjected to the provisions relating to premature withdrawal.

Interest Accrued But Not Due

3.61 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

3.62 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.

Inoperative Accounts

3.63 Internal controls over inoperative accounts, is imperative. A response to the letter addressed to the Branch will assist the auditor to take a view on the system of dealing with inoperative Accounts. Attention needs to be sharply focused on debits/withdrawals to ascertain whether these are unauthorised. In testing the debits, attention should be specially paid to large and repetitive debits out of otherwise dormant accounts. Centralisation of these needs to be encouraged and such a recommendation needs to be made through the LFAR.

3.64 While scrutinising deposit ledgers, it is appropriate to ensure whether there are any stagnant/ inoperative accounts, which remain to be transferred. Computer generated exception reports will also reveal the status of the inoperative accounts.

Window-dressing

3.65 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.

3.66 Unauthorised Deposits, particularly, during the period that deposits of demonetized currency notes were allowed, comprise the bank's liability and can be treated as Deposits, pending completion of any enquiry/investigation, with the safeguards the bank may take to avoid any wrongful claim thereon. The auditor may consider reporting the same in the LFAR by way of information.

Know Your Customers Norms

3.67 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 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.

IV-4

Capital, Reserves and Surplus

Capital

4.01 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.

4.02 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. If circumstances permit, items which can be combined may be shown under one head, for instance, 'Issued and Subscribed Capital'.

4.03 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.

4.04 The RBI's Master Circular no. RBI/2015-16/99 DBR.BP.BC No.23/21.04.018/2015-16 dated July 1, 2015 on "Disclosure in Financial Statements – Notes to Accounts" lays down the certain aspects to be disclosed in respect of capital for the current as well as the previous year.

Capital Adequacy Measures in India

4.05 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. RBI/2015-16/85 DBR.No.BP.BC.4./21.06.001/2015-16 dated July 1, 2015 on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)" provides the guidelines to be followed by banks for capital adequacy. As per RBI circular RBI/2016-17/321 DBR.No.BP.BC.74/21.06.009/2016-17 dated June 13, 2017 Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF) - Eligible Credit Rating Agencies – INFOMERICS Valuation and Rating Pvt Ltd. (INFOMERICS) - The long term and short term ratings issued by these domestic credit rating agencies have been mapped to the appropriate risk weights applicable as per the Standardised Approach under the Basel II Framework. Some of the important aspects of the circular are covered below.

4.06 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. AS per RBI circular RBI/2016-17/222, DBR.BP.BC.No.50/21.06.201/2016-17 dated Feb 2, 2017, Additional Tier 1 capital, the change in coupon discretion needs to be considered.
- ***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.

4.07 The 2015 Master Circular on Prudential Norms on Capital Adequacy and Market Discipline – New Capital Adequacy Framework (NCAF) also covers the concept of 'Capital Adequacy Requirement for Credit Default Swap (CDS) Positions in the Banking Book'. Readers may refer to the aforesaid Circular for detailed guidelines in this regard.

Components of Capital

4.08 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.

Undisclosed Reserves

4.09 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

4.10 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.

4.11 However, as per RBI's circular no. RBI/2015-16/331 DBR.No.BP.BC.83/ 21.06.201/ 2015-16 dated 1st March, 2016, revaluation reserves arising out of change in the carrying amount of a bank's property consequent upon its revaluation may, at the discretion of banks, be reckoned as Common Equity Tier 1 (CET1) capital at a discount of 55%, instead of as Tier 2 capital under extant regulations, subject to meeting the following conditions:

- bank is able to sell the property readily at its own will and there is no legal impediment in selling the property;
- the revaluation reserves are shown under Schedule 2: Reserves & Surplus in the Balance Sheet of the bank;
- revaluations are realistic, in accordance with Indian Accounting Standards;
- valuations are obtained, from two independent valuers, at least once in every 3 years; where the value of the property has been substantially impaired by any event, these are to be immediately revalued and appropriately factored into capital adequacy computations;

- the external auditors of the bank have not expressed a qualified opinion on the revaluation of the property;
- the instructions on valuation of properties and other specific requirements as mentioned in the RBI's circular no. RBI No.2006-2007/224 DBOD.BP.BC No. 50 / 21.04.018/ 2006-07 dated 4th January, 2007 on 'Valuation of Properties - Empanelment of Valuers' are strictly adhered to.

Foreign Currency Translation Reserve (FCTR)

4.12 As stated in RBI's circular no. RBI/2015-16/331 DBR.No.BP.BC.83/ 21.06.201/2015-16 dated 01st March, 2016, Banks may, at their discretion, reckon foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 as CET1 capital at a discount of 25% subject to meeting the following conditions:

- the FCTR are shown under Schedule 2: Reserves & Surplus in the Balance Sheet of the bank;
- the external auditors of the bank have not expressed a qualified opinion on the FCTR.

4.13 ***Deferred Tax Asset (DTA)*** – As per RBI's circular no. RBI/2015-16/331 DBR.No.BP.BC.83/ 21.06.201/2015-16 dated 01st March, 2016:

(i) Deferred tax assets (DTAs) associated with accumulated losses and other such assets should be deducted in full from CET1 capital.

(ii) DTAs which relate to timing differences (other than those related to accumulated losses) may, instead of full deduction from CET1 capital, be recognised in the CET1 capital up to 10% of a bank's CET1 capital, at the discretion of banks [after the application of all regulatory adjustments].

(iii) The amount of DTAs which are to be deducted from CET1 capital may be netted with associated deferred tax liabilities (DTLs) provided that:

  - both the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority;
  - the DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets; and
  - the DTLs must be allocated on a pro rata basis between DTAs subject to deduction from CET1 capital as at (i) and (ii) above.

General Provisions and Loss Reserves

4.14 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

4.15 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 Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF).

4.16 As per RBI's circular no. RBI/2015-16/428 DBR.BP.BC.No.105/ 21.06.001/ 2015-16 dated 23rd June, 2016, the extant instructions have been reviewed and it has been decided that banks need not submit a copy of the offer document with respect to any debt/capital raised as above, to Reserve Bank of India. Banks shall however, report to the Principal Chief General Manager, Department of Banking Regulation, Reserve Bank of India, Mumbai, the details of the debt raised as per the format prescribed in this circular duly certified by the compliance officer of the bank. The compliance with the Basel III Capital regulations will continue to be examined by RBI's Department of Banking Supervision, in course of the supervisory evaluation.

4.17 Banks shall however, continue to obtain and keep on their records a certificate from statutory auditors and an external legal opinion in terms of Annex 16 of the Master Circular on Basel III Capital Regulations dated 01st July, 2015.

Subordinated Debt

4.18 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 Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF).

Investment Reserve Account

4.19 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.

4.20 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.

Reserves and Surplus

Balance Sheet Disclosure

4.21 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 Reserve Account

(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

4.22 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. Section 17(2) of the 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.

4.23 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

4.24 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. As per RBI master circular No DBR No BP.BC.6 /21.04.141/2015-16 dated July 1, 2015 - Profit on sale of investments in this category should be first taken to the Profit & Loss Account, and thereafter be appropriated to the 'Capital Reserve Account'. It is clarified that the amount so appropriated would be net of taxes and amount required to be transferred to Statutory Reserves. Loss on sale will be recognised in the Profit & Loss Account.

Securities Premium Account

4.25 According to sub-section (1) of section 52 of the Companies Act, 2013, 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 this Act regarding reduction of capital also apply to securities premium account. As per sub-section (2) of section 52 of Companies Act, 2013, 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; or

(e) for the purchases of its own shares or other securities under section 68 of Companies Act, 2013.

As per sub-section (3) of section 52, the security premium account may be applied by such company, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under section 133 of the Companies Act, 2013.

(a) in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or

(b) in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company; or

(c) for the purchases of its own shares or other securities under section 68.

4.26 A banking company has to report to the RBI any appropriations made from the securities premium account. Such an appropriation can be made only for the purposes described above or in accordance with the provisions governing reduction of share capital by a company.

Revenue and Other Reserves

4.27 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.

4.28 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 Reserve Account' representing write back of excess provision on investments has to be treated as revenue reserve.

Balance in Profit and Loss Account

4.29 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.

4.30 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.

4.31 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

4.32 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.

4.33 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.

4.34 The auditor should also check the compliance with capital adequacy requirements for banks.

4.35 The auditor should verify the compliance with the RBI reporting and other requirements issued from time to time.

4.36 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.

4.37 In case of issuance of new share capital by bank, the auditor should examine the compliance with section 13 of the Banking Regulation Act, 1949 in respect of restriction on commission, brokerage, discount etc. on sale of shares.

Reserves and Surplus

4.38 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 account, 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, the auditor should examine whether the appropriations from securities premium account conform to the relevant legal requirements.

4.39 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.

4.40 The auditor should examine the nature of various accounts included under this head to examine 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.

IV-5
Other Liabilities and Provisions

Balance Sheet Disclosure

5.01 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

5.02 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

5.03 The balance in inter-office adjustments account, if in credit, is to be shown under this head. Chapter 12 of Part IV of the Guidance Note provides the detailed guidelines on the aspects of Inter-office Transactions.

Interest Accrued

5.04 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)

5.05 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. and tax deduction by bank payable on or before the due date.

(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) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

5.06 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.

(i) Unamortized interest income on the bills purchased/ discounted.

5.07 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

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

Bills Payable

5.09 The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

(a) Demand drafts, mail transfers, traveller's cheques, etc., should be made out in standard printed forms.

(b) Unused forms relating to demand 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[5] 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., demand draft, has to be cancelled (say, due to error in preparation), it should be examined whether the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of demand drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which demand drafts issued are entered.) Cases of frequent cancellation and re-issuance of demand drafts, pay orders, etc., should be carefully looked into by a responsible official.

5.10 Based on auditor's 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

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[5] Telegrams has been discontinued since 15th July, 2013 and this is now just for academic purposes.

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)

5.11 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 under Chapter on Assets Classification, Income Recognition and Provisioning 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. Specifically, in case of tax deducted by the bank and payable to the government authorities on or before the due date, this function may be centralized or de-centralized. While verifying this, the auditor must check whether tax has been correctly deducted from payments as per the provisions of the Income Tax Act, 1961 and paid on or before the due date as specified under the Act or Rules thereunder. Many a times in case of branch audit, reporting has to be done before the due date of paying tax deducted at source for the month of March. In such cases the auditor should report delays observed till the date of his verification and clearly bring out the fact that he has not verified the payment of tax, due date of which would be after the date of the audit report.

IV-6

Contingent Liabilities and Bills for Collection

Balance Sheet Disclosure

6.01 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

6.02 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

6.03 The concepts of Letters of Credit, Bank Guarantees and Letters of Comfort have been discussed in the Chapter 2 "Advances-Other than Agriculture" of Part III of the Guidance Note.

Liability on Partly Paid Investments

6.04 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

6.05 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

6.06 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

6.07 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).

6.08 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

6.09 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.

6.10 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

6.11 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.

6.12 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.

6.13 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.

6.14 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”.

6.15 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.

6.16 The liability involved in cases lodged against the bank in various courts including consumer dispute redressal forums, Banking Ombudsman as per

Reserve Bank of India and any other Authority are in the nature of contingent liability and should be disclosed.

Bills for Collection

6.17 Bills held by a bank for collection on behalf of its customers are to be shown as a footnote to the balance sheet.

6.18 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.

6.19 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.

6.20 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.

6.21 Bills received by the bank from its outstation branches and agents, etc. for collections are called Inward Bills for Collection.

6.22 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

6.23 In its Master Circular No. RBI/2015-16/76 DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances", the RBI had reiterated the need for the banks to be cautious while co-accepting bills of their customers and discounting the same so as to avoid loss to banks arising on account of frauds perpetrated in the guise of bills. The circular requires the banks, *inter alia,* not to extend their co-acceptances to house bills/ accommodation bills drawn by group concerns on one another. In the circular, the RBI had also listed a number of safeguards to be undertaken by banks while co-accepting bills.

Audit Approach and Procedures

Contingent Liabilities

6.24 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 verify whether there exists a system whereby the non-fund based 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 examine whether in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.

(d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.

(e) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.

(f) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.

(g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

(h) 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 Regulation 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)[6]. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.

(j) Verify whether the bank has extended any non-fund facility or additional/*ad hoc* credit facilities to persons other than its regular customers. In such cases, auditor should examine the existence of concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

6.25 The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

Claims Against the Bank Not Acknowledged as Debts

6.26 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,

[6] 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.

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. The auditor should use professional judgement to determine as to which claims can be construed as a contingent liability.

Liability on Account of Outstanding Forward Exchange Contracts

6.27 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

6.28 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.

6.29 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 stock of forms are periodically verified and reconciled with the book records, etc.

6.30 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.

6.31 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".

6.32 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. Many a times it is observed that in certain cases, old and expired bank guarantees are not cancelled from the records. This would result in excess capital adequacy provisioning for the bank. Also, it should be confirmed that the margins are recorded at their proper value including the interest accrued. The auditor should verify the Bank Guarantee register for the purpose.

Acceptances, Endorsements and Other Obligations

6.33 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.

6.34 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

6.35 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.

6.36 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

6.37 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.

6.38 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

6.39 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.

6.40 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.

6.41 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.

6.42 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.

6.43 The auditor should also look into the manner of disclosure of interest rate swaps and other derivative transactions in the financial statements of the bank.

6.44 The auditor should check whether any liability is involved in cases lodged against the bank.

6.45 The auditor may verify other items under this head in the same manner as in case of other entities.

Bills for Collection

6.46 The auditor should examine whether the bills drawn on other branches of the bank are not included in bills for collection.

6.47 Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.

6.48 The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

6.49 Regarding bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

6.50 The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer’s account with the amount of bank’s commission as soon as a bill collected is credited to the customer’s account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

Co-acceptance of Bills

6.51 The auditor should examine whether the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI’s Master Circular No. RBI/2015-16/76 DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on “Guarantees and Co-acceptances” to ascertain whether such system, *inter alia*, captures all such items, appropriately records the same and also determines all the material items forming contingent liabilities, whether any item needs a provision in the books.

IV - 7

Treasury Operations-Foreign Exchange and Derivative Transactions

This Chapter has four sections as follows:

Section A: Overview of Treasury Operations in a Bank

Section B: Investments

Section C: Forex and Derivatives

Section D: Compliance with CRR and SLR Requirements

Section A: Overview of Treasury Operations in a Bank

7.01 Treasury operations is one of the most important function of a bank, responsible for the processing of all financial market transactions and usually much more, including a crucial role in managing risk. Treasury comprises two main components – Investments (comprising transactions related to domestic investments and money market operations) and Forex & Derivatives.

Core functions of Treasury Operations in Bank

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

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

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

Front office Operations

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

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

Middle office Operations

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

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

Back office Operations

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

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

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

Functions of Back Office

Input and completion

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

Counterparty confirmation

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

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

F-TRAC (FIMMDA Trade Reporting and Confirmation) System

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

Settlement

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

Reconciliation

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

Section B: Investments

Disclosure Requirements

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

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

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

Important Terms

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

Approved Securities

7.18 Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the Central or State Government, or any other security expressly authorised by the Central Government by notification in the official gazette.

Subsidiary General Ledger (SGL)

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

Repo and Reverse Repo Transaction

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

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

Accordingly, all repo/ reverse transactions are required to be accounted as lending and borrowing transactions with effect from 3rd October 2016.

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

7.23 RBI vide notification RBI/2016-2017/156 FMOD.MAOG No. 117/01.01.001/2016-17 dated November 25, 2016 has decided that the Oil Bonds issued by GOI will qualify as eligible securities for Repos, Reverse Repos and MSF, on E-Kuber system. In terms of RBI notification no. RBI/2016-17/49 FMRD.DIRD.6/14.03.002/2016-17 dated August 25, 2016, repo transactions are now allowed between the permitted entities, namely, (a) SGL A/c holders; (b) A SGL A/c holder and its own gilt account holder (GAH); (c) A SGL A/c holder and a GAH under another custodian; (d) GAHs under the same custodian; and (e) GAHs under two different custodians, subject to the conditions as specified in the said notification.

Short Sale

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

STRIPS

7.25 STRIPS stand for Separate Trading of Registered Interest and Principal

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

7.26 ‘When, as and if issued’ (commonly known as ‘when-issued’ (WI)) security refers to a security that has been authorized for issuance but not yet actually issued. ‘WI’ trading takes place between the time a new issue is announced and the time it is actually issued. All 'when issued' transactions are on an 'if' basis, to be settled if and when the actual security is issued.

The NDS-OM members have been permitted to transact on ‘When Issued’ basis in Central Government dated securities, subject to the guidelines of RBI.

Certificate of Deposit (CD)

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

7.28 Banks have to maintain appropriate reserve requirements, i.e., CRR and SLR, on the issue price of the CDs. There is no lock-in period for the CDs. Though, NRIs may also subscribe to CDs (but only on non-repatriable basis), such CDs cannot be endorsed to another NRI in the secondary market.

Banks/FIs may account the issue price under the Head "CDs issued" and show it under deposits. Accounting entries towards discount will be made as in the case of "Cash Certificates".

Commercial Paper (CP)

7.29 It is an unsecured money market instrument issued in the form of a promissory note by Corporates, PDs, FIs subject to compliance with the guidelines issued by RBI vide Master Direction on Money Market Instrument: Call/Notice Money Market, Commercial Paper, Certificate of Deposit and Non Convertible Debentures dated July 7, 2016. The tenure of CP should not be less than 7 days and not more than one year, from the date of issue.

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

Non-Convertible Debentures (NCDs)

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

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

REITs & InvITs

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

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

Legal Requirements

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

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

7.37 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.

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

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

(a) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure the minimum number of members as required by law.

(b) Investments may be deposited with the bankers of the company for collection of dividend or interest.

(c) Investments may be deposited with, or transferred to, or held in the name of, the State Bank of India or a scheduled bank to facilitate transfer thereof, subject to the conditions laid down in this behalf.

(d) Investments may be deposited with, or transferred to, any person by way of security for repayment of a loan or performance of an obligation undertaken by the company.

(e) Investments in the form of securities may be held in the name of a depository.

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

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

Balance Sheet Presentation

7.42 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)

7.43 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.

7.44 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.

7.45 For disclosures relating to investments in notes on accounts, please refer Chapter 9 of Part IV of the Guidance Note.

Guidelines of the RBI regarding transactions in Securities

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

Classification of Investments

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

(i) Held-to-maturity (HTM)

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

(ii) Held-for-trading (HFT)

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

(iii) Available-for-sale (AFS)

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

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

(a) SLR Securities upto prescribed percentage of their DTL as on the last Friday of the second preceding fortnight (updated vide RBI notification RBI/2017-18/70 DBR.No.Ret.BC.90/12.02.001/2017-18 dated October 4, 2017), which is as follows:

Period	**Prescribed percentage of DTL**
07 January 2017 to 25 June 2017	20.50%
24 June 2017 to 13 October 2017	20.00%
14 October 2017 onwards	19.50%

(b) Non-SLR securities included under HTM as on September 02, 2004.

(c) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio, excluding re-capitalisation bonds of other bank acquired for investment purpose.

(d) Fresh investment in the equity of subsidiaries and joint ventures.

(e) RIDF/SIDBI/RHDF deposits.

(f) Investment in long-term bonds (with a minimum residual maturity of seven years) issued by companies engaged in infrastructure activities.

7.49 The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position. RBI vide its circular dated 16th July 2015 decided that for accounting periods commencing on or after April 1, 2015, deposits placed with NABARD/ SIDBI/ NHB on account of shortfall in priority sector targets should be included under Schedule 11- 'Other Assets' under the subhead 'Others' of the Balance Sheet instead of disclosing under Schedule 8 "Investments".

Exposure Limits

7.50 The RBI, *vide* its Master Circular dated July 1, 2015 on "Exposure Norms" provides requirements in respect of exposure limits for banks. Further, the Reserve Bank of India vide Notification No. RBI/2016-17/167 DBR.No.BP. BC.43/21.01.003/2016-17 December 01, 2016 has issued guidelines on Large Exposure Framework (LEF). These guidelines shall come into effect with effect from April 1, 2019.

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

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

Audit Approach and Procedures

7.52 The auditor's primary objective in audit of investments is to satisfy themselves 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 auditors should keep this in view while designing their audit procedures relating to investments. The Reserve Bank of India has started issuing Master Directions on all regulatory matters beginning January 2016.

Internal Control Evaluation and Review of Investment Policy

7.53 The auditors should familiarise themselves with the instructions/ directions issued by the RBI regarding transactions in investment securities. The Banks should frame Internal Investment Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed / amended to include Primary Dealer (PD) activities also. Further, the Reserve Bank of India has issued Master Directions on Operational Guidelines for Primary Dealers dated July 1, 2016, which should be complied by Banks. The auditor should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank.

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

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

7.56 Some of the typical audit procedures would include:

- perusing the investment policy and preparing brief note on key points of compliances.
- examing whether the Investment policy has been periodically reviewed by the Management.
- verify whether investment policy lays down clear parameters for stop loss limits or there exits any separate stop loss policy.
- perusing the minutes of board/board appointed committee for approval of investment policy and obtain the list of modification made in the policy compared to earlier approved policy.
- examining whether the investments made by the bank are in accordance with the laid down investment policy and are also in compliance with the RBI guidelines w.r.t. exposure norms.
- verification of valuation of investments as per the method and frequency as defined by RBI.
- perusing reports on concurrent audit of treasury transactions, system audit report, if any and follow-up action taken by the management thereon.
- perusing the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949.
- Verification of voice recording mechanism and to ensure user ids of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

Process Review, Walk through and Control Testing

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

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

7.59 Some of the typical audit procedures include:

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

Substantive Audit Procedures

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

Examination of Reconciliation

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

7.62 Some typical audit procedures would include:

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

Inspection of Documents

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

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

7.65 Some typical audit procedures would include:

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

Examination of Existence of Investments

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

7.67 The auditor should verify the investments held with PDO, custodians and the depository, at the close of business on the date of the balance sheet with the statement of holdings. The auditor should circulate and maintain control over independent investments' balance confirmation requests to the custodian and other constituents (for example, RBI for SGL and CSGL balances) in accordance with SA 505, “External Confirmations” issued by ICAI. Furthermore, an auditor should design sufficient alternative audit procedures in situations where the independent confirmations are not received back (after reasonable follow up procedures) before the auditor signs off on the bank’s financial statements. These alternative procedures should also be designed in such a way that independent data points are used for corroborating investment balances. (e.g.: the auditor gets the bank personnel download the investment statement in his own presence e.g. from E-Kuber for Government Securities, DP’s website for Shares and Bonds etc.)

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

7.69 Investments are normally dealt with at the head office and not at the branches. However, sometimes, for realisation of interest etc., and other similar purposes, some of the investment scrips may be held at branch offices. In such cases, the auditor needs to examine the records maintained at the head office to record details of scrips held at other locations and request the respective branch auditors to physically verify such scrips as a part of their audit. The auditor needs to obtain a written confirmation to this effect 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.

7.70 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. In case the investment scrips are held at an unaudited branch, the auditor should request the management to obtain the scrips at the head office for his examination.

Cut-off Procedures

7.71 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 in the master circular above, the banks should follow 'Settlement Date' accounting for recording transactions in Government securities. In respect of transactions other than in Government securities, the bank should follow the accounting policy consistently either 'Trade Date' or 'Settlement Date' accounting.

7.72 Some typical audit procedures would include:

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

7.73 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.

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

Examination of Classification and Shifting

7.75 The auditor should examine whether the shifting of the investments to/from HTM category is carried out only once during a financial year and at the beginning of the financial year unless otherwise stipulated by RBI under special dispensation. Such shifting is required to be duly approved by the Board of Directors of the bank. As regards the shifting of investments from AFS to HFT, the auditor should verify the same as having been duly approved by the Board of Directors / ALCO / Investment Committee. In case of exigencies, the shifting from AFS to HFT may be done with the approval of the Chief Executive of the Bank/ Head of ALCO, but should be ratified by the Board of Directors later. Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

7.76 Transfer of scrips from AFS / HFT category to HTM category should be made at the lower of book value or market value. In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value.

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

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

b. If the security was originally placed in the HTM category at a premium, it may be transferred to the AFS / HFT category at the amortised cost. After transfer, these securities should be immediately re-valued and resultant depreciation, if any, may be provided.

7.78 It is to be noted that in case if the bank is following 'Weighted Average Method', the cost of acquisition of the security is required to be considered redundant and instead book value (which would be weighted average value) needs to be considered for the purpose of above mentioned both clauses.

7.79 If the value of sale or transfer (excluding one-time shifting and additional shifting explicitly permitted by RBI), exceeds 5% of the book value of HTM investments as at the beginning of the year, the bank should disclose market value of the investments under HTM category along with disclosure of excess of book value over market value for which provision is not made.

7.80 The audit procedures in this regard would include:

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

Examination of Accounting and Valuation

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

7.82 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.

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

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

i) Equity shares should be marked to market preferably on daily basis, but at least on a weekly basis;

ii) Banks which undertake short sale transactions, the entire HFT portfolio including the short position should be marked to market on daily basis.

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

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

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

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

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

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

7.89 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 an expert to check the integrity of system logic (to avoid, 'garbage in garbage out' kind of output).

7.90 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.

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

'Capital Reserve Account' net of taxes and Net Loss will be recognised in the Profit & Loss Account.

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

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

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

7.95 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.

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

7.97 Some of the typical audit procedures would include:

- obtaining list of investment as at reporting period from Bank and ascertaining completeness of the same by reconciliation process as highlighted above.
- checking the carrying amount of investments and ensuring that same is calculated on consistent basis. This is normally calculated by system, hence need to check IT controls and calculation on sample basis for ensuring accuracy.
- In case quotes are available, checking source of capturing market price/ fair value as at reporting date.
- In case quotes are not available, checking calculation for fair value as at reporting date to ensure compliance with RBI guidelines.
- checking calculation of Marked to Market Gain/ loss and accounting for same in compliance with RBI guidelines.

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

Type of Investment	Basis of Valuation
Unquoted Central Government Securities	Prices / YTM rates put out by PDAI / FIMMDA
Treasury Bills	Carrying Cost (acquisition cost plus discount accrued)
State Government Securities	By YTM method by marking it up by 25 basis point above Central Government Securities' Yield as put in by PDAI / FIMMDA
Other Approved Securities	By YTM method by marking it up by 25 basis point above Central Government Securities' Yield as put in by PDAI / FIMMDA
Debentures / Bonds	Valued with appropriate mark-up (which would be graded based on rating assigned to the security, and subjected to minimum of 50 basis point) over Central Government Securities' Yield as put in by PDAI / FIMMDA
Bonds issued by State Distribution Companies (DISCOM) under Financial Restructuring Plan	Same as above except that the mark-up would be 50, 75 and 100 basis point, when the liability is with the respective state government, guaranteed by respective state government or not guaranteed by state

Type of Investment	Basis of Valuation
	government, respectively
Zero Coupon Bonds (ZCBs)	Present Value (PV) to Face Value (FV) of ZCBs to be calculated by using 'Zero Coupon Yield Curve (ZCYC)' with appropriate mark up as per zero coupon spread put out by FIMMDA
Preference Shares	Valued with appropriate mark-up (which would be graded based on rating assigned to the security) over Central Government Securities' Yield as put in by PDAI / FIMMDA, subjected to an upper cap of redemption value of preference shares
Equity Shares	Valued at break-up value without considering 'revaluation reserves', if any
Units of Mutual Funds	Latest Re-purchase price or NAV and if NAV is not available, at cost
Commercial Papers	Carrying Cost (acquisition cost plus discount accrued)
Investments in RRBs	Carrying Cost (i.e., at book value)
Securities issued by Securitisation Company (SC) / Reconstruction Company (RC)	Lower of redemption Value or Net Book Value (NBV)
Venture Capital Funds (VCFs)	For first three years, VCFs may be classified under HTM and subsequently under AFS and valued for Units / Equity / Bonds as per specified norms

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

Non-Performing Investments (NPI)

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

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

(i) Interest/ installment (including maturity proceeds) is due and remains unpaid for more than 90 days.

(ii) The above would apply *mutatis-mutandis* to preference shares where the fixed dividend is not paid. If the dividend on preference shares (cumulative or non-cumulative) is not declared/paid in any year it would be treated as due/unpaid in arrears and the date of balance sheet of the issuer for that particular year would be reckoned as due date for the purpose of asset classification.

(iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 3.7.5 of the RBI Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks dated July 1, 2015, those equity shares would also be reckoned as NPI.

(iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and *vice versa*. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA. The Auditor should review the mechanism adopted by the Bank for classifying the investments as NPI where the credit facility has been classified as NPA and vice versa and test the effectiveness of the mechanism followed particularly the timeliness of such classification.

(v) The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

(vi) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA *ab initio* in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

Classification of State Government guaranteed investments as NPI

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

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

7.102 The audit procedures would include:

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

Special Aspects

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

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

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

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

7.106 The RBI's Master Circular specifies the following guidelines with respect to IFR and IRA:

Investment Fluctuation Reserve

(i) Banks were advised to build reserves towards investment fluctuation, of a minimum 5% of the investment portfolio within 5 years period.

(ii) To ensure smooth transition to Basel II norms, banks 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) As advised by RBI in October, 2005, Banks maintaining capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (of items - open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures) and AFS category as on March 31, 2006 may treat the entire balance of IFR as Tier I capital, may transfer the balance in the IFR 'below the line' in the Profit & Loss Appropriation account to statutory reserve, general reserve or balance of Profit and Loss Account.

Investment Reserve Account

(i) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit & Loss Account and equivalent amount (net of taxes, if any and net of transfer to Statutory Reserve as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves and Surplus" under the head "Revenue and Other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25% of total risk weighted assets prescribed for general provisions/ Loss Reserves.

(ii) The Investment Reserve Account can be utilised in the manner prescribed in the Master Circular.

(iii) The amounts debited to the Profit & Loss Account for provision should be debited under the head "Expenditure - Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the Profit & Loss Account should be shown as "below the line" item in the Profit and Loss Appropriation Account after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle but would, also result in a wrong statement of the profit for the accounting period:

   (a) the provision is allowed to be adjusted directly against an item of reserve without being shown in the profit and loss account, or

   (b) a bank is allowed to draw down from the Investment Reserve Account before arriving at the profit for the accounting period (i.e., above the line), or

   (c) a bank is allowed to make provisions for depreciation on investment as a below the line item, after arriving at the profit for the period,

   Hence none of the above options are permissible.

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

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

7.108 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.

7.109 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.

7.110 If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and also an undertaking from them that they hold the securities on behalf of the bank. The auditor may also check compliance with Section 89 of the Companies

Act, 2013 - Declaration in respect of beneficial interest in any share.

7.111 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. They 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.

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

Income from investments

7.113 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.

7.114 Some of the typical audit procedures would include:

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

7.115 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.

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

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

Special-purpose Certificates Relating to Investments

7.118 It may be noted that pursuant to RBI’s circulars, issued from time to time, banks require their Central Statutory 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.

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

Dealings in Securities on Behalf of Others

7.120 Apart from making investments on its account, a bank may also deal in securities on behalf of its customers only with the prior approval from RBI.

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

7.121 The auditor should examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.

The auditor also needs to give certificate for reconciliation of securities held by the bank as custodian.

The text of Illustrative Checklist for the Verification of the aspects of the Treasury/Investments of the Bank in Statutory Audit is given in CD.

Section C: Forex and Derivatives

Overview of Forex and Derivative Operations in a Bank

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

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

7.124 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.

7.125 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

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

7.127 "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 RBI from time to time.

Products offered in Forex and Derivative business

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

- DBOD.No.BP.BC. 44/21.04.157/2011-12 dated 2 November 2011 modifying the 20 April 2007 circular
- DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011 regarding credit default swaps
- IDMC.MSRD.4801/06.01.03 dated June 3, 2003 on Exchange-Traded

Interest Rate Derivatives

- IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 on Guidelines on Exchange Traded Interest Rate Derivatives
- RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 on "Guidelines on trading of Currency Options on Recognised Stock / New Exchanges
- DBOD.No.BP.BC.51 / 21.06.101 / 2010-11 dated October 28, 2010 on Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges
- RBI/2016-17/199 FMRD.DIRD.12/14.01.011/2016-17, December 29, 2016 on Introduction of Interest Rate Options in India, detailed directions of which are given in Notification No. FMRD-DIRD.11/2016 dated December 28, 2016.

Derivatives Markets

7.129 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

7.130 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

7.131 *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. The major objectives/purpose for undertaking derivative transactions has been explained below:

Objectives/Purpose	Reasons
Balance Sheet Management	• Use of derivatives by the Bank to manage its balance sheet exposures. • The Bank will use derivatives as a means for managing the interest rate, liquidity and foreign exchange risks arising from its banking operations.
Client servicing	• Offering derivative products to existing and new clients as an additional product from the Bank. • The Bank will offer derivative products to enhance product offerings to its existing clients as well as to build new client relations.
Proprietary Trading	• The Bank will undertake derivative transactions to earn trading profits. • The Bank's treasury may take view-based transactions as well as offer two-way quotes on derivatives within the limits prescribed by this policy.

Broad Principles for Undertaking Derivative Transactions

7.132 The major requirements for undertaking any derivative transaction include:

- In addition to generic derivative products, market-makers may also offer structured derivative products to users as long as they do not contain any derivative instrument as underlying and have been specifically permitted by RBI in its Master Direction No. 1/2016-17 dated July 5, 2016 (updated March 21, 2017) on 'Risk Management and Inter-Bank Dealings' and guidelines contained in RBI's Circular DBOD.No.BP.BC.86/21.04.157/2006-07 dated 20 April 2007 on Comprehensive Guidelines on Derivatives and further amendments issued vide circulars DBOD.No.BP.BC. 27 / 21.04.157/2011-12 dated 2 August 2011 and DBOD.BP.BC.44/21.04.157/2011-12 dated 2 November 2011 on 'the Comprehensive Guidelines on derivatives'.

    a. The following derivative instruments used to hedge an existing interest rate and forex exposure, on a standalone basis, may be treated as generic derivative products:

        o Forex Forward Contracts

- Forward Rate Agreements
- Interest rate caps and floors (plain vanilla only)
- Plain Vanilla Options (call option and put option)
- Interest Rate Swaps
- Currency Swaps including Cross-Currency Swaps
- Exchange traded Currency Futures
- Exchange traded currency options
- Interest Rate Options.

b. The following derivative products may be treated as structured derivative products:

- Instruments which are combination of either cash instrument and one or more generic derivative products
- Instruments which are combination of two or more generic derivative products

- 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 approach specified in the Comprehensive Guidelines on derivatives.

7.133 It may be ensured that structured products do not contain any derivative, which is not allowed on a standalone 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

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

(a) appropriate oversight by the board of directors and senior management;

(b) adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and

(c) comprehensive internal controls and audit procedures.

Suitability and Appropriateness

7.135 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 blocks of the transaction.

 (iii) Rationale along with appropriate risk disclosures.

 (iv) Sensitivity analysis identifying the various market parameters that affect the product.

 (v) Scenario Analysis encompassing both the possible upside as well as the downsides.

(b) Analyse the expected impact of the proposed derivatives transaction on the user.

(c) Before offering any derivative product to a client, obtain Board resolution from the corporate which contains the details specified in the Comprehensive Guidelines on derivatives.

(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/email 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

7.136 The comprehensive guidelines on derivatives circular require the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects.

Identification and Management of Risk

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

- credit risk
- market risk

- liquidity risk
- interest risk
- operational risk
- legal risk

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

Risk limits

7.138 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

7.139 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

7.140 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

7.141 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, DBOD.No. BP.BC.57/21.04.157/2008–09 dated October, 13 2008, DBOD.No.BP.BC. 28/21.04.157/2011-12 dated August 11, 2011 and DBOD.No.BP.BC.31 /21.04.157/2012-13 dated July 23, 2012 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and RBI's Master Circular No. RBI/2015-16/70/DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015 on "Exposure Norms".

Asset Classification of Derivatives

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

i. The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for a period of 90 days from the specified due date for payment.

ii. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.

iii. However, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which 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.

7.143 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.

7.144 RBI *vide* its Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/ 2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" 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.

7.145 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 of aforementioned circular, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account.

- The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account.
- On payment of the overdues in cash, the balance in the 'Suspense Account-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

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

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

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

Risk management

7.148 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved – which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modeling associated with derivatives trading and hedging. In between can come monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department.

Risk Identification Process

Price or Rate Risk

Foreign Exchange Rate Movement Risk

7.149 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

7.150 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

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

Credit Risk

7.152 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

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

Settlement Risk

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

Market risk

7.155 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

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

Market Liquidity Risk

7.157 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

7.158 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

7.159 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

7.160 This can occur if an error in processing results in a loss and/or excess over prescribed risk/regulatory limits.

Legal risk

7.161 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

7.162 Regulatory risk is the risk of loss arising from failure to comply with regulatory or legal requirements.

Reputation risk

7.163 Reputation risk is the risk of loss arising from adverse public opinion and damage to reputation.

Risk Management Limits and Monitoring

7.164 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

7.165 NOOPL may be fixed by the boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should not exceed 25 percent of the total capital (Tier I and Tier II capital) of a bank, refer RBI Master Directions – Risk Management and Inter Bank Dealings dated July 5, 2016 (updated March 21, 2017). This limits the maximum allowable excess of assets plus exchange bought contracts over liabilities plus exchange sold contracts ("overbought" position) and the reverse ("oversold" position) that may be carried overnight in foreign currencies.

Daylight Limit

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

Value at Risk ('VAR') limits

7.167 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. Some banks compute VAR as per FEDAI circular while some banks have developed their own computation mechanisms.

7.168 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

7.169 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.

7.170 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.

7.171 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

7.172 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

7.173 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

7.174 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)

7.175 MAT 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.

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

7.176 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.

7.177 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

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

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

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

7.181 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

7.182 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. The Comprehensive Guidelines on derivatives also requires the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects.

Rate Reasonability

7.183 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

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

Regulatory Reporting requirements

7.185 Derivatives are governed by the Foreign Exchange Management

(Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are allowed only under the provisions of these regulations and amendments since, or with the prior permission of the Reserve Bank of India. The reporting requirements under RBI Master Direction No. 1/2016-17 dated July 5, 2016 (updated March 21, 2017) 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 adhering to.

7.186 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.

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 those details of exposures of all corporate clients who meet the prescribed criteria have to be included in the report. The AD banks should submit this report based on bank's books and not based on corporate returns.

v) Details of option transactions (FCY-INR) undertaken on a weekly basis.

vi) Total outstanding foreign currency borrowings under all categories as on the last Friday of every month.

vii) Monthly report (as on the last Friday of every month) on the limits granted and utilized by their constituents under the facility of booking forward contracts on past performance basis.

viii) Statement in form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).

ix) A monthly statement, in respect of cover taken by FIIs, indicating the name of the FII / fund, the eligible amount of cover, the actual cover taken, etc.

x) List (in triplicate) of all bank's offices/branches, which are maintaining Rupee accounts of non-resident banks as at the end of December every year.

xi) Quarterly report on the forward contracts booked and cancelled by SMEs and Resident Individuals.

xii) Consolidated data on the transactions undertaken by non-residents under the scheme.

xiii) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.

7.187 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').

7.188 Moreover, ADs have to provide forms A2 for all interbank cross-currency deals done with overseas banks maturing during a fortnight to the RBI through the R-Return which is submitted on a fortnightly basis.

7.189 ADs also have to submit a report (MAP/ SIR) in the format as prescribed by the RBI. This is required to be prepared for 4 major currencies (i.e. US$, GBP, YEN and CHF). MAP will be prepared for the last reporting Friday of each month.

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

7.191 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

7.192 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.

7.193 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.

7.194 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.

7.195 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

7.196 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.

7.197 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.

7.198 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.

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

FX spot / forwards	Prices as published by Foreign Exchange Dealers Association of India ('FEDAI'). With effect from 31 December 2014, these are further required to be adjusted

	for arriving net present value.
Exchange traded interest rate 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.

7.200 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.

7.201 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.

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

7.203 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.

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

7.205 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.

7.206 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.

7.207 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

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

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

7.210 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.

7.211 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.

7.212 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.

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

Audit Approach

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

7.215 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

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

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

Product Program and Policy

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

Further, in accordance with the Comprehensive Guidelines on derivatives, the auditor should obtain and verify full particulars of the model used for valuation and the documented algorithms used by the Bank.

Customer/User Suitability and Appropriateness Policy

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

Auditor should also verify the process followed by the bank for classification of customer into different grades/classification.

Credit limits

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

- Check whether the name of the counterparty is in the approved counterparty list for the purpose of treasury transactions.
- Check whether the credit limits are set for different customers and they are adhered to in a consistent manner and for any limit breaches, appropriate sanctions / ratifications are in place.
- Check whether the counterparty exposure limit reports for all brokers, lenders, etc., are generated and monitored on a regular basis.
- Check 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.
- Check whether the above limits are entered into the software system being used by the Branch for conducting the said transactions.

Deal Initiation and Recording

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

- For the selected samples check whether the deal ticket is complete and accurate with respect to all transaction details like counterparty name, contract rate, notional amount, transaction date / maturity date, value date / settlement agent and buy / sell date.
- Check whether deal tickets are generated automatically by front office systems, or trader should use sequentially numbered deal tickets.
- Check whether the dealers use dedicated calling lines and all the telephone lines are linked to a voice recording machine.
- Verify the adherence to the voice recording mechanism
- Verify whether user IDs of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

- Verify whether, the Use of Mobile Phones is restricted in the Dealing Room and mechanism for ensuring adherence thereto
- Verify the recordings for few of the selected samples to ascertain that the recording machine is working in order.

Deal Authorisation

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

- Check whether proper authorization levels are set for treasury operations and observe and verify whether the prescribed procedure is followed.
- For the selected samples, check whether deals entered in front office system are authorised by the back office team after verifying the deal details with external evidences like Reuters' conversation, telephonic conversation with customers' back office, etc.
- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sampled deals are authorised at the proper levels of authority against the deal slip.
- Check whether alterations and cancellations on deal slips are duly authorised.

Segregation of Duties

7.223 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 should be involved in checking or receiving deal related documents.
- Verify whether there is any overlapping of duties
- Verifying that there is clear segregation, functionally and physically, between the front office, back office and middle office in respect of derivative transactions.
- Checking that there is segregation between functions of authorisation, execution and recording of transactions.
- In cases where management override has taken place, ascertain that satisfactory reasons for doing so were recorded and produced for audit verification.

- Checking whether treasury personnel have availed minimum leave during the financial year.

Counterparty confirmations

7.224 For this, the auditor would *inter alia*:

- Understand the process of sending and tracking the confirmations including follow – up procedures
- Understand the process of MIS reporting to the senior management in respect of the non-receipt of counterparty confirmations.
- Verify that confirmations from Bank to counterparty are sent within a reasonable time and there exists a mechanism for follow-ups for pending counterparty confirmations.
- Determine the status of any missing / pending confirmations (currently in the Confirmation Tracking List) and assess whether there are any provisioning concerns on the trades
- Check whether the format of the counterparty confirmation is as approved by the Local Legal Counsel of the Bank from time to time.
- Verify controls implemented by banks to ensure completeness of all deal confirmations.
- Inquire of any exception report or other mechanism of tracking missing confirmations.

Customer Complaints

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

Underlying document

7.226 The audit procedures for this aspect include:

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

- The auditor should ensure that the bank should obtain the original documents from the client and or certified document by the person who is authorised to do the derivative deal. The auditor should check the details in client master page by checking the board resolution.
- The auditor should ascertain whether the Bank has a mechanism whereby, if the documents are not submitted by the customer within 15 days, the contract gets cancelled, and the exchange gain, if any, is not passed on to the customer. The primary responsibility for ensuring this remains with the Bank and the auditors should verify controls around the same.
- The auditor should ensure that the Bank has a mechanism to ensure that if the underlying is not provided three times a year; then the client will have to produce upfront underlying and the 15 days grace will not be allowed to the client.
- For the selected samples, review and check the underlying documents duly received by the bank.
- In cases, where the underlying documents with regard to the forex transactions are maintained at branches, then, the auditor may obtain confirmation from such branches about existence of the underlying documents and review sudden spurt in foreign exchange transactions of any branch in a particular month/period, if any, and test adherence to the RBI guidelines relating to merchant transactions

Accounting of transaction in the general ledger

7.227 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.
- Understand the accounting scheme for the various products. Further, inquire about the routine and non – routine accounting entries with the bank,
- For the selected samples, verify the accounting entries passed

Position Reconciliation

7.228 The audit procedures include:

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

Deal Settlements

7.229 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.
- Examining whether deal is settled / cancelled in case no confirmation is received from customers till expiry dates.

Realised profit / loss on derivative transactions

7.230 The audit procedures include:

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

Rate Scan

7.231 The audit procedures for this would include:

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

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

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

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

Assessment of controls

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

- Existence of comprehensive treasury policy and operating procedures manual (SOP).
- Review of the policies and procedures document and assess comprehensiveness of the same.
- Determining whether the above document addresses, in granular detail, the framework within which the treasury business and operations have to be conducted.
- Inquiring on the procedures the bank has when there is a change over or new appointment to a 'review' role within the treasury function.
- 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.
- 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).

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.

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

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

Outsourced/Hubbed process

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

NOSTRO and VOSTRO Accounts

7.234 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

7.235 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.

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

- Whether a system of periodical reconciliation is in place.
- Whether the reconciliation process followed ensures matching of each item and not for overall matching of total amount
- Whether logs are generated for any change made in entry and whether maker checker is implemented for authorising changes made in entry, if any, for reconciliation
- Whether confirmations from the foreign banks are obtained on a periodic basis. This may be either through physical confirmations, swift messages, emails, etc.
- whether Information to the controlling office is sent on a timely basis.
- whether long outstanding are taken up and cleared.
- random check of the method of reconciliation.
- Debits outstanding in the NOSTRO accounts are to be verified and recommend for provision wherever necessary.
- Set off the credit against debits only at the permission of the head office for long outstanding entries.

7.237 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 may be large in a few cases and hence susceptible to frauds. Accordingly, the banks should transfer the following balances in the "Sundry Debtors/ Unclaimed Deposits Accounts" appearing in the books of the bank as on September 30, 2001 to distinct "Blocked Accounts" and shown under "Other Liabilities and Provisions" (item no. iv of Schedule 5) in the balance sheet:

(i) the net credit balance arising out of the netting of entries pertaining to the period prior to April, 1996; and

(ii) credit entries originated on or after April 1, 1996 and remaining unreconciled in NOSTRO/ mirror accounts for more than three years.

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

7.238 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.

7.239 The audit considerations for this aspect include:

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

Evaluation of Internal Audit/Concurrent Audit

7.240 The audit considerations for this aspect include:

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

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

7.241 The audit considerations for this aspect include:

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

(vi). Establishes risk measurement methodologies which are consistent with the nature and scale of the derivative activities;

(vii). Requires stress testing of risk positions;

(viii). Details the type and frequency of reports for monitoring risks which are submitted to the Board (or committees of the Board);

(ix). Typical risks and commonly used risk limits in respect of derivative transactions.

Information Technology ('IT') Controls

7.242 The audit considerations for this aspect 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 ascertain 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 ascertain that risk identification, measurement, control, and monitoring are commensurate with the complexity of the bank's technology and operating environment.
- Evaluate the separation of duties and responsibilities in the operation and data processing of treasury functions.
- Evaluate the adequacy of input/output controls and 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

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

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

7.244 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. In such cases the auditor should also check system controls and if deemed necessary, consider involving an expert to check the integrity of system logic. Further, the auditor can select certain samples as per the methodology or depending upon the nature, timing and extent for getting it re – valued from the valuation expert. Auditor should also obtain the understanding of rate upload process and verify the timing of rates upload in the system for valuation of derivative contracts. Auditors should carry out the valuation of the samples selected in a spreadsheet and compare the end results with the valuation as provided by the software system. Sometimes the software systems are not capable of valuing certain treasury products such as partly redeemable perpetual bonds, Security Receipts etc., for which the Branch has to value such products manually and the auditor should gain sufficient knowledge to understand and confirm their valuation.

Section D: Compliance with CRR and SLR requirements

7.245 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 per cent 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.

7.246 The RBI *vide* its Master circular No. RBI/2015-16/98 DBR.No.Ret.BC.24/12.01.001/2015-16 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2015, has specified that consequent upon amendment to the Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the

Reserve Bank can prescribe the Statutory Liquidity Ratio (SLR) for Scheduled Commercial Banks in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time.

7.247 Further, Reserve Bank has specified *vide* notification RBI/2016-17/83 DBR.No.Ret.BC.15/12.02.001/2016-17 dated October 13, 2016 that every Scheduled Commercial Bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 20.75 per cent from October 1, 2016 and 20.50 per cent from January 7, 2017, on the total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

(a) Cash or

(b) Gold as defined in Section 5(g) of Banking Regulation Act, 1949 valued at a price not exceeding the current market price, or

(c) Unencumbered investment in the following instruments which will be referred to as "Statutory Liquidity Ratio (SLR) securities":

   (i) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;

   (ii) Treasury Bills of the Government of India;

   (iii) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme; and

(d) the deposit and unencumbered approved securities required, under sub-section (2) of section 11 of the Banking Regulation Act, 1949 (10 of 1949), to be made with the Reserve Bank by a banking company incorporated outside India;

(e) any balance maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under section 42 of the Reserve Bank of India Act,1934 (2 of 1934);

7.248 Provided that the instruments referred to in items (1) to (3) above that have been acquired under reverse repo with Reserve Bank of India, shall not be included as SLR securities for the purpose of maintenance of SLR assets up to October 2, 2016. From October 3, 2016 such securities acquired from Reserve Bank shall be considered as eligible assets for SLR maintenance.

7.249 However, in term of Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks dated

July 1, 2015, the regulatory treatment of market repo transactions in Government securities will continue as hitherto, i.e., the funds borrowed under repo will continue to be exempt from CRR/SLR computation and the security acquired under reverse repo shall continue to be eligible for SLR.

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

7.251 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.

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

(a) value of securities held for the purpose of compliance with SLR and

(b) the excess cash balances maintained by them with RBI in the prescribed format.

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

7.253 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.

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

Computation of CRR

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

Computation of SLR

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

Audit Approach and Procedures

7.257 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.

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

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

7.260 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.

7.261 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.

7.262 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.

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

(a) Net credit balance in Branch Adjustment Accounts. The credit entries in branch adjustment account which are outstanding for more than 5 years are required to be considered at gross;

(b) Interest on deposits as at the end of the first half year if reversed in the beginning of the next half-year.

(c) Borrowings from abroad by banks in India needs to be considered as ‘liabilities to other’ and thus, needs to be considered at gross level unlike ‘liabilities towards banking system in India’, which are permitted to be netted off against ‘assets towards banking system in India’. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'

(d) The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.

7.264 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.

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

7.266 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. Thus, such interest accrued but not accounted for in books should be included in the computation of DTL.

7.267 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.

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

IV-8
Profit and Loss Account

8.01 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

8.02 The Profit and Loss Account as set out in Form B has four broad heads:

- Income
- Expenditure
- Profit/ Loss
- Appropriations

The information to be provided under each of the above heads is also specified in the Schedule. It would be pertinent to note that knowledge of the Bank's accounting policies is of utmost importance before verifying the items within the profit and loss account. The auditor must make enquiries with the management to ascertain whether there have been any changes in the accounting policies and also review the closing circulars issued by the controlling authorities of the Bank.

Applicability of AS 5 and Materiality

8.03 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.

8.04 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.

Income

Interest Earned

8.05 The following items are included under this head:

(a) *Interest/Discount on Advances/Bills:* This includes interest and discount on all types of loans and advances like cash credit, overdrafts, demand loans, term loans, export loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue and penal interest and interest subsidy, if any, relating to such advances/bills. The amount to be included under this head is net of the share of participating banks under inter–bank participation schemes on risk–sharing basis. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system. The auditor must consider the internal controls over modification in interest rates in the CBS system and verify whether these have been appropriately accounted for in the accounts

(b) *Interest Income on Investments:* This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. Broken period interest paid on securities purchased and amortisation of premium on SLR investments is net off from the interest income on investments.

(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

8.06 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.

- *Profit on Sale of Investments:* Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and 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.
- *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 recognized 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. The net profit or loss on account of the revaluation of investments held by the bank is reported under this head.

Other Income

8.07 The following items are included under this head:

(i) *Commission, Exchange and Brokerage:* This item comprises of the following:

(a) Commission on bills for collection.

(b) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.

(c) Commission on letters of credit and guarantees, letter of comforts.

(d) Loan processing, arranger and syndication fees.

(e) Mobile banking fees.

(f) Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.

(g) Rent from letting out of lockers.[7]

(h) Commission on Government business.

(i) Commission on other permitted agency business including consultancy and other services.

(j) Brokerage on securities.

(k) Fee on insurance referral.

[7] 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.

(l) Commission on referral of mutual fund clients.

(m) Service/transaction banking charges including charges levied for transaction at other branches.

(n) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services.

(ii) *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.

(iii) *Profit on exchange transactions:* This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc.

(iv) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.

(v) Miscellaneous income.

Profit/Loss on Revaluation of Property, Plant & Equipment (PPE)

8.08 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 (Revised), *Property, Plant & Equipment*, relating to revaluation of fixed assets assume significance. According to the AS 10 (Revised), when a PPE is revalued in financial statements, the entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. It is also provided that an increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve. However, if such increase is related to and not greater than a decrease arising on revaluation which was previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. On the other hand, any decrease in net book value arising on revaluation of fixed assets should be charged directly to the profit and loss account except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to revaluation reserve account.

8.09 From the above, it can be seen that as per AS 10(Revised), surplus on revaluation of a fixed asset cannot be credited to the profit and loss account except to the extent that such surplus represents a reversal of a related previous revaluation decrease that was charged to the profit and loss account.

Profit on Exchange Transactions

8.10 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 has become a systems driven adjustment. The auditor should understand the process of foreign exchange rate upload in the system for revaluation of forward contracts and derivative contracts. Each bank has a process to daily upload of day's foreign exchange rate and curves etc. in the system at the specific time. The auditor should verify independently rates on sample basis which are uploaded in the system. The auditor should verify the internal controls in place for such centralized system upload including whether the same are done under appropriate authority. The auditor should also obtain the audit trail from the system to understand whether subsequent modification in system has been made and reason for the same.

b) Obtaining the revaluation report of outstanding forward exchange contracts and other derivative contracts as on the reporting date and agreeing the currency-wise notional amounts of the forward exchange contracts and other derivative contracts with the foreign currency general ledger to ascertain completeness of revaluation report. Further, on a sample basis, recompute the valuation of the forward exchange contracts and other derivative contracts using a valuation tool. Further As per AS-11, in recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

c) Obtaining the bank's risk policy to understand the bank's process of classification of hedge, assessment of hedge effectiveness and accrual of hedge cost. The auditor should obtain the report of hedge transaction outstanding on reporting date and hedge effectiveness.

d) Testing large transactions and check whether these are recorded in compliance with the directions of the controlling authority.

e) Scrutinising transactions recorded in the post–balance sheet period to ascertain that no material items have been ignored up to the year end.

f) Enquiring and obtaining explanations regarding unusual large transactions/entries involving huge gains/ losses for the year and the same needs to be documented in the work paper.

Income Earned by Way of Dividends, etc. from Subsidiaries and Joint Ventures abroad/in India

8.11 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

8.12 This head generally includes following items of income:

(a) Recovery in Written off Accounts

(b) Rental income from bank's properties;

(c) Security charges;

(d) Insurance charges recoverable from customers;

(e) Other income from carrying out other services like selling of gold coins etc.

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.

8.13 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

8.14 Expenditure is to be shown under three broad heads: interest expended; operating expenses; and provisions and contingencies.

Interest Expended

8.15 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. Usually, the rates of term deposits of banks are amended from time to time by the ALCO or the Board. The auditor must verify the system in place to give effect to these changes in the CBS system of the Bank.

(b) *Interest on Reserve Bank of India/ Inter–Bank Borrowings:* This includes interest/ discount on all borrowings and refinance from the RBI and other banks.

(c) *Others:* This includes discount/ interest on all borrowings/ refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.

Auditor should verify the interest reset on premature withdrawals of deposits and interest charged on loan overdraft against the same. Appropriate charge of penalty as per each bank's policy should also be verified.

8.16 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 January 25, 2012), has deregulated the savings bank deposit interest rate. In other words, the banks are now free to determine their savings bank deposit interest rate. The auditor should verify that prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) has been obtained by a bank while fixing interest rates on such deposits.

8.17 Further, *vide* its Circular No. DBOD.Dir.BC.64/13.03.00/2011-12 dated December 16, 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.

8.18 Attention is also drawn to RBI Master circular no. DBR.No.Dir.BC.8/13.03.00/2015-16 dated 1st July 2015, by which RBI has consolidated instructions pertaining to FCNR(B) deposits by Banks. Specific consideration should be given to the ceiling on interest rates, 360 days to a year basis for interest payment, rounding off of interest etc. Recurring Deposits should not be accepted under the FCNR (B) Scheme. The interest on FCNR (B) deposits should be calculated and paid at intervals of 180 days each and thereafter for the remaining actual number of days. However, the depositor will have the option to receive the interest on maturity with compounding effect.

Auditor should verify concurrent or internal audit reports for revenue leakages detected but not rectified till date. Appropriate entries if necessary could be passed.

Operating Expenses

8.19 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.

(ii) *Rent, Taxes and Lighting:* This item includes rent paid by the bank on buildings, municipal and other taxes, electricity charges and other similar charges and levies. Auditor should specifically review cases where rental increases are in dispute & unpaid. Necessary provisions / disclosures should be appropriately made. It may be noted that income-tax and interest on tax are not to be included under this head. Similarly, house rent allowance and other similar payments to staff would not appear under this head.

(iii) *Printing and Stationery:* This item includes books and forms and stationery used by the bank and other printing charges except those incurred by way of publicity expenditure. While some stationery may have been purchased by the branch, other stationery (security paper like draft forms, cheque books) would have been received by the branch from the head office. Auditor should specifically note the bank policy in this regard whether the same is expensed out on purchase or on usage. In any case any unusable or outdated stationery should be expensed out. If any Stationery is shown as an asset, necessary physical verifications should be done.

(iv) *Advertisement and Publicity:* This item includes expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material. Auditor should specifically review such agreements to find out commitments made for such expenses in future periods.

(v) *Depreciation on Bank's Property:* This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may be either centralised at the head office level through fixed asset management software or decentralized and manual at branches and other offices. Auditor should specifically review the useful life at the year end and provide for additional depreciation in case there is any downward revision in the useful life. Auditor should ensure that fixed assets are accounted from the date the asset is put to use. Necessary accounting of the asset to be done & depreciation calculated from this date. Generally, banks account for fixed assets on date of final payment irrespective of the asset being put to use much earlier.

Auditor should note the process for verifying assets booked by branch but allotted to employees & located at Bank residential premises allotted to these employees.

(vi) *Directors' Fees, Allowances and Expenses:* Expenditure incurred in this regard is recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.

(vii) *Auditors' Fees and Expenses:* Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like reimbursements are recorded under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.

(viii) *Law Charges:* All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here. Auditor should specifically review the Legal agreements to note future commitments for payables. Expenses paid to advocates recovered from Borrowers by direct debit to that account should be specifically noted for consistency in accounting. The auditor should also co-relate law charges with the contingent liability appearing in financial statement or with the specific annexure/report to be certified by the Branch Auditors'.

(ix) *Postage, Telegrams, Telephones, etc.:* This item includes all postal charges like stamps, telegrams, telephones, teleprinters, etc. Issuance of

Telegrams has been discontinued since 15th July 2013 and this head is now just for academic purposes.

(x) *Repairs and Maintenance:* This item includes repairs to bank's property, their maintenance charges, etc. Amortization of such expenses should be specifically noted.

(xi) *Insurance:* This item is usually dealt with at the head office level and may not therefore be relevant at the branch level. This includes Premium paid to DICGC, Insurance of Cash on Hand, in ATM & in transit and also Insurance of Fixed Assets, Employee Fidelity Insurance, Fraud Covers, Coverage for Cyber Risks. Auditor should specifically ensure that all risks are insured adequately. Decision not to insure specific risks / assets should be approved at appropriate Management levels & Auditor should obtain the relevant documents for record.

(xii) *Direct Marketing Expenses:* These are the expenses incurred majorly for sourcing of retails loans/credit cards and collection of retail overdue loans. RBI circular RBI/2006/167/DBOD.NO.BP.40/21.04.158/2006-07 dated 3rd November 2006 clearly states that activities of internal audit, compliance function and decision making functions like compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management of retail loans cannot be outsourced.

(xiii) *Other Expenditure:* This item includes all expenses other than those included in any of the other heads, like, license fees, donations[8], subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss

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[8] The Reserve Bank of India, from time to time, prescribes the limits up to which banks can make donations. As per the Reserve Bank of India's circular no. DBOD. No. Dir. BC. 50/ 13.01.01/ 2005–06 dated December 21, 2005, the policy relating to donations given by banks to various entities may be formulated by the Board of Directors of the banks. While formulating any such policy, the circular requires the directors to take into account *inter alia,* the following principles:

(i) profit making banks, during a financial year, may make donations upto one percent of the published profits for the previous years. This limit of one percent would include contributions made by the bank to any fund created for specific purposes such as encouraging research and development. However, donations/ subscriptions to the Prime Minister's National Relief Fund and to professional bodies related to banking industry, such as the Indian Banks Association, Indian Institute of Banking etc., is excluded from such limit of one percent.

(ii) loss making banks can make donations upto Rs. 5 lakhs in a financial year including donations to the Prime Minister's National Relief Fund and other professional organisations listed in (i) above.

The circular has clarified that the unutilised portion of one percent cannot be carried forward to the next year. The Circular also outlines the procedure for making contribution to the Prime Minister's National Relief Fund.

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.

Some banks follow the policy of providing for the promotional points earned by the customers on the use of Debit/Credit cards on actuarial basis. These provisions could be shown under this head.

Expenses should be accounted on accrual basis and not on cash basis. Necessary payment vouchers of April month could be verified for the same. Necessary confirmations or representations for the same could be obtained.

Provisions and Contingencies

8.20 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

Provisioning norms for NPA are given in circular RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated 1st July 2015. Interest reversal in case of advances which have become NPA to be specifically checked. The most important item included in this head is the provision in respect of non–performing assets. The other provisions are usually made at the head office level.

Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961

8.21 RBI *vide* its Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 on "Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961" dated December 20, 2013 advised banks, that as a matter of prudence, DTL should be created on Special Reserve.

8.22 For this purpose, banks may take the following course of action:

a) If the expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 has not been fully charged to the Profit and Loss account, banks may adjust the same directly from Reserves. The amount so adjusted may be appropriately disclosed in the Notes to Accounts of the financial statements for the financial year 2013-14.

b) DTL for amounts transferred to Special Reserve from the year ending March 31, 2014 onwards should be charged to the Profit and Loss Account of that year.

In view of the requirement to create DTL on Special Reserve, banks may reckon the entire Special Reserve for the purpose of computing Tier-I Capital. Reference in this regard is also drawn to the Announcement "Manner of Reporting by the Auditors In Respect of RBI's Circular on Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961" dated April 30, 2014 issued by the Auditing and Assurance Standard Board of the Institute of Chartered Accountants of India.

Appropriations

8.23 Under this head, the net profit/ loss for the year as well as profit/ loss brought forward have to be shown. The appropriations of the aggregate thereof are to be shown under the following heads:

(a) Transfer to Statutory Reserves.

(b) Transfer to Capital Reserves.

(c) Transfer to Investment Fluctuation Reserve.

(d) Transfer to Debenture Redemption Reserve.

(e) Transfer to Other Reserves.

(f) Transfer to Government/ Proposed Dividend.

(g) Transfer to Tax on Dividend.

8.24 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. According to RBI circular RBI/2006-07/132 DBOD.BP.BC No. 31 / 21.04.018/ 2006-07 dated 20th September 2006 all expenses including provisions and write-offs recognized in a period, whether mandatory or prudential, should be reflected in the profit and loss account for the period as an 'above the line' item (i.e. before arriving at the net profit).

Audit Approach and Procedures

Income

8.25 In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period. In view of the mandatory requirement of recognition of income, the recognition of revenue will have to be subjected to examination *vis-à-vis* the guidelines. *Vide* circular DBOD.No.BP. BC. 89 /21.04.018/2002-03 dated 29th March 2003, RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per AS-9. If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify the statements in that situation. As per AS-9 Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. If revenue recognition is postponed, as per AS 9, an enterprise should also disclose the circumstances in which the revenue recognition has been postponed pending the resolution of significant uncertainties.

8.26 Since the entire accounting in banks is done on the CBS, the auditor should plan the audit procedures based on controls testing. If he is not satisfied with the controls in place for accounting and recording of items of income and expenses correctly, he should resort to more of substantive checking of documents and records.

In case the auditor decides to adopt the control reliance strategy, the auditor should perform test of controls which mitigate the risk of what could go wrong.

Interest Income

8.27 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. Income in case of NPA account should be recognised only on realisation on cash basis as per circular RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/ 2015-16 dated 01/07/2015. These norms are also applicable to Government Guaranteed Advances.

8.28 In case of accounts under Corporate Debt Restructuring (CDR) scheme, the auditor should see whether the income on projects under implementation which have been classified as standard has been accounted for on accrual basis pursuant to the RBI's income recognition norms. Banks are not permitted to recognize income on accrual basis from projects under implementation which have been classified as 'sub–standard' asset. Bank may recognize income in such accounts only on realisation on cash basis. Income in respect of Funded Interest and where loans are converted into equity, debentures or any other instrument is to be recognized on the same basis as in the case of restructuring and re-scheduling of loans.

8.29 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.

8.30 The auditor may assess the overall reasonableness of the figure of interest earned by working out the ratio of interest earned on different types of assets to the average quantum of the respective assets during the year. The auditor should obtain an in-depth understanding as to how the bank's management monitor their business, analyse its credit portfolio and the interest income thereon.

8.31 For example, the auditor may obtain from the bank an analysis of sector-wise and segment-wise deployment of credit, including the lending rates of advances in various sectors and figures of advances outstanding at the end of each month/quarter. From such information, the auditor may work out a weighted average lending rate. This analysis can be done for corporate and retail loan portfolio separately. In case of retail loans, the portfolio can be further bifurcated into home loans, auto loans, personal loans, jewel loans, etc. Further, the auditor should understand the process of computation of the average balance and re-compute the average balance on sample basis.

8.32 The auditor should set the expectation for the movement in yield based on the discussion and inquiries made with the management; rate movement observed in the industry, etc., and should obtain explanations for major variances in the yield on month on month basis or quarterly basis.

8.33 To ascertain completeness of interest income in the analysis, the auditor should obtain general ledger break-up for the interest income earned during the respective months/quarter and examine whether the aggregation of the same agrees with the interest income considered for the yield analysis. The auditor should analyze monthly/quarterly yields and document the reasons for the variances as per the expectation set. The auditor may also compare the average yield on advances with the corresponding figures for the previous years and analyse any material differences. The auditor may also compare the reported market yield in percentage terms with market rates, RBI rates, advertised rates and rates across various products of the bank. Interest Income includes interest accrued but not due on investments.

8.34 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.

8.35 The auditor should also understand the process of accrual of interest income on credit card portfolio. Credit card account will be treated as an NPA if the minimum amount due as stated in statement is not fully paid within 90 days from the date of last statement The auditor should understand the assumption taken for accrual of interest income such as revolving portfolio, standard assets etc. and independently assess the reasonableness of these assumptions.

8.36 The auditor should also satisfy himself that interest on non–performing assets has not been recognised unless realised.

8.37 As per AS 9, "*Revenue Recognition*", dividends should be recognised when the right to receive payment is established, i.e. dividend has been declared by the corporate body at its Annual General Meeting and the owner's right to receive payment is established. The auditor should test certain samples of the dividend income booked during the period by obtaining the counterfoils of dividend warrants and the amount credited in the bank account.

8.38 In the case of bill discounting, interest income is received in advance hence, the auditor should examine whether the interest income for the period has been accounted for properly and the balance is treated as other liabilities. In CBS, the interest on bill discounted is system driven and the auditor should verify the in-built logic of the system. For the sample cases, the auditor should verify the interest income on bill discounted by obtaining the underlying documents like purchase order, letter of credit, etc.

8.39 The auditor should also understand the process of increase or decrease in base rate and process of updating in the system. The auditor should also ascertain compliance with RBI guideline in respect of increase in tenor of retail loan due to increase in base rate. The auditor should also verify on sample basis as to whether the increase/decrease in base rate are effected in the system on the effective date.

8.40 Interest income includes interest accrued but not due on assets. However, as banks normally debit the borrower's account with interest due on the month end, at balance sheet date there would not usually be any amount of interest accrued but not due on advances on balance sheet date. Auditor should verify the same.

8.41 The auditor should examine the completeness of accrual of the interest by obtaining a detailed break-up of the loan portfolio (scheme wise or segment wise) and the interest accrual on the same. The aggregation of loan portfolio should be agreed to the general ledger.

8.42 The auditor should examine whether interest has been accrued on the entire investment and money market lending portfolio by obtaining the detailed break-up of the investment and money market lending portfolio along with the interest accrued thereon and agree the same with the general ledger. The auditor should re-compute the interest accrual on sample basis considering parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the term sheet, deal ticket, agreements, etc.

8.43 The auditor should obtain the list of the dividend income booked during the period and agree the total with the general ledger. Income on NPI should be realised on cash basis only.

Readers may note that income on investments has been explained in detail in Chapter 7 of Part IV of the Guidance Note.

8.44 In determining the extent of sample checking, the auditor should take into account, *inter alia*, the results of the analytical procedures and the reports, if any, on income and expenditure/ revenue audit as well as other internal and RBI inspection reports. The auditor's assessment of the effectiveness of concurrent audit would also affect the extent of his detailed checking of interest earned. In determining the extent of sample checking, the auditor may place greater emphasis on examining interest on large advances.

Commission Income

8.45 Auditor may check the items of commission, exchange and brokerage on a test check basis. Such examination can be done for commission earned on bills sent for collection, commission on letters of credit, guarantees and letter of comforts. The auditor should examine whether the commission on non–funded business (e.g., letters of credit, guarantees and bills for collection) has been properly apportioned between the current year and the following year.

8.46 The auditor should obtain details of loans sanctioned and disbursed during the period as well as verify the policy of the bank for booking the processing fee income on such loans. For corporate loans, the processing fee income for the material loans sanctioned and disbursed should be re-computed and verified on test check basis by obtaining the loan agreements, sanction letter, etc. Further, for loans sanctioned but not disbursed wherein the processing fee income has been booked on accrual basis, the auditor should verify the subsequent receipt of the same and enquire for subsequent reversals. For retail loans, the auditor should perform analytical procedures for computing the processing fee percentage for different ticket size loans.

8.47 The auditor should obtain an understanding of the various types of fee income earned on credit cards and debit cards. Further, the auditor should obtain the rate matrix for various fees charged to the customer. On a sample basis, the auditor should verify whether the fees charged and accounted is as per the rate matrix. Interchange fees is earned from service providers namely Visa, Master card, Amex proportionate to the transactions entered by the customer. On a sample basis, the auditor should verify whether the interchange fees have been received and accounted as per the agreement. Merchant acquiring income is earned on the transactions entered by the customers of other banks on the bank's terminal. The auditor should perform analytical procedures for such income and obtain the explanation for the variances, if any.

8.48 The auditor should understand how management monitors non-funded business and use their analysis for analytical procedures. The auditor should understand the relation with fee income with the business. For example, month on month /quarter loan processing fees with sanction value to arrive at average processing fees on monthly/quarterly basis. The auditor should analyse monthly/quarterly fee percentage and document the reasons for the variances as per the expectation set. Similarly auditor can perform analysis of other fee income by doing monthly/quarterly guarantee fees with average monthly/quarterly guarantee amount, interchange credit card fees *vis a vis* inter charge transactions etc.

8.49 The auditor may also compare the average fee income with the corresponding figures for the previous years and analyse any material differences.

8.50 The auditor should also check whether any fees or commission earned by the banks as a result of renegotiations or rescheduling of outstanding debts has, in terms of the income recognition guidelines issued by the RBI, have been recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

8.51 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.

8.52 Fee on insurance referral is fast emerging as a major source of income for banks. In terms of the RBI Master Circular No. DBR.No.FSD.BC 19/24.01.001/2015-16 dated July 1, 2015 on “Para Banking Activities”, banks are permitted to undertake insurance business as agents of insurance companies on fee basis or referral arrangement without any risk participation subject to the conditions prescribed under the Master Circular. The auditor should carefully examine the agreement entered into by the bank and the concerned insurance company to see the basis for calculation of the said fee, time when the referral fees becomes due to the bank. Normally, as an industry practice, such agency arrangements also contain clauses known as “claw back” of agency fee, whereby if the client referred to the insurance company by the bank fails to pay the insurance premium for a stipulated amount of time, the agency fees paid or due to the bank becomes recoverable from the bank or is frozen. Such clauses have a direct impact on the recognition of income from the agency fees in terms of Accounting Standard 9, Revenue Recognition and may, therefore, require creation of a corresponding provision in the accounts.

8.53 *Profit on Sale of Investments:* As per Circular DBOD/BP.BC.34/

21//04.19/2010-11 dated 6 August, 2010, investments are dealt in the course of banking activity and hence the profit or losses on sale of investments are taken to Profit & Loss account. The auditor should obtain the investment policy of the bank and understand whether the bank is using FIFO method or weighted average cost method for computing the profit/loss on sale of investments. 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.

Valuation of investment

8.54 Held to maturity - investment classified under HTM category need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity.

8.55 AFS - the individual scrip in the category will be marked at quarterly or at more frequent intervals.

8.56 *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.

8.57 *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.

8.58 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 PPE

8.59 The auditor should satisfy himself about the appropriateness and proper application of the basis of revaluation of PPE 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 him about their adequacy for audit purposes.

8.60 The revaluation of PPE 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.

8.61 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, unless the asset is carried at revalued amount in accordance with AS 10 (Revised). In such a case, any impairment loss of a revalued asset should be treated as a revaluation decrease under AS 10 (Revised). 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.

Interest on Deposits

8.62 The auditor may assess the overall reasonableness of the amount of interest expense in accordance with Master Direction DBR.Dir. No.84/13.03.00/2015-16 dated March 03, 2016 “Reserve Bank of India (Interest Rate on Deposits) Directions, 2016” by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For example, the auditor may obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. The auditor may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

8.63 The auditor should, on a test check basis, verify the calculation of interest. He should satisfy himself that:

(a) Interest has been provided on all deposits and borrowings upto the date of the balance sheet; and verify whether there is any excess or short credit of material amount.

(b) Interest rates are in accordance with the bank's internal regulations, the RBI directives, and agreements with the respective depositors;

(c) In case of Fixed Deposits it should be examined whether the Interest Rate (as applicable) in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.

(d) Interest on Savings Accounts should be checked on a test check basis in accordance with the rules framed by the bank in this behalf.

(e) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year;

(f) Payment of brokerage is properly authorized.

(g) Interest on inter–branch balances has been provided at the rates prescribed by the head office.

(h) Interest on overdue/ matured term deposits should be estimated and provided for.

8.64 The auditor should ascertain whether there are any changes in interest rate on saving deposits and term deposits during the period. The auditor should obtain the interest rate card for various types of term deposits and analyse the interest cost for the period. The auditor should examine the completeness that there has been interest accrued on the entire borrowing portfolio by obtaining the detailed breakup of the money market borrowing portfolio and the interest accrued and the same should agree with the GL code wise break up. The auditor should re-compute the interest accrual on sample basis i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc from the term sheet, deal ticket, agreements, etc.

Expenditure

Operating Expenses

8.65 Generally the audit procedures followed by auditors in any entity are to be followed.

Payments to and Provisions for Employees

8.66 The auditor should ascertain the procedure followed by the bank in this regard while verifying this item. The auditor should obtain the human resource policy and identify the benefits available to employees. Auditor should understand the compensation structure and process of payment of salary, benefits like employee stock options, car assistance, leave encashment, asset assistance, etc. to the various grades of employees. He should obtain the standard compensation structure for each grade of employee. In case, where payment is made on production of evidence or incurrence by employee, auditor should ascertain whether provision for the same has been made in the books.

8.67 The auditor should perform an overall analytical review for the payments and provisions for employees by month on month grade-wise analysis of the employees cost and number of employee in that grade to identify per employee cost month on month and enquire about the variances, if any. The auditor should examine whether all the benefits for all the employees have been appropriately accounted for.

8.68 The auditor should also check the calculation of salaries and allowances, etc. on a test check basis with reference to appointment/awards/offer letters. He may also assess the reasonableness of expenditure on salaries, allowances, etc. by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

8.69 Auditor should also obtain an understanding of the provision for payment of bonus and other incentive and ascertain adequacy of the amount recorded by the bank. Further, the auditor should verify whether the bank has made adequate provisions for employee benefits and has complied with the recognition, measurement and disclosure requirements of AS 15.

Rent, Taxes and Lighting

8.70 The auditor may check the following on a test check basis:

- Rent paid and verify whether adjustments have been made for the full year on account of rent at the rates as applicable and as per agreement in force.
- Rent does not include House Rent Allowance to employees.
- Whether municipal rates/ taxes are duly paid/ adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account upto the year-end.
- Further, the auditor should obtain the listing of the premises which have been obtained on lease. If the lease agreements have escalation clause, lease equalization should be done in accordance with AS-19 unless the terms and conditions of the lease indicate otherwise.
- In addition, the auditor should perform month on month rent analysis and verify major variance in the average rent per month per branch. The auditor

should also verify the provision made for the expired lease rent agreements.

Printing and Stationery

8.71 The auditor should verify this item with reference to documents evidencing purchase/debit note received.

Advertisement and Publicity

8.72 Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material is verified with the documents.

Repair and Maintenance Expenses

8.73 The auditor should verify the Annual Maintenance Contract (AMC) at the Branch and should verify the provisioning and prepaid accounting of these contracts.

Depreciation on Bank's Property

8.74 The auditor should ascertain the procedure followed by the bank while verifying this item. This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non–banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may either be centralised at the head office level or decentralised.

8.75 The auditor should check head office instructions as regards adjustments of depreciation on the fixed assets of the Branch. The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by head office.

8.76 The auditor may also report unadjusted depreciation on assets acquired but not capitalised. The auditor should re-compute the depreciation for the period, perform depreciation rationalisation and agree the amount with the general ledger. The auditor may also verify and obtain explanation for the unadjusted depreciation on assets acquired but not capitalised.

Provisions and Contingencies

8.77 The auditor should ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.

8.78 The auditor should obtain an understanding as to how the Bank computes provision on standard assets and non-performing assets. It will primarily include the basis of the classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. For verification of provision on standard assets, the auditor should verify the loan classification on a sample basis. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balance with the general ledger. The auditor should examine whether by performing re-computation the provisions in respect of standard loans, NPA and NPI comply with the regulatory requirements.

8.79 The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961 and as per Income Computation and Disclosure Standards (ICDS). The other provisions for expenditure should be examined *vis a vis* the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

IV-9

Disclosure Requirements in Financial Statements

9.01 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.

9.02 The disclosure requirements for disclosure in the financial statements can be broadly classified in the following four categories:

(i) Prescribed by Reserve Bank of India.

(ii) Prescribed by Accounting Standards and other pronouncements.

(iii) Requirement emanating from Statues.

(iv) Requirement emanating from Listing Agreement.

9.03 *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. DBR.BP.BC No. 23/21.04.018/2015-/16 dated July 1, 2015 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. Banks should, at a minimum, disclose the items listed in the circular in the 'Notes to Accounts'. However, banks should also 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 legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

9.04 *Disclosures Required Under Accounting Standards*: The disclosure requirements under the various notified Accounting Standards, prescribed under section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 and various applicable pronouncements of the ICAI.

9.05 *Requirements of Statutes*: The requirements of the Companies Act, 2013 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 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.

9.06 *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

9.07 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 include 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 (including strategic Debt Restructuring), Employee Benefits, Provision for Taxation, etc.

9.08 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 respective 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.

9.09 The previous year's comparatives should also be disclosed along with the disclosures for the current year.

Audit Approach

9.10 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 standards requirements is also an important objective in as much as non-compliance may have a direct and material impact in understanding the financial statements. The auditor should keep this in view while designing audit procedures relating to disclosures. The auditor could have a checklist of all the prescribed disclosure requirements which should include a column of the manner in which the data is extracted by the bank and the manner of auditor's verification of the same. This will ensure completeness and accuracy of the various disclosures. Care needs to be taken that the qualitative disclosures emanate from various policies, procedures and practices of the bank and represent the manner in which the bank conducts its activities referred to in the disclosures. The auditor needs to be satisfied that the quantitative disclosures originate from the books of account and other related records. The auditor should be satisfied with regard to the procedure of the bank to extract the relevant information. In case the process of extraction is automated the auditor can focus on the concerned systems controls too. In case the process is manual then more rigorous verification is necessary. Some of the disclosures could emanate from software and management information systems that are not seamlessly linked to the core banking software or any accounting software. In such cases the auditor should obtain audit evidence as to the robustness of the process followed by the bank to arrive at the data / information that is eventually disclosed in the financial statements.

9.11 The following paragraphs list the various requirements of disclosures. The audit approach for verification of these disclosures is detailed in the respective chapters of this Guidance Note.

Disclosures Prescribed by RBI[9]

9.12 Banks are also required to comply with AS 1 on "Disclosure of Accounting Policies" issued by 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":

9.13 Capital[10]

[9] The RBI *vide* its Master Circular No. DBR.BP.BC No.23 /21.04.018/2015-16 dated July 1, 2015 on "Disclosure in Financial Statements - Notes to Accounts" prescribes the disclosures to be made by the banks in the notes to accounts.

(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.

(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 equity capital raised

(iv) Amount of Additional Tier 1 capital raised; of which

   a. Perpetual Non cumulative Preference Shares (PNCPS)

   b. Perpetual Debt Instrument (PDI)

(v) Amount of Tier 2 capital raised; of which

   a. Debt capital instrument

   b. Preference Share Capital Instrument: [Perpetual Cumulative Preference Shares (PCPC)/Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable Cumulative Preference Shares (RCPS)]

(vi) For nationalized banks percentage of the shareholding of the Government of India should also be disclosed.

9.14 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:

   (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, appropriation/transfer, if any, from Investment Fluctuation reserve, 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

[10] For the format of disclosures please refer to the relevant paragraphs of "Master Circular- Disclosure in Financial Statements-Notes to Accounts".

category need only be shown.

Repo Transactions

9.15 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.

9.16 *Non-SLR Investment Portfolio*

(i) The composition of issuer of Non SLR investments should be disclosed in notes to account categorizing 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.

Sale and transfers to/from HTM Category

9.17 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 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.

9.18 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[11],

b) Losses which would be incurred if counterparties failed to fulfill their obligations under the agreements,

c) Collateral required by the bank upon entering into swaps[12],

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[13].

(ii) ***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.

iii) 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,

[11] 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.

[12] Examples of concentration could be exposures to particular industries or swaps with highly geared companies.

[13] 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.

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.

9.19 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) Following details are to be disclosed in respect of Loan Assets subjected to restructuring:

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 classified under different categories as under:

- Type of restructuring- Under CDR Mechanism, Under SME Debt Restructuring Mechanism and Others

- Asset Classification of restructured accounts- Standard, Sub-standard, Doubtful and Loss assets
- Movement under 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 Master Circular on Disclosure in Financial Statements - Notes to Accounts dated July 1, 2015.

RBI vide its circular no. DBR.No.BP.BC.33/21.04.132/2016-17 dated 10.11.2016 requires banks to make certain disclosures in their annual financial statements on application of the Scheme for Sustainable Structuring of Financial Assets:

Banks should also disclose investment in equity shares under strategic Debt Restructuring.

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 have been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities/ accounts of that particular borrower.

Further RBI vide its Circular No. RBI /2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 dated 18th April, 2017 requires disclosure in the "Notes to Accounts" to the Financial Statements in relation to divergence in the asset classification and provisioning.

(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.

To enhance transparency additional disclosure for investment in Security Receipts (SRs) is required

Particulars	**SRs issued within past 5 years**	**SRs issued more than 5 years ago but within past 8**	**SRs issued more than 8 years ago**

		years	
(i) Book value of SRs backed by NPAs sold by the bank as underlying			
Provision held against (i)			
(ii) Book value of SRs backed by NPAs sold by other banks/ financial institutions/ non-banking financial companies as underlying			
Provision held against (ii)			
Total (i + ii)			

Disclosures on the Scheme for Sustainable Structuring of Stressed Assets (S4A), as on March 31 (INR Crore)				
No. of accounts where S4A has been applied	**Aggregate amount outstanding**	**Amount outstanding**		**Provision Held**
		In Part A	**In Part B**	
Classified as Standard				
Classified as NPA				

Additional disclosures are required to be made in respect of Flexible Structuring of existing loans, Accounts still under the stand-still period under SDR scheme, Change in Ownership outside SDR scheme, Change in Ownership of projects under Implementation, as per format in the Appendix to RBI Circular RBI/2016-17/122 DBR. No. BP.BC.34/21.04.132/2017-17 dated November 10, 2016.

(iv) ***Details of non-performing financial assets purchased/sold -*** Banks which purchased/ 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 off 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.

Business Ratios

9.20 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 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.

Asset Liability Management

9.21 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 3 months & upto 6 months

(vii) Over 6 months & upto 1 year

(viii) Over 1 year & upto 3 years

(ix) Over 3 years & upto 5 years

(x) Over 5 years

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. Auditor will also have to verify the accuracy of the maturity pattern generated by the system at Branch level and also at controlling office level to ensure the accuracy of disclosure made under this paragraph.

Exposures

9.22 The RBI vide its Master Circular DBR.No.Dir.BC. 12/13.03.00/2015-16 dated July 1, 2015 on “Exposure Norms” provides requirements in respect of exposure limits for banks. Under the master circular on Disclosure in Financial Statements – Notes to Accounts, 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. DBR.No.Dir.BC. 12/13.03.00/2015-16 dated July 1, 2015 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.

(C) ***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 categorized into various risk categories listed below:

(i) Insignificant

(ii) Low

(iii) Moderate

(iv) High

(v) Very High

(vi) Restricted

(vii) Off-credit

(viii) Total

9.23 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.

(D) ***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. If there is no such disclosure, auditor may take representation from bank in this regard.

Following disclosure need to be made:

i. The number and amount of exposures in excess of the prudential exposure limit during the year.

ii. Credit exposure as percentage to capital funds and as a percentage to total assets, in respect of:

- the largest single borrower.
- the largest borrower group.
- the 20 largest single borrower.
- the 20 largest borrower group.

iii. Credit exposure to the five largest industrial sectors (if applicable) as percentage to total loan assets.

iv. Total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. have been taken as also the estimated value of such intangible collateral. The disclosure shall be made under a separate head to differentiate such loans from other entirely unsecured loans.

v. Factoring exposures.

vi. Exposures where the Bank had exceeded the Prudential Exposure Limits during the year.

(E) ***Unsecured Advances* -** To ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the banks are required to follow the norms as under:

- For determining the amount of unsecured advances for reflecting in Schedule 9 of the published balance sheet, the rights, licenses, authorizations, 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.

Disclosure of Penalties imposed by RBI

9.24 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. The penalty also is required to be disclosed in the "Notes on Accounts" to the Balance Sheet.

Provisions and Contingencies

9.25 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).

Floating Provisions

9.26 Banks are required to 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 is required to be mentioned.

Draw Down from Reserves

9.27 Suitable disclosures should be made regarding any draw down of reserves.

Disclosure of complaints

9.28 Banks are also required 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.

Disclosure of Letter of Comforts (LoCs) issued by banks

9.29 The banks are required to 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. Auditor would be required to verify the accuracy of system generated data in respect of this disclosure and verify that disclosure is correctly made.

Provisioning Coverage Ratio (PCR)

9.30 The PCR (ratio of provisioning to gross non-performing assets) should be disclosed in the Notes to Accounts to the Balance Sheet.

Bancassurance Business

9.31 The details of fees / brokerage earned in respect of insurance broking, agency and bancassurance business undertaken by bank is required to be disclosed in the 'Notes to Accounts' to the Balance Sheet.

Concentration of Deposits

9.32 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.

Concentration of Advances

9.33 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.

Concentration of Exposures

9.34 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.

Concentration of NPAs

9.35 Total Exposure to top four NPA accounts should be disclosed by the bank in the notes to accounts.

Sector-wise NPAs

9.36 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.

Movement of NPAs

9.37 Movement in NPAs during the year including opening balance, additions during the year, less upgradations, recoveries (excluding recoveries made from upgraded accounts) and write off during the year, should be disclosed by the bank in the notes to accounts.

9.38 **Overseas Total Assets, Total NPAs and Total Revenue** should be disclosed by the bank in the notes to accounts.

9.39 **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.

Unamortized Pension and Gratuity Liabilities

9.40 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.

Disclosures on Remuneration

9.41 Private sector banks and foreign banks (to the extent applicable) are advised to disclose remuneration as specified in the Master Circular on "Disclosures in Financial Statements- Notes to Accounts".

Disclosures relating to Securitisation

9.42 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 information duly certified by the SPV's auditors obtained by the originating bank from the SPV.

Credit Default Swaps

9.43 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.

Intra Group Exposure

9.44 With the developments of financial markets in India, banks have increasingly expanded their presence in permitted financial activities through entities that are owned by them fully or partly. As a result, banks' exposure to the group entities has increased and may rise further going forward. In order to ensure transparency in their dealings with group entities, banks should make the following disclosures for the current year with comparatives for the previous year: (a) Total amount of intra group exposures (b) Total amount of top 20 intra group exposures (c) Percentage of intra group exposures to total exposure of the bank on borrowers / customers (d) Details of breach of limits on intra group exposures and regulatory action thereon, if any.

The details may be verified by the auditor from investment details of Bank and other relevant information available with Bank.

Transfer to Depositor Education and Awareness Fund (DEAF)

9.45 Unclaimed liabilities where amount due has been transferred to DEAF is required to be reflected as 'Contingent Liability - Others, items for which the bank is contingently liable' under Schedule 12 of the annual financial statements. Banks are also required to disclose the amounts transferred to DEAF under 'Notes to Accounts' as per the format given below.

(Amount in Rs. crore)

Particulars	**Current Year**	**Previous Year**
Opening balance of amounts transferred to DEAF		
Add: Amounts Transferred to DEAF during the year		
Less: Amounts reimbursed by DEAF towards claim		
Closing balance of amounts transferred to DEAF		

Unhedged Foreign Currency Exposure

9.46 Banks are required to disclose-

i. their policy on managing credit risk arising out of unhedged foreign currency risk of the Borrowers.
ii. Incremental provision and additional capital held by the Bank for unhedged foreign currency exposure of their borrowers.

The auditor needs to understand the policy of the bank for unhedged foreign currency exposure and verify that it is appropriately disclosed. As also incremental provision and additional capital held.

9.47 Liquidity Coverage Ratio (LCR)

i. Banks are required to disclose information on their Liquidity Coverage Ratio (LCR) in their annual financial statements under 'Notes to Accounts', for which the LCR related information needs to be disclosed in the elaborate format as given in the Master Circular.

LCR is a ratio of two factors, viz, the stock of High Quality Liquid Assets and the Net Cash Outflows over the next 30 calendar days.

The LCR requirement would be binding on banks from January 1, 2015; with a view to provide a transition time for banks, the requirement would be minimum 60% for the calendar year 2015 i.e. with effect from January 1, 2015, and rise in equal steps to reach the minimum required level of 100% on January 1, 2019, as per the time-line given below:

	January 01, 2017	January 01, 2018	January 01, 2019
Minimum LCR	80%	90%	100%

ii. Besides above, banks are also required to provide qualitative discussion around the LCR to facilitate understanding of the data provided, for example:

(a) the main drivers of their LCR results and the evolution of the contribution of inputs to the LCR's calculation over time;

(b) intra period changes as well as changes over time;

(c) the composition of HQLA;

(d) concentration of funding sources;

(e) derivative exposures and potential collateral calls;

(f) currency mismatch in the LCR;

(g) a description of the degree of centralisation of liquidity management and interaction between the group's units; and

(h) other inflows and outflows in the LCR calculation that are not captured in the LCR common template but which the institution considers to be relevant for its liquidity profile.

iii. The relevant RBI circular reference no. DBOD.BP.BC.No.120 / 21.04.098/2013-14 dated June 9, 2014 can be referred for further details.

Fraud Reporting

9.48 As per RBI circular DBR.No.BP.BC.92/21.04.048/2015-16 dated April 01, 2016 on Provisions pertaining to Frauds, Bank should make suitable disclosure regarding

i. No. of Frauds reported;
ii. Amount involved in such frauds;
iii. Quantum of Provisions during the year;
iv. Quantum of unamortized Provision debited to other reserves

Disclosures prescribed by Accounting Standards

9.49 This Guidance Note deals with only those disclosure requirements where RBI has issued guidelines in respect of disclosure as per Accounting Standards.

1. 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")

2. Disclosure with regards to the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. (AS-9, "Revenue Recognition")

3. Banks may follow the disclosure requirements prescribed under AS 15 (revised), 'Employees Benefits' issued by ICAI.

4. 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.

5. *Related Parties:* Related parties for a bank are its parent, subsidiary(ies), associates/joint ventures, Key Management Personnel (KMP)

and relatives of KMP. KMP 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”).

6. 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".

7. 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.

8. 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.

9. 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 finalized by the bank and

(ii) the discontinued operation is substantial in its entirety.

10. 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 also refer to circulars DBS.ARS.No.BC.4/08.91.001/2001-02 dated October 25, 2001 and DBS.ARS.No.BC.17/08.91.001/2002-03 dated June 5, 2003 and adopt the format prescribed by the RBI for the purpose.

11. 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.

9.50 **Other Disclosures:**

- Disclosure as required under Micro, Small and Medium Enterprises Development Act, 2006 (MSMED).
- The disclosure requirements in Section 22 requires any buyer, whose annual accounts audited under any law for the time being in force, to furnish the following additional information in his annual statement of accounts.

9.51 The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

1. The principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
2. The amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;
3. The amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
4. The amount of interest accrued and remaining unpaid at the end of each accounting year; and
5. The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Corporate Social Responsibility (CSR)

9.52 As per Section 135 of the Companies Act, 2013 a CSR committee has been formed by the Company. The funds are utilized throughout the year on the activities which are specified in Schedule VII of the aforesaid Act.
Gross Amount required to be spent by the company during the year – XX crores.

The areas of CSR activities and contributions made thereto are as follows –

Particulars	In cash	Yet to be paid in Cash	Total
Amount spent during the year on – 1) Construction/ Acquisition of any assets 2) For purposes other than (1) above: (Specify)			

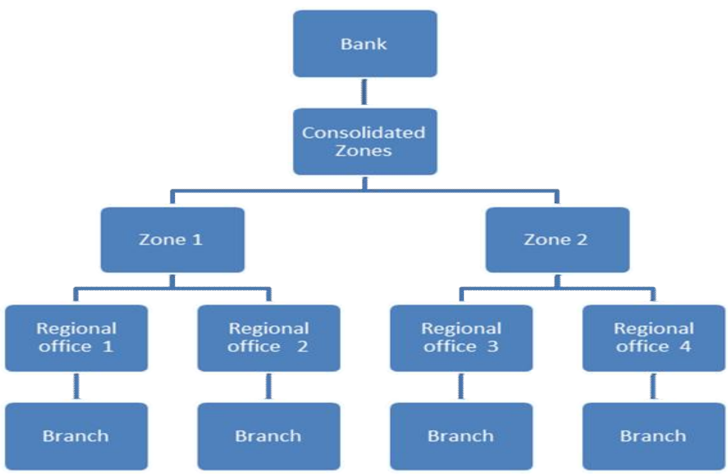
For detail guidance, refer "Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities", issued by ICAI in May, 2015.

IV-10
Consolidation of Branch Accounts

10.01 Consolidation of branch accounts (audited and unaudited) is one of the important and sensitive aspect of the financial statements of a bank. Preparation of the consolidated financial statements of the bank as a whole (after consolidation of accounts of branches) is the responsibility of the bank's management. RBI *vide* its Circular No DBOD.No.BP.BC.72/21.04.018/2001-02 dated February 25, 2003 has issued guidelines to banks on consolidated accounting and other quantitative methods. The following documents are consolidated:

- Balance Sheets
- Profit and Loss Accounts
- LFAR (Long Form Audit Report)
- Ghosh Committee compliance checklists
- Jilani Committee compliance checklists
- Tax Audit reports
- Other various reports like, Assets classification, fixed assets, bills payable, sundries, credit subventions, etc

Process of consolidation



10.02 The consolidation process starts from the Branch level and the accounts of branches get consolidated at the respective regional office and all regional offices get consolidated at respective Zonal office and all zonal offices get consolidated at Head Office. The procedures regarding consolidation of accounts vary from bank to bank, in some banks mostly in a private sector the entire consolidation work gets done at the head office.

Bank managements generally follow the below mentioned process for the purpose of consolidation:

Step 1

Back up of the Financial Statements as on 31st March

10.03 At the year-end i.e., 31st March, the bank takes the backup of financial data and keeps the same on different software. This data is given for audit purpose to the statutory auditor.

Step 2

Effect of Memorandum of Changes (MOC)

10.04 There are two types of financial statements, Pre-MOC, i.e., the original data and Post-MOC, i.e., after giving the effect of accounting entries suggested by the central statutory auditor (which is known as MOC). The MOC are not fed in the live data but are recorded on a different software (e.g., ROSS, ADF) at all levels like Branches, Region, zone and Head office. All MOC suggested at branches get consolidated and recorded at regions and MOC of regions get consolidated at the concerned Zone and MOC of the Zones get consolidated at Head Office.

In this way, the effect of MOC at all levels of bank gets recorded in the parallel software e.g. ROSS, ADF. For making any changes in the financial statement there has to be an MOC approved by the statutory auditor. Therefore, there will be an MOC for difference between Pre-MOC financial statements and Post-MOC financial statements.

Accounting of MOC effect in live data

10.05 After the financial statements get approved and signed with all changes the MOCs gets accounted in live data. For example, the financial statements for the financial year 2016-17 gets approved and signed on 30th April, 2017, then on that day or on any other day with value date of 30th April, 2017, all MOCs will be accounted in the live data. So from that day a particular account will be shown as NPA if the same had been made NPA by way of MOC during the audit.

Step 3:

Regional office

10.06 Process:

1. Branches depending on the limits prescribed can be either audited branches or unaudited branches.
2. At the branch level the audited financial statements as well as unaudited financial statements signed by Bank manager is uploaded in the system and consolidated data is generated at regional office level.
3. Regional office accounts get consolidated and also adjustments if any are made at regional level. The Regional Office is a cost centre and the auditor has to certify the financial statements of the Regional Office in addition to the consolidation of the Branches under the relevant Regional Office.

Audit Approach:

1. Statutory Central Auditor (SCA) for a Region must verify the completeness of the data uploaded by the branches into the system.
2. SCA on sample basis must also verify the completeness of the data.
3. SCA should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the regional office level.
4. SCA should also check the arithmetic accuracy of the number of financial statements to be uploaded at regional office level.
5. SCA may communicate to the SBAs, the requirements regarding process of consolidation for the current year, about the significant observations from the previous year's audit, quarterly reviews and additional precautions, modifications in Audit Program required considering the recent RBI Circulars. This communication can be circulated along with the closing instructions to SBAs.
6. SCA should ensure on sample basis if all the documents as required by the respective banks have been taken at each level of consolidation i.e. appropriate flow of data along with the required documents.

Zonal Office and Head Office

10.07 Process:

At zonal level all the regional office data is consolidated and further adjustments if any is made. Bank as a whole then consolidates all the zones ensuring the accuracy of the data uploaded at each stage of hierarchy. Similar to the Regional office, the Zone also is a cost center and has its own financials which need to be certified by the auditor. Mainly the expenses comprise of salaries, advertising and promotions etc.

Audit Approach - Zonal Office Auditor:

1. Statutory Central Auditor (SCA) for a Zone must verify the accuracy of the data uploaded by the Regional office into the system.
2. SCA on sample basis must also verify the completeness of the data
3. SCA should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Zonal office level.
4. SCA should also check the arithmetic accuracy of the number of financial statements to be verified at Zonal office level.

Audit Approach to be followed by Bank consolidating Auditor:

1. The consolidating Auditor must ensure the completeness as well as accuracy of the data at the bank as a whole.
2. Auditor should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Bank level.

10.08 The Statutory Central Auditor should also examine the following key additional aspects;

a. Reversal of interest on inter-branch balances and other similar items.

b. Cancellation of transfers of assets among branches.

c. Review of observation made by the branch auditor in audit report and LFAR.

d. Review of the various audited and unaudited returns.

e. Effect of Memorandum of Changes (MOC).

Review of MOCs so as to ascertain whether there are systemic issues or deficiencies which need to be addressed by the management.

IT Controls

10.09 There is a significant and voluminous data involved during this whole process of consolidation. Consolidation being a system oriented process, auditor must verify if the IT controls of the bank are effective.

Consolidation of Overseas Branches

10.10 While consolidating the overseas branches the auditor should examine the following aspects;

a. The various reports of the overseas branches would be received in the local currencies of the reporting countries which need to be converted into the Indian currency.

b. The effect of reinstatement of assets and liability which is given in Accounting standard 11 (The Effects of Changes in Foreign Exchange Rates). RBI has also issued a circular for compliance of the AS 10. DBOD.BP.BC.No.76/21.04.018/2005-06) dated April 5, 2006.

c. Foreign exchange gain and loss.

d. 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".

e. In terms of its circular no DBOD.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005, the RBI has prescribed that with the issuance of the said circular, there should normally be no need for any statutory auditor for qualifying financial statements of a bank for non-compliance with Accounting Standard 11 (revised 2003). Whenever specific difference in opinion arises among the auditors, the statutory central auditors would take a final view. Continuing difference, if any, could be sorted out in prior consultation with RBI, if necessary.

f. The auditor may also review the compliance with the applicable local laws and regulations of the concerned country by the overseas branches.

g. As advised by ICAI, statutory auditor has 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”.

10.11 The auditor should furnish the statement of Adjustments for non-uniform accounting policies

IV-11
Consolidation of Financial Statements

11.01 The Reserve Bank of India, in its requirement of disclosures in Financial Statements has included AS 21: Consolidated Financial Statements (CFS) that includes consolidated Balance Sheet, consolidated Profit and Loss Account & notes, explanatory material that form an integral part thereof and also consolidated cash flow statements.

11.02 Consolidated Financial Statements are presented for a group of entities under the control of a parent. A parent is an entity that has one or more subsidiaries. For the purpose of CFS it may be noted that if a parent does not have subsidiary but has investment in associates and joint ventures, it will be required to prepare CFS. However, for the purpose of quarterly reporting under SEBI guidelines, CFS will not be necessary if the parent does not have subsidiary but has investments in associates and joint ventures. For the purpose of this guidance a parent would mean a Consolidating Bank.

Responsibility of a Bank

11.03 The responsibility for preparation and presentation of CFS is that of the Bank. This responsibility, *inter alia*, includes:

1. Identifying components including financial information.
2. Identifying reportable segments.
3. Identifying related party transactions.

Responsibility of the Statutory Central Auditor

11.04 It is necessary for the auditor to take into consideration the accounting standards relevant for the purpose of CFS. They are AS 21: Consolidated Financial Statements, AS 23: Accounting for Investments in Associates and AS 27: Financial Reporting of Interests in Joint Ventures. Further, careful consideration should be given by the auditor of CFS to Other Matters, Emphasis of Matter, Modified Opinion in the report issued by the component auditors.

In addition to the Accounting Standards, it is pertinent for an auditor to consider the relevant accounting and auditing Guidance Notes.

11.05 When the parent's auditor decides that to make reference to the auditor's report of the other auditors in the auditor's report on CFS, the latter should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). This may be done by stating the rupee amounts or percentages of total assets and total revenue of subsidiary(ies) included in CFS not audited by the parent's auditor. However, reference in the report of the auditor of CFS to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a modification of the opinion. The auditor should also consider implications on reporting if some of the components are unaudited[14].

11.06 Generally, while conducting audit of a bank, SCA has a practice of issuing general instructions for the SBAs to facilitate easy consolidation of branch accounts. It would be appropriate to have a similar approach with respect to auditors of components, if the component auditors are different from the group auditor. This is especially important in case of "the other financial information" which is necessary for the purpose of consolidation and preparation of notes. It is advisable to make sufficient arrangements for co-ordination and efforts at the planning stage.

Audit of CFS

11.07 Audit of CFS needs to be planned properly with regards to following aspects:

1. Accounting policies of Bank and its various components. It is very much probable that the policies of the components may differ from each other depending upon the respective business lines.
2. Auditor should obtain list of all the subsidiaries, associates and joint ventures of Bank, whether to be included under CFS or not. Any entity that has been kept outside CFS should be carefully examined for its exclusion with respect to the relevant statute. At this stage it is important to note that the ownership of the voting rights does not necessarily qualify for the purpose of CFS. It would be necessary to understand the concept of the control of the enterprise. If the auditor establishes that the bank exercises control over the entity in spite of minor shareholding by virtue of control over the composition of board of directors/governing body, such enterprise would qualify for CFS. There would be many other ways to exercise the control. To verify the same it is advisable that the auditor verifies the board minutes,

[14] Attention in this regard is drawn to the Announcement on "Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s)" issued by ICAI in February, 2014.

shareholder agreements entered into by the bank with the other entities, the various business agreements such as technology and knowhow supply, or enforcement of statue as the case may be. The auditor would need to exercise professional judgment to determine the control in such cases.

3. The auditor should identify the changes in the shareholding that might have taken place since the last audit.

4. Following transactions require attention for current period consolidation adjustment:

   a) Intra group interest/management fees paid and received.

   b) Unrealized intra group profits on assets acquired within the components.

   c) Intra group indebtedness.

   d) Adjustments relating to harmonizing different accounting policies within the group.

   e) Adjustments made for the effects of the significant transaction or event that occur between the date of financial statement of the bank and one or more of the components, if they follow different financial reporting dates.

   f) Determination of movement of equity attributable to minority since the date of subsidiary.

   g) In case of step acquisition, appropriate adjustments need to be carefully audited.

   h) Further due care be taken in respect of impairment of goodwill in addition to review of net worth and profit reconciliation to ensure completeness of consolidation exercise.

5. As far as possible the formats of the financial statements and cash flows used for the purpose of bank's individual financial reporting should be used for the CFS.

6. The auditor should examine that the financial statements used in the consolidation are drawn up as of the same reporting date. If that is not possible, AS 21 allows adoption of six month old balance sheet of subsidiaries and prescribes that adjustments shall be made for the effects of significant transactions or other events that have occurred during the intervening period. In case that the balance sheet dates of parent and subsidiaries are different, inter-group netting shall be done as on the balance sheet date of the parent entity. In the cases where the balance sheet date coincides with that of the bank, the bank shall publish its CFS without waiting for the audit of their subsidiaries by the Comptroller and

Auditor General. However, the bank shall ensure completion of statutory audit of the accounts of such subsidiaries before consolidation with the parent's accounts.

7. The SCAs should examine that the CFS is prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to do so, that fact shall be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied. For the purpose of preparing the CFS using uniform accounting policies, the banks shall rely on a Statement of Adjustments for non-uniform accounting policies, furnished by the Statutory Auditors of the subsidiaries.
8. In cases where different entities in a group are governed by different accounting norms laid down by the concerned regulator for different businesses, the bank shall use for consolidation purposes the rules and regulatory requirements applicable to the banks in respect of like transactions and other events in similar circumstances. In situations where regulatory norms have not been prescribed by RBI, the norms as applicable according to the accounting standards may be followed.
9. For the purpose of valuation, the investments in associates (other than those specifically excluded under AS 23) shall be accounted for under the "Equity Method" of accounting in accordance with AS 23 which shall be examined by the auditor.
10. The valuation of investments in subsidiaries which are not consolidated and associates which are excluded under AS 23, shall be as per the relevant valuation norms issued by the Reserve Bank of India. The valuation of investments in joint ventures shall be accounted for under the 'proportionate consolidation' method as per AS 27. The banks may take into account the provisions of the accounting standards relating to the exclusion of subsidiaries, associates or joint ventures from consolidation under specific circumstances shall be examined by the auditor.

Management Representations

11.08 SA 580, "Written Representations" requires the auditor to obtain written representations from management and where appropriate those charged with governance. Such representations would include:

a) Completeness of components included in the CFS.

b) Identification of reportable segments for segmental reporting.

c) Identification of related parties and related party transactions for reporting.

d) Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transitions.

IV-12

Inter Office Transactions

12.01 Inter-office transactions mostly take place at branches. The balances can be debit balance or credit balances in Balance Sheet of the branches. Branches have number of transactions amounting to large sums with the other branches and controlling office, hence it becomes very important to monitor the same. It is the responsibility of the bank to reconcile their transactions on a daily basis and keep a track on un-reconciled transactions.

12.02 Followings are the major transactions which occur between branches and Head office.

a. Issue of remittance instruments like drafts/TTs/MTs on other branches.
b. Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
c. Payment to / receipts from other branches of the proceeds of instruments received/sent for collection /realization/clearing.
d. Payments made under LCs of other branches.
e. Cash sent to/received from other branches.
f. Payment of instruments like gift cheques/ banker's cheques/ interest warrants/ dividend warrants/repurchase warrants/refund warrants / travelers cheques, etc. which are paid by the branch on behalf of other branches which have received the amount for payment of these instruments from the customers concerned.
g. Head office interest receivable and payable by the branches.
h. Profit/loss transferred by the branch to head office.
i. Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
j. Operations by the authorised branches on the bank's NOSTRO accounts.
k. Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.
l. Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.
m. Gold Banking Transactions at the branch on behalf of nodal branches.
n. Transactions through NEFT, RTGS, NACH, UPI, etc.

o. ATM transactions of the customer either at ATM linked with other branches or with merchant establishments.

p. Internet based transactions other than inter-account transfers with the same branch.

q. Credit card related transactions of the customers.

r. Nostro Accounts of Indian Branches maintained with Overseas Branches of the bank.

s. Capital Funds with the Overseas Branches.

t. Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.

u. Service Tax transactions advises to Nodal branches where Service Tax remittance is made where Service Tax is remitted on behalf of other branches within their fold.

12.03 Following are the most common types of errors observed in inter branch transactions.

- Wrong identification of the nature of transaction.
- Recording of particulars in incorrect fields.
- Wrong accounting of bank charges, commission, etc.
- Errors in writing the amounts.
- Incorrect branch code numbers
- Incorrect schedule numbers.
- Recording the same transaction twice.
- Difference between the closing and opening balances in successive daily statements.
- Squaring off the transaction by same amount without checking the transactions.

12.04 Banks generally have a separate department to deal with the process of reconciliation of inter branch transactions. Following is the generally followed reconciliation process.

- Each branch submits the transaction statement (can be also generated through CBS System) in the prescribed format. 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.

- On receipt of the statement, reconciliation department scrutinizes the data like opening balance, account heads etc. and rectify the same for any error in data.
- After rectifying the error, the same are fed into the system.
- 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 netting reference number, account currency, foreign currency amount, local currency amount, event, reporting branch code no., date of transaction at the reporting branch, type of transaction, draft no., etc., to the reconciliation department.
- Some of the transactions do not reconcile due to incorrect data entry or non-accounting of transactions by other branch, which might indicate fraud if debit transaction in one branch does not have corresponding credit effect in other branch.

  The total number of inter-branch transactions makes their reconciliation a tedious task. Lack of reconciliation causes this account to be susceptible to frauds. Recognizing 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, "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.

  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.

12.05 Many Banks have the concept of 'Service Branches' for such inter branch transactions. These Service Branches exclusively provide the following services:

a. They act as agents for the other branches of the bank for collection of instruments drawn on local branches of other banks (Clearing).
b. To centralise the payment of drafts drawn by other outside branches.

Audit Approach

12.06 Inter branch account has been very sensitive area and can prove to be problematic or prone to errors and frauds. The Auditor should review the system of operation for such sensitive account. Several times it has been observed that there are old entries in such accounts due to migration issues. The auditor should check thoroughly the details of such entries with their ageing and also the improvement in settlement of the entries on a periodic basis by the Bank and its reporting to the audit committee. Such old entries have been noticed between the Treasury Branch and other Branches/ Head Office.

- Every bank has its own procedures and methodology for inter branch transactions hence it is very important for the auditor to understand the procedure followed by the bank for recording inter-branch transactions. The procedure followed by the bank for maintaining inter-branch transactions should be as per the RBI requirements.
- RBI has directed banks to introduce the system of segregating DD/TT/MT transactions, with reconciliation at weekly intervals and close monitoring of large amounts vide its circular no. DBS.CO.SMC.BC No. 28/22.09.001 dated 20th August, 1998.
- Bank has to provide 100% provision against the net debit balance arising out of the un-reconciled entries outstanding for more than 6 month in the inter-branch account, from the year ending March 31st, 2004 vide its circular no. DBOD No. BP.BC. 73 /21.04.018/2002-03 dated 26th February, 2003.
- As per RBI Circular from 1st April 1999, Bank should maintain category wise/Head wise accounts of various types of transactions under inter branch accounts and the netting off the transactions should be done on category wise, hence the net debit in one category is not to be set-off against net credit in another category.
- Banks have been advised by RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head 'Other liabilities and provisions–Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office if the amount exceeds Rs.1 lakh
- There are some transactions like dividend warrant, interest warrant, refund order etc. which required special attention because in the recent past number of transactions has been reported by the bank in these groups. In these transactions the funds are deposited at one branch and payments

take place at many branches. Hence to prevent the frauds the outstanding balances of these accounts should be checked with professional skepticism.

- Auditor should review all material transactions accounted in inter-branch account just before the year end and where required, request the bank management to rectify the same by accounting in the correct account head.
- The auditor should cautiously review all material transactions outstanding in inter branch account even if it is outstanding for more than 6 month for which 100% provision is made.
- The auditor should check all adjustments in the account and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity. Also verify that the reversal entries are made under proper authority and after due explanation and evidence.
- The account should be adjusted only on the basis of advices and not on the strength of entries found in the statement of account received from other branches.
- Prompt action should be taken preferably by central authority, if any entries particularly debit entries are not responded to any branch within a reasonable time.
- The auditor should report on the year end status of inter branch accounts indicating the dates upto which all or any segments of accounts have been reconciled. The auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries. The auditor can obtain the relevant information primarily from branch audit reports.
- Normally Inter-branch accounts are reconciled at HO and unreconciled entries are sent to originating branches for their response. Branch auditor is expected to check whether such responses are sent promptly.
- Branches must ensure to respond the entries in Inter Branch Transaction System (IBTS) at their earliest. Items of revenue nature such as travelling expenses bills, and any other expense/income item should not be allowed to float in Inter Branch Transaction System (IBTS) for a longer period.
- Nostro Accounts at branch - Branches should also prepare reconciliation statement (REC) relating to those accounts for each of the Foreign Offices or Foreign Correspondents, as the case may be for examination by SBAs.

PART - V

V-1
Long Form Audit Report in Case of Bank Branches

1.01 The audit of Bank Branches for a long time was advance centric and covered mainly the Balance sheet Items. The audit report did not throw much light on the internal controls and procedures of the Branch/ Banks, which are key to efficient functioning of Bank /Branches. In order to serve this purpose RBI contemplated a format which would throw light on internal controls and Procedures encapsulating and encompassing all aspects of Banks/ Branches including Advances and thus was born the Long Form Audit report, popularly abbreviated as LFAR. It cannot be gainsaid that if LFAR reporting is done scrupulously, all facets of Bank Audit except perhaps Tax Audit would be covered. It is a tool which the statutory Central Auditors depend on to have an idea of Branches under the Bank.

1.02 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).

1.03 In the year 1985, RBI advised the Public Sector Banks to obtain LFAR from the auditors. 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, in the format prescribed by the RBI. The latest format of LFAR has been revised in the year 2003 and was made effective from 31st March, 2003. RBI *vide* its Circular No. RBI/2014-15/626 DBS.CO.ARS.BC 8/08.91.001/2014-15 dated June 4, 2015 provides that the branches below the cut-off point, which are subject to concurrent audit by chartered accountants, shall submit their LFARs and other certifications audited by the concurrent auditors. They shall submit their LFAR only to the Chairman of the bank. The banks in turn will consolidate / compile all such LFARs submitted by the Concurrent Auditors and submit to Statutory Central Auditor as an internal document of the bank.

1.04 Following are the important aspects which requires special attention while reporting in Long Form Audit Report:

a. The LFAR is not a substitute for the Branch statutory report and is not deemed to be a part of the main audit report. Further the main report is a self-contained document and should not make any reference to the reporting made in LFAR. Hence mere comment in LFAR in lieu of comment in main report and reporting about change in assets classification of advances in lieu of Memorandum of change (which is form part of main report) shall be considered inappropriate reporting. It is to be noted that at Corporate office level the compilation of Branch LFAR takes place subsequent to the finalisation of the Branch Auditors Report, therefore it to be taken care that the important observation reported in LFAR, which has a material impact on financial statement including internal control over financial reporting, should also be appropriately reported in the Branch auditor report.
b. 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. It should be noted here that mere comment in LFAR may not be sufficient without corresponding comment in the main audit report, should it be a matter of qualification
c. 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.

1.05 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 considered 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.

1.06 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 consider 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 about adverse comments of a material nature in which remedial action was warranted and the same is yet to be carried out.

1.07 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. It should be noted here that mere comment in LFAR may not be sufficient without corresponding comment in the main audit report, should it be a matter of qualification. Hence mere comment in LFAR in lieu of comment in main report will not be considered to be appropriate reporting.

1.08 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 reports 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.

1.09 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 Central Auditors. It would also be desirable that the branch auditors also familiarise themselves with the questionnaire applicable to the Statutory Central Auditors. In response to a question, the Statutory Central Auditor should consider comments made by the branch auditors in their LFAR with respect to such question. He should use his judgement to determine whether comments / observations made in the branch LFAR is material enough to be incorporated in his own report.

1.10 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.

1.11 In the LFAR, replies are given only to questions enumerated in the LFAR. The LFAR is only indicative in nature however adverse finding on any additional areas like, KYC compliance / Demat accounts / Lockers / Security arrangements / Risk based audits / Service Tax/ ATM's / TDS, Mobile Banking/Internet Banking/ RTGS/NEFT transactions etc. may be reported in other matter,

1.12 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 the auditor has to study the system presently in operation in the bank so as to give his reply.

(e) In certain questions the auditor has to specifically give suggestions, especially, regarding improvement in computerised information system and minimising possibility of frauds.

(f) LFAR should not be treated as mere information providing mechanism. wherein auditor merely lists observations without drawing any conclusion thereon. Doing this may not be construed to be proper audit reporting

An illustrative list /information which is to be collected /noted 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.
- Various policies (Credit, Investment, Recovery etc.)
- Cash retention limit.
- Insurance for cash / cash-in-transit.
- Bank confirmations / bank reconciliations.
- In case of advances of more than Rs. 2 crores sanctioned limit and outstanding balance. (both funded and non-funded)
- List of all advances party-wise and limit-wise.
- List of outstanding facility-wise.
- List of NPA's and provisioning thereon.
- List of overdues / overdrawings.
- Cases of sanctions not disbursed.
- Cases of overdue proposals for review/renewal.
- Cases wherein stock/ book debt statements and other periodic operational data and financial statements etc. not received/ not received timely.
- Stock audit reports/ unit inspection reports.
- List of borrowers wherein inspection/ physical verification of securities charged to bank have been carried out by the branch.
- List of non-corporate entities enjoying limit more than Rs.10 lakh.
- Valuation reports of NPA accounts where outstanding is more than Rs.1 crore and valuation has been done prior to three years.
- Status of claims lodged with ECGC/DICGC/CGST.
- Details of cases of compromise / settlement and write off involving write off / waivers in excess of Rs. 50 Lakhs.
- Report in desired format of advances of more than Rs. 2 crores.
- List of accounts downgraded/ upgraded.(with outstanding in excess of Rs. 1 Crore)
- Listing of expired guarantees.
- Details of outstanding amount of guarantees invoked and funded by the Branch
- Details of outstanding amount of letters of credit funded by the branch.
- Stock register/ Insurance register/ Stationery draw power register/ Cheque book issuance register/ Cash book/ Sanction register/ Custody register/ DD issued register/ Document register.

- Break up of suspense accounts.
- List of sundry deposits/ bills payables/suspense accounts.
- List of provisions / prepaid expenses.
- List of contingent liabilities.
- List of frauds and follow-up action.
- List of security items as at 31st March.
- List of fixed assets.
- Year-wise break-up of matured deposits.
- Schedule of charges (for booking of Income).
- System audit report, conducted, if any.
- 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 anti-virus upgrades.
- Number of inoperative accounts and the process of allowing operations thereon.
- Number of accounts maintaining balances below prescribed minimum.
- Details of customers complaints.
- System generated statement for documents time barred by limitation.

1.13 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.
j) Physical verification of assets.
k) Amounts outstanding for substantial period in Suspense Account, Nominal Accounts, Bills Payable, Sundry Deposits, etc.
l) Matters, that can not be adequately supported by any evidence, such as cash retention limit, insurance cover for cash-in-transit, rotation of duties, etc.

1.14 SA 580, "Written Representations" requires an auditor to seek written representations from the auditee, which in the case of branch audit will be furnished by the branch Management (generally the branch head).

1.15 As per Paragraph 18 of SA 580 when one or more requested written representations are not provided, the auditor needs to discuss the matter with the Management, re-evaluate the integrity or Management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and take appropriate actions, including the possible effect on the opinion in the auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Long Form Audit Report of Bank Branches

1.16 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.

1.17 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?

- A letter received from controlling office to be perused to ascertain the cash retention limit allotted to the branch (including foreign currencies).
- The limits as above to be verified with the daily closing cash balance (including foreign currency) of the Branch.
- Any exceptions may be reported as under:

  i. We have been informed that Controlling Office had fixed Cash Retention Limit of Rs. -----vide letter no…….dated---.

  ii. During the year under audit the cash balance was in excess of Retention Limit on many / few occasion. The instances are as under:-

Date	**Balance in Rs.**

The above data can be obtained from system generated report.

(b) Does the branch hold adequate insurance cover for cash-on-hand and cash-in- transit?

- Generally, the Branch cash balance has been covered under the Bankers' Indemnity Policy.
- A copy of the policy to be obtained from Branch. In case the insurance is taken by Head Office / Controlling Office, a copy of policy or any correspondence from Head Office / Controlling Office in this regard to be perused.

(c) Is cash maintained in effective joint custody of two or more officials, as per the instructions of the Controlling Authorities of the bank?

- Obtain the instructions in this regard and peruse the compliance thereof.
- Generally, the Cash is held in the Joint Custody of Cashier and Officer of the Branch.

- Specify the name and designation of the concerned persons.

(d) *Has the cash balances at the branch been checked at periodic intervals as per the procedure prescribed by the Controlling Authorities of the bank?*

- Obtain the copy of the procedure prescribed by the Controlling Authorities and examine the compliance thereof. In addition, ascertain, whether the branch is under Concurrent Audit. Generally, the Concurrent Auditors do the Cash verification every month.
- In addition to above, officials who are not dealing with cash are also doing verification on monthly basis.

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.*

- Balance confirmation certificates obtained in respect of outstanding balances as at the year end.
- Obtain the Bank Reconciliation Statement.
- If the reconciliation is not carried out or carried out incorrectly the same to be reported.
- If any difference is observed, then report the amount, nature of difference and period since lying in the reconciliation statement

(b) *Your observations on the reconciliation statements may be reported in the following manner:*

(i) *Cash transactions remaining unresponded*

- Give full details.

(ii) *Revenue items requiring adjustments/ write-off*

- Give full details.

(iii) *Old outstanding balances remaining unexplained/ unadjusted. Give details for:*

- *Outstanding between six months and one year; (including Receivable or payable)*
- *One year and above (including Receivable or payable)*

(c) *In case any item deserves special attention of the Management, the same* *may be reported.*

- Give full details.

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, lay down by the Controlling Authorities of the bank have been complied with?

- Generally, this is looked after by Treasury Department, hence, such types of transactions generally do not appear in Branch Books.
- However, confirm that no such transactions are appearing in the Branch Trial Balance.
- If there are transactions, obtain the instructions / guidelines laid down by the Controlling Authorities and examine the compliance thereof.

Investments

- Generally, this is looked after by Treasury Department, hence, such types of transactions do not appear in Branch Books.
- However, confirm that no Investments are appearing in the Branch Trial Balance.
- If Investments are appearing in the Trial Balance physical verification should be conducted and reported accordingly. Also verify investment balance confirmation of counter party (Investee) with balance appearing in Branch Books.

(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?*

   - If Investments are held on behalf of Head Office / Other Offices physical verification of the records should be conducted and reported accordingly.

b) *Whether any amounts received as income on such investments have been reported to the Head Office?*

   - Confirm from the Branch Trial balance whether any such income is received. If yes, ascertain whether the instructions in this regard of the head office / controlling office is complied with..

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?*

- Confirm from the Branch Trial balance whether any such income is received. If yes, ascertain whether the instructions in this regard of the head office / controlling office are complied with.

d) *Whether there are any matured or overdue investments, which have not been encashed? If so, give details?*

- Give full details including details about the investment, the date on which the said investment has got matured or overdue, maturity value, etc.

e) *Whether the guidelines of the Reserve Bank of India regarding Transactions in Securities have been complied with.*

- Refer guidelines of Reserve Bank of India together with Head Office instruction.

f) *Whether the guidelines of the Reserve Bank of India regarding valuation of Investments have been complied with.*

- Refer guidelines of Reserve Bank of India together with Head Office instruction (Valuation Policy of the Bank).

(B) For Branches outside India

- The audit of Branches outside India is not allotted to Indian Chartered Accountants Firms; hence not applicable.

a) *In respect of purchase and sale of investments, has the branch acted within its delegated authority, having regard to the instructions/ guidelines in this behalf issued by the Controlling Authorities of the bank?*

b) *Have the investments held by the branch whether on its own account or on behalf of the Head Office/ other branches been made available for physical verification? Where the investments are not in the possession of the branch, whether evidences with regard to their physical verification have been produced?*

c) *Is the mode of valuation of investments in accordance with the RBI guidelines or the norms prescribed by the relevant regulatory authority of the country in which the branch is located, whichever are more stringent?*

d) *Whether there are any matured or overdue investments, which have not* *been encashed? If so, give details?*

Advances

(a) Credit Appraisal

In your opinion, has the branch generally complied with the procedures/ instructions of the Controlling Authorities of the bank regarding loan applications, preparation of proposals for grant/ renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.

- Refer circular issued by Head Office regarding Credit Appraisal.
- Enquire whether specific facility wise loan application form is prescribed by the Bank.
- Confirm that the instructions are followed by the Branch while accepting the loan application form.
- Refer circular issued by Head Office regarding preparation of proposals for grant / renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.
- While reporting under this clause, auditor should consider the "Early mortality cases" in the branch

The auditor would also need to consider whether:

- The branch is adhering to various guidelines issued by RBI regarding lending against own shares, lending to directors or their relatives.
- In respect of lending under consortium / multiple banking arrangement, the branch is obtaining declaration from the borrowers about the credit facilities already enjoyed by them from other banks in the format prescribed in circulars DBOD.No.BP.BC.46/08.12.001/2008-09 dated September 19, 2008 and DBOD.No.BP.BC.94/08.12.001/2008-09 dated December 08, 2008.
- Bank is exchanging / sharing information of the credit facilities sanctioned to the borrowers with other lending bankers as per RBI/2012-13/304 DBOD.BP.BC.No. 62/21.04.103/2012-13 dated 21/11/2012 including compliance to any sanction of fresh loans/ad hoc loans/renewal of loans to new/existing borrowers to be done only after obtaining/sharing necessary information.
- The branch is practicing due diligence to assess the credit worthiness of the borrowers and not relying on margin and security as a substitute for due diligence.

- The branch is adhering to the prudential exposure limits prescribed by RBI and Head Office.
- In case of corporate borrower, it is necessary for branch auditor to carefully go through the annual reports to ensure that there no adverse comments in main auditor report or CARO report on annual accounts of the borrower that affects sanction at the branch level.
- Latest IT returns of Borrowers / Guarantors have been obtained and verified with financial documents and other information available on record.
- Latest CIBIL or other Credit Information Company report has been obtained and verified.

(b) Sanctioning/ Disbursement

(i) In the cases examined by you, have you come across instances of credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch? Are such cases promptly reported to higher authorities?

- Confirm sanctioning / disbursement discretionary power regarding advances.
- Report the cases where credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch
- Whether such type of cases promptly reported to higher authorities.
- Such type of cases may be reported in the following format.
- Generally, cases are seen in the branch where the limits of existing borrowers are allowed to be overdrawn for a period beyond permissible time. Such cases should be reported.

Sr. No.	Name of the borrower	Account Number	Type of facility	Sanction date/ Authority	Sanction limit	Balance outstanding on 31.03.20XX	Amount sanctioned exceeding the delegated authority	Date of sanction / ratification from Higher Authority

(ii) In the cases examined by you, have you come across instances where advances have been disbursed without complying with the terms and conditions of the sanction? If so, give details of such cases.

- Obtain original Title deed, Execution of Documents. Vetting of documents by legal dept./ legal resource.
- Report the cases where advances have been disbursed without complying with the terms and conditions of the sanction letter.

  Main aspects to be covered are:

  - Registration of charges – search report.
  - Resolutions – guarantees – mortgage creation.
  - Legal opinion – valuation – encumbrance certificate – insurance.
  - Lien on deposits – margins for BG and LC and loan on deposits.
- Report the cases along with the deviations.

(c) Documentation

(i) In the cases examined by you, have you come across instances of credit facilities released by the branch without execution of all the necessary documents? If so, give details of such cases.

- Report the cases where credit facilities released by the branch without execution of all the necessary documents. Physical verification of documents is critical. This is one of the important functions of the branch audit and the reason why branch audit exists.
- Verify Custody of Documents – Whether document movement register tracking changes is maintained. Whether scanning of important documents is maintained.
- The exact nature of irregularity / document not obtained may be provided in the following format.

Sr. No.	Name of the borrower	Account Number	Type of facility	Sanction date / Authority	Sanction limit	Balance outstanding on 31.03.20XX	Nature of irregularity / documents not obtained

(ii) In respect of advances examined by you, have you come across cases of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc.? If so, give details of such cases.

- Report cases of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc.
- Make sure that the documents are adequately stamped and also that they are executed within six months of purchasing the stamp paper.
- The instances should be reported in the following format.

Sr. No.	Name of the borrower	Account Number	Type of facility & a/c no.	Sanction date / Authority	Sanction limit	Balance outstanding	Nature of irregularity

- Time barred documents list to be furnished as under

Sr. No.	Name of the borrower	Account Number	Outstanding balance	Sanction limit / Authority	Date of document

- The time barred accounts statement can be generated through system.
- When the document becomes time barred, no legal action can be initiated against the borrower.

(iii) Whether advances against lien of deposits have been properly granted by marking a lien on the deposit in accordance with the guidelines of the Controlling Authorities of the bank.

- Refer the guidelines issued by Head Office in this regard.
- Report the cases, where the deposits / NSCs, paper securities etc., are matured, however not adjusted against the respective advances.
- Instances should be given in the following format.

Sr.	Name of the	Account Number	Sanction limit /	Outstanding balance	Date of document	Particulars of Security

No.	borrower		Authority			

(d) Review/Monitoring/ Supervision

(i) Is the procedure laid down by the Controlling Authorities of the bank, for periodic review of advances including periodic balance confirmation/ acknowledgement of debts, followed by the branch?

Provide analysis of the accounts overdue for review/ renewal

- *between 6 months and 1 year, and*
- *over 1 year*

- Refer the guidelines issued by Head Office in this regard.
- Date / month in which accounts were due for review and the date / month on which the review was done may be obtained.
- It may be noted that there would be cases that are seen performing at the balance sheet date but evidently stressed. Comments on such account with respect to branch efforts on monitoring and information availability on same should be commented upon.
- In view of changes in the reporting requirements in CARO for corporate borrowers, it is necessary for branch auditor to carefully go through the annual reports to ensure that there no adverse comments in the balance sheet of a borrower that affects reporting at the branch level.
- Date / Month of review can be verified from the sanction documents / terms
- Instances should be given in the following format.

Sr. No.	Name of the Borrower	Type of Facility & Account Number	Balance outstanding as on 31.03.20XX	Review overdue since	Ageing

(ii) Are the stock / book debt statements and other periodic operational data and financial statements, etc., received regularly from the borrowers and duly scrutinised? Is suitable action taken on the basis of such scrutiny in appropriate cases?

- Borrower wise / month wise record showing receipt of security statement be confirmed.
- Confirm the working of drawing power based thereon.
- Confirm whether these statements are obtained on time.

- Compare movement shown in book debt & creditors with debit/credits in the Bank.

Further, in respect of consortium advance, the drawing power should be determined by the lead bank and circulated to the other member banks (circular no. No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association).

(iii) *Whether there exists a system of obtaining reports on stock audits periodically? If so, whether the branch has complied with such system?*

- Refer the guidelines issued by Head Office in this regard and confirm the compliance thereof.
- Examine the compliances obtained, action taken in cases wherein deficiencies are reported by the stock auditors.
- Obtaining written reverts from the Borrower.
- Whether adverse issues in stock audit reports are duly factored in review / renewal notes.
- Compare with annual accounts for divergences and obtain satisfactory explanations

(iv) *Indicate the cases of advances to non-corporate entities with limits beyond Rs.10 lakhs where the branch has not obtained the accounts of borrowers, duly audited under the RBI guidelines with regard to compulsory audit or under any other statute.*

- Obtain list of non corporate borrowers enjoying facilities in excess of Rs.10.00 lakhs and report where audited statements are not on record.
- A list of such cases is to be given in the following format.

Sr. No.	**Name of the Borrower**	**Account Number**	**Sanction Limit**	**Date of last audited accounts obtained**

(v) *Has the inspection or physical verification of securities charged to the Bank been carried out by the branch as per the procedure laid down by the Controlling Authorities of the bank?*

- Refer the guidelines issued by Head Office in this regard.
- Reporting deviations if any reasons for the deviations
- A list of such cases is to be given in the following format.
-

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Last date of inspection or physical verification

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

- Note down the remarks regarding deficiencies in value of securities and inspection report submitted by the concerned officer.
- Confirm whether Insurance is in favour of Bank.
- Check whether Insurance covers risks the mortgaged securities are subject to – Check adequacy of Insured value and location wise.-
- The cases where frequent / unauthorized over drawings beyond limits are granted is to be given in the following format.

Sr. No.	Name of the Borrower	Account number	Sanction Limit	Balance Outstanding	Drawing power	Irregularity

- For cases, wherein insurance details are not available is to be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Value of Security

- For cases, wherein there is inadequate insurance may be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Value of Security	Insured for Rs.	Inadequate Insurance

(vii) *In respect of leasing finance activities, has the branch complied with the guidelines issued by the Controlling Authorities of the bank relating to security creation, asset inspection, insurance, etc? Has the branch complied with the accounting norms prescribed by the Controlling Authorities of the bank relating to such leasing activities?*

- Refer the guidelines issued by Head Office in this regard.

(viii) Are credit card dues recovered promptly?

- Refer the guidelines issued by Head Office in this regard.
- Whether the branch maintains debit balances in the card dues customers.
- Confirm, whether such debit balances are included in advances classification statements.

(ix) Has the branch identified and classified advances into standard/sub-standard/ doubtful/ loss assets in line with the norms prescribed by the Reserve Bank of India.

- Refer the guidelines issued by Reserve Bank of India together with Head Office in this regard.
- Wherever, such guidelines are not followed, Memorandum of Changes be given with reasons.
- The branch auditor shall also verify compliance with the guidelines issued by Head Office with regard to *identification and classification of loan accounts into special mention accounts and incremental provisioning requirement on account of unhedged foreign current exposures in line with the norms prescribed by the Reserve Bank of India*

(x) Where the auditor disagrees with the branch classification of advances into standard / sub-standard / doubtful / loss assets, the details of such advances with reasons should be given. Also indicate whether suitable changes have been incorporated / suggested in the Memorandum of Changes.

- Refer the guidelines issued by Reserve Bank of India together with Head Office in this regard.
- Wherever, such guidelines are not followed Memorandum of Changes be given with reason.

(xi) Have you come across cases where the relevant Controlling Authority of the bank has authorised legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so, give details of such cases.

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Instructions to take legal action on	Present Status

(xii) Have all non-performing advances been promptly reported to the relevant Controlling Authority of the bank? Also state whether any rehabilitation programme in respect of such advances has been undertaken, and if so, the status of such programme.

- ➢ Refer the guidelines issued by Head Office in this regard.
- ➢ Wherever, such guidelines are not followed such cases be reported

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Rehabilitation programme sanctioned	Present Status

(xiii) Have appropriate claims for DICGC/CGSTE and Export Credit Guarantee/ Insurance and subsidies, if any, been duly lodged and settled? The status of pending claims giving year wise break-up of number and amounts involved should be given in the following format:

- ➢ DICGC not applicable, as most of the Banks have opted out of DICG.
- ➢ Report here the claims if any outstanding on account of ECGC/CGST.
- ➢ Report the cases not accepted / rejected by ECGC/CGST.

Particulars	Number	Amount (Rs.)
Claims as at the beginning of the year (Give year-wise details)		
Further claims lodged during the year		
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**	____ ===	______ ======

(xiv) In respect of non-performing assets, has the branch obtained valuation reports from approved valuers for the fixed assets charged to the bank, once in three years, unless the circumstances warrant a shorter duration?

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported in the following format.
- Whether valuation is done on a consistent basis – at fair Market value, Realizable value, Distress value – Whether Fall in Market value has been factored in the valuation -

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Balance Outstanding	Security	Value of Security	Latest Valuation Report date

(xv) In the cases examined by you has the branch complied with the Recovery Policy prescribed by the Controlling Authorities of the bank with respect to compromise/ settlement and write-off cases? Details of the cases of compromise/ settlement and write-off cases involving write-offs/ waivers in excess of Rs.50 lakhs may be given.

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Balance Outstanding	Compromised / Settlement Amt.	Recovery Effected	Recovery To be effected

(e) Guarantees and Letters of Credit

- Normally handled at Corporate or Head Office.

- However, inquire whether such types of cases are handled at Branch and reply accordingly.

(i) Details of outstanding amounts of guarantees invoked and funded by the branch at the end of the year may be obtained from the Management and reported in the following format:

(a) Guarantees invoked, paid but not adjusted:

Sr. No.	Date of invocation	Name of the party	Name of beneficiary	Amount	Date of Recovery	Remarks

(b) Guarantees invoked but not paid:

Sr. No.	Date of invocation	Name of the party	Name of beneficiary	Amount	Date of Recovery	Remarks

(ii) Details of the outstanding amounts of letters of credit and co-acceptances funded by the Branch at the end of the year may be obtained from the Management and reported in the following format:

Sr. No.	Date of funding	Name of the party	Nature (LC/ co-acceptance, etc.)	Amount	Date of Recovery	Remarks

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?

- The Head Office instructions to be seen and confirm whether internal control is in existence.
- Carry out the physical verification of security items including stamps.
- Whether lost security items are reported to Controlling Authority.
- Note down the accounting treatment given to Stationery items as every Bank is having different policy in this regard.
- Comment on the usage of security items during the year and the stock of such items *vis a vis* usage.
- Report lacunas observed in the system at the branch as this is a fraud prone area.

(ii) Have you come across cases of missing/ lost items of such stationery?

- Deficiencies in controls that lead to the missing stationery to be stated.

Sr. No	Description of the security item	Consecutive No. of the item	Date of Loss	Missing Reported on

(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

- Refer the guidelines issued by Head Office in this regard.
- Whether, such guidelines are followed strictly.
- The Debit entries in the opinion of the auditor, not recoverable should be reported for making adequate provision.
- Age wise analysis report through the system may be referred for the same.
- Reasons for such debits to be clarified.

(ii) Does your test check indicate any unusual items in these accounts? If so, report their nature and the amounts involved.

- Information to be given in the following format
- In case of long outstanding entries over a period of one year the details to be seen with regard to its nature and possibility of recovery in case of debit items, if you feel that items are not recoverable necessary provision to be suggested in Memorandum of Changes (MOC)

Sr. No.	Particulars of debit entry	Outstanding balance as on 31.03.20XX	Whether provision is necessary, reasons there of

- Follow the above said procedure in this regard.

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.

- Refer the guidelines issued by Head Office in this regard.
- Whether, such guidelines are followed strictly.
- Wherever the guidelines are not followed report the same along with full details.
- Whether system identifies the inoperative accounts and converts the status of such accounts to inactive.
- Whether branches are transferring inoperative accounts and shown under a separate DEAF Deposits accounts in the branch General Ledger.
- Whether unclaimed liabilities (whether amount due has been transferred to DEAF) is reflected as Contingent Liability.
- Note down the procedure for making such inoperative account, operative.

(ii) After the balance sheet date and till the date of audit, whether there have been any unusual large movements (whether increase or decrease) in the aggregate deposits held at the year-end? If so, obtain the clarifications from the Management and give your comments thereon.

- Compare the aggregate deposits as on 15th March, 20XX, 31st March, 20XX and last day of audit.
- Ascertain the reason for large variation other than due to application of interest / provision as on 31st March, 20XX
- Ensure there is no evergreening

(iii) Are there any overdue/ matured term deposits at the end of the year? If so, amounts thereof should be indicated.

- Refer the guidelines issued by Head Office in this regard.
- Whether, such guidelines are followed strictly.
- Whether interest is provided on matured deposit as per RBI guidelines.
- Follow up done with customers to renew such accounts

Other Liabilities

Bills Payable, Sundry Deposits, etc.

(i) *The number of items and the aggregate amount of old outstanding items pending for three years or more may be obtained from the branch and reported under appropriate heads. Does the scrutiny of the accounts under various sub-heads reveal old balances? If so, give details in the following format:*

Year	No. of items	Amount (Rs.)	Remarks

- Refer the guidelines issued by Head Office in this regard.
- Whether, such guidelines are followed strictly.
- Obtain the listing of bills payable together with the due date

(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.*

- Refer the exceptional transaction report generated through system.
- Movement in such accounts may be compared and reason may be analysed.

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?

- List of claims against the branch together with the status of claim may be obtained.
- List of contingent liability to be verified and the same to be compared with last year's list.
- The items not appearing in the current year's list may be enquired with reasons thereof.
- Whether any provisioning is warranted against these Contingent 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.*

- Refer concurrent audit / internal inspection audit / income & expenditure audit reports.
- Test check interest / discount calculations. Whether changes in interest rates are correctly captured.
- Generate Exceptional Transactions report and verify interest is applied to all applicable accounts
- Generally, interest application is a system-generated entry; hence test check may be applied for confirming interest calculations.
- Wherever excess / short credit of material amount is noticed, such cases may be reported in the following format.
- Test check cases of premature withdrawals for re-computing interest wrt revised tenor.

Sr.No	A/c No	Interest calculated by the system	Interest calculated by us	Difference

(b) *Has the branch complied with the Income Recognition norms prescribed by the RBI?*

- Refer RBI Master circular on IRAC norms together with other circulars issued by RBI on IRAC norms from time to time.
- Ensure asset classification is being done through system and no manual intervention is in place.
- In case, the income recognition in NPA accounts is done manually and is not automated, then the auditor should also verify the system and process being followed by the branch to ascertain whether their exist a systematic manner of recognition of income and should also test whether the same complies with the Accounting Policy of the Bank relating to appropriation of recoveries

Confirm whether IRAC norms are followed strictly through system

(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.*

- Refer the guidelines issued by Head Office/RBI in this regard.
- Whether, such guidelines are followed strictly.

- Check the correctness of interest rates fed in the system with the sanction terms on test check basis. Also, updation of base rates in the system, in case of changes may be verified.
- Generally, interest application is a system-generated entry; hence test check may be applied for confirming interest calculations.
- Wherever excess / short credit of material amount is noticed, such cases may be reported in the following format.

Sr. No	A/c No	Interest calculated by the system	Interest calculated by us	(Short) / Excess Interest calculated by the system

(d) Does the bank have a system of estimating and providing interest accrued on overdue / matured term deposits?

- Refer the guidelines issued by Head Office in this regard.
- Whether, such guidelines are followed strictly.
- In most of the Banks such exercise is carried out at Head Office through system.

(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.

- The divergent trends can be identified by way of comparison analysis on the basis of previous quarters / half year / previous year figures, keeping in mind the changes in business volumes and business mix.
- Compare the aggregate figures as on 15th March, 20XX, 31st March, 20XX and last day of audit. Also compare some of the transfers on the last two days of the year end and identify whether there are any transfers of undrawn portion from the loan accounts to current account or deposit account.

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?

- Now a days CBS is followed hence question of maintaining manual books of accounts does not arise.
- Balancing is also done through system.
- Balancing report may be generated to confirm that no difference is appearing in the balancing report.
- Exception Reports can be generated from the system to verify whether there are differences. If there are differences, the same should be reconciled / rectified by branch.

(b) In respect of computerised branches:

- *Whether hard copies of accounts are printed regularly?*

  Refer the guidelines issued by Head Office. On the basis of instructions, documents to be stored in hard copies and the periodicity of printing may be identified.
- *Indicate the extent of computerisation and the areas of operation covered through manual intervention.*
- *Are the access and data security measures and other internal controls adequate?*

  Refer the guidelines issued by Head Office – Awareness of Branch officials with Security guidelines -

  Password Policy, Anti viruses on systems, Access to pen drives etc. may be checked as a part of access and data security controls
- *Whether regular back-ups of accounts and off-site storage are maintained as per the guidelines of the Controlling Authorities of the bank?*

  Refer the guidelines issued by Head Office for compliance – Whether backups are periodically tested.
- *Whether adequate contingency and disaster recovery plans are in place for loss/ encryption of data?*

  Refer the guidelines issued by Head Office & compliance thereof. Note if any fire drills or any other evacuation drills are conducted – Whether any Fire Safety Audits are conducted -
- *Do you have any suggestions for the improvement in the system with regard to computerised operations of the branch?*

Reconciliation of Control and Subsidiary Records

- Enquire at branch the system of reconciliation followed.
- Whether any long outstanding debit entries are appearing in the reconciliation statement.
    - *If answer is positive, same should be reported.*

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

Inter-Branch Accounts

- Check for any entries not responded -
- Now a day's CBS is implemented hence question of reconciliation of Inter – Branch Accounts does not arise at Branch.

(i) Does the branch forward on a daily basis to a designated cell/ Head Office, a statement of debit/ credit transactions in relation to other branches?

(ii) Does a check of the balance in the Head Office Account as shown in the said statement during and as at the year-end reveal that the same is in agreement with the Head Office Account in the general ledger?

(iii) Are there any outstanding debits in the Head Office Account in respect of inter-branch transactions?

(iv) Does the branch expeditiously comply with/ respond to the communications from the designated cell/ Head Office as regards unmatched transactions? As at the year-end are there any unresponded/ uncomplied queries or communications? If so, give details?

(v) Have you come across items of double responses in the Head Office Account? If so, give details.

(vi) Are there any old/ large outstanding transaction/ entries at debits as at year-end which remain unexplained in the accounts relatable to inter-branch adjustments?

Audits/Inspections

(i) Is the branch covered by concurrent audit or any other audit/ inspection

during the year?

(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.*

- Obtain a list of audit which the Branch was subjected to during the previous year.
- The scope of each audit may be reviewed to identify adequate coverage of branch activities.
- Obtain all the reports and peruse the reports for any adverse remarks.
- Whether branch has been addressing all issues noted promptly – whether there are any repeat issues –
- Whether the Gap or Process failure that lead to the transactional error reported is addressed -

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

- Enquire about any fraud reported to Controlling Authority/vigilance dept. Head Office during the financial year.

  The auditor should also examine whether:

  - the branch is having an effective credit monitoring for its Advances portfolio.
  - the branch has an adequate system in place to identify Early Warning Signals(EWS) of incipient sickness / fraudulent activities in respect of loans. Some of the Early Warning signals which should alert the bank officials about some wrongdoings in the loan accounts which may turn out to be fraudulent:
    - Default in payment to the banks/ sundry debtors and other statutory bodies, etc., bouncing of the high value cheques.
    - Raid by Income tax /sales tax/ central excise department.

- Frequent change in the scope of the project to be undertaken by the borrower.
- Under insured or over insured inventory.
- Invoices devoid of TAN and other details.
- Dispute on title of the collateral securities.
- Costing of the project which is in wide variance with standard cost of installation of the project.
- Funds coming from other banks to liquidate the outstanding loan amount.
- Foreign bills remaining outstanding for a long time and tendency for bills to remain overdue.
- Onerous clause in issue of BG/LC/standby letters of credit.
- In merchanting trade, import leg not revealed to the bank.
- Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
- Delay observed in payment of outstanding dues.
- Financing the unit far away from the branch.
- Claims not acknowledged as debt.
- Frequent invocation of BGs and devolvement of LCs.
- Funding of the interest by sanctioning additional facilities.
- Same collateral charged to a number of lenders.
- Concealment of certain vital documents like master agreement, insurance coverage.
- Floating front/ associate companies by investing borrowed money.
- Reduction in the stake of promoter/ director.
- Resignation of the key personnel and frequent changes in the Management.
- Substantial increase in unbilled revenue year after year.
- Large number of transactions with inter-connected companies and large outstanding from such companies.
- Significant movements in inventory, disproportionately higher than the growth in turnover.
- Significant movements in receivables, disproportionately higher than the growth in turnover and/or increase in ageing of the receivables.
- Disproportionate increase in other current assets.
- Significant increase in working capital borrowing as percentage of turnover.

- Critical issues highlighted in the stock audit report.
- Increase in Fixed Assets, without corresponding increase in turnover (when project is implemented).
- Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
- Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
- Substantial related party transactions.
- Material discrepancies in the annual report.
- Significant inconsistencies within the annual report (between various sections).
- Poor disclosure of materially adverse information and no qualification by the statutory auditors.
- Frequent change in accounting period and/or accounting policies.
- Frequent request for general purpose loans.
- Movement of an account from one bank to another.
- Frequent ad hoc sanctions.
- Not routing of sales proceeds through bank.
- LCs issued for local trade / related party transactions.
- High value RTGS payment to unrelated parties.
- Heavy cash withdrawal in loan accounts.
- Non submission of original bills.
- Whether there is a system to identify these EWS and take appropriate remedial action.
- Whether an Anti-fraud policy is in place and communicated to all.
- Whether Anti-fraud trainings are organized? Whether any fraud risk scenarios are identified and any fraud control measures mapped to such risks.
- Whether corporate borrower is a reported shell company, then peruse the impact on loan account.

Miscellaneous

(i) Does the examination of the accounts indicate possible window dressing?

- Compare the aggregate figures as on 15th March, 20XX, 31st March, 20XX and last day of audit.

(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.

- Refer the guidelines issued by Head Office in this regard.
- Whether, such guidelines are followed strictly.

(iii) *Are there any other matters, which you as a branch auditor would like to bring to the notice of the Management or the Statutory Central Auditors?*

Instances are given as under:

- System related issues
- Issues relating to Statutory Payments and Accrual of Statutory Liabilities
- Short / Excess Provisioning in NPA Accounts / Non Provisioning for SMA2 Accounts
- Compliance with the requirements of RBI and Head Office instructions for Unhedged Foreign Currency Exposure
- ATM related issues
- Whether AMC's terms are followed strictly
- Security related issues.
- Issues which may impact other Branches and not just the branch under audit.

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For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation)
Membership Number

Place of Signature:
Date:

Questionnaire Applicable to Specialised Branches

A. For Branches dealing in Foreign Exchange Transactions

1.18 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.

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) any other area

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. Auditor to verify proper filing of BEF &

XOS returns -

3. Obtain a list of all NOSTRO Accounts maintained/ operated by the Branch from the branch Management.

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?

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?

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.

While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of NOSTRO Accounts with the respective mirror 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 mirror 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.

(d) Whether the branch is following HO guidelines for reporting requirements under Foreign Account Tax Compliance Act (FATCA) and Common

Reporting Standards (CRS).

4. *Does the Branch follow the prescribed procedures in relation to maintenance of VOSTRO Accounts?*

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 Directions FED Master Direction No.2 /2015-16 dated January 01, 2016 (updated on May 19, 2017) on "Opening and Maintenance of Rupee/Foreign Currency VOSTRO Accounts of Non-resident Exchange Houses".

B. 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/ Statutory Central Auditors should be appended to the Long Form Audit Report.*

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.

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 statutory central auditor is required to consider it for qualifying and/or disclosing in main report, should be attached as an annexure to LFAR. In cases where limits are allocated to any branch, by a Main branch, the exchange of information between branches has to be verified -

2. *What, in your opinion, are the major shortcomings in credit appraisal, monitoring, etc.?*

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.

For advance accounts where outstanding balance is in excess of Rs. 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.

C. 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.

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.

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.

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?

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.

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.

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.

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?

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.

D. 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?

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:

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.

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:

<table>
<tr><th rowspan="2">Date of Sanc-tion</th><th rowspan="2">Nature of facilities</th><th rowspan="2">Limit (Rs. in Lakhs)</th><th rowspan="2">Prime Security</th><th rowspan="2">Collateral Security</th><th rowspan="2">Margin %</th><th colspan="2">Balance outstanding at the year-end</th></tr>
<tr><th>Current Year</th><th>Previous Year</th></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="8">Provision made: Rs.________ lakhs</td></tr>
</table>

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	

Terms and Conditions			Compliance
	c)	Registration of charges with Registrar of Companies	
	d)	Insurance with date of validity of Policy	
(ii)	Collateral Security		
	a)	Charge on collateral security	
	b)	Mortgage of fixed assets	
	c)	Registration of charges with Registrar of Companies	
	d)	Insurance with date of validity of policy	
(iii)	Guarantees - Existence and execution of valid guarantees		
(iv)	Asset coverage to the branch based upon the arrangement (i.e., consortium or multiple-bank basis)		
(v)	Others:		
	a)	Submission of Stock Statements/ Quarterly Information Statements and other Information Statements	
	b)	Last inspection of the unit by the Branch officials: Give the date and details of errors/ omissions noticed	
	c)	In case of consortium advances, whether copies of documents executed by the company favouring the consortium are available.	
	d)	Any other area of non compliance with the terms and conditions of sanction	

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

V-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, the auditor should consider whether a qualification in the 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. Credit policy b. Credit appraisal c. Sanctioning / Disbursement	e. Review / Monitoring / Supervision f. Recovery Policy in respect of Bad / Doubtful Debts/NPAs

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. Further every bank will have its own limits above which the instances of observations be attached to LFAR comments. It would be prerogative of the auditors to revise these limits in consultation with the Management.

2.08 Further, as per the “Master Circular – Loans and Advances – Statutory and Other Restrictions” dated July 1, 2015, DBR.No.Dir.BC.10/13.03.00/2015-16 issued by the RBI, all banks are required to frame “Fair Practices Code for Lenders” based on the Guidelines contained in this 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, 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.

Credit 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", DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015, provides a framework of the rules / regulations / instructions issued to Banks on statutory and other restrictions on loans and advances. The Master Directions on "Lending to Micro, Small & Medium Enterprises (MSME) Sector"_RBI/FIDD/2017-2018/56 Master Direction FIDD.MSME & NFS.12/06.02.31/2017-18, July 24, 2017, 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. The auditor 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, External Rating, 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, the auditor 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, the auditor 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.
- System of monitoring of unhedged foreign currency exposure and adequacy of provisioning thereof.
- System of classification, monitoring, reporting and provisioning, if required of loan accounts in 3 categories as special mention accounts.

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 instalments/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 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. In case a bank uses this tool, auditors may peruse the information from an audit perspective.

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 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. Where the bank has discontinued the Health Code System the auditor should state this fact.

2.30 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.

2.31 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.

2.32 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, Debit card and Rupee Denominated Cobranded Prepaid Card Operations of banks" (RBI/2015-16/31 DBR.No.FSD.BC. 18/ 24.01.009/ 2015-16) dated July 1, 2015. 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 *vide* Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" (DBR.No.BP.BC.2/21.04.048/2015-16) dated July 1, 2015. 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) are to be 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.

2.48 In case the auditor notices a trend of the adverse observations then he may suitably report them in a summarised manner. In case this adverse trend is of a significant nature the auditor will need to consider the same while reporting on the effectiveness of internal financial controls, if such reporting is applicable to the bank.

II. Liquidity and Funds Management

Investments

2.49 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 and diminution in the value of 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.*

2.50 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" DBR No BP.BC.6 /21.04.141/2015-16 dated July 1, 2015). 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 under permanent and current categories. The auditor should familiarise himself with these guidelines and examine whether the bank has complied with them.

2.51 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.

2.52 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.

2.53 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.

2.54 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.

2.55 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.

2.56 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.*

2.57 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.

2.58 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.

2.59 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.

2.60 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.

2.61 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.

2.62 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.

2.63 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

2.64 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*

2.65 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, the value of which shall not, at the close of business on any day, be less than such percentage as may be specified, on the total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time. This is referred to as 'statutory liquidity ratio' (SLR).

2.66 The schedule of changes relevant to period in the SLR prescription has been detailed in the table below:

Effective date (from the fortnight beginning)	SLR on net demand and time liabilities (per cent)
January 7, 2017	20.50
June 24, 2017	20.00
October 14, 2017	19.50

2.67 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 4.00 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 4.00 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.

2.68 These requirements seek to ensure that banking institutions maintain adequate liquid assets in an unencumbered form so as to safeguard the interests of depositors.

2.69 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.

2.70 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. The auditor 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.

2.71 The auditor may examine compliance with SLR/CRR requirements with reference to the eligible assets maintained by the bank.

2.72 It may be noted that the RBI, vide its Master Circular No. RBI/2015-16/98 DBR. No. Ret. BC.24/12.01.001/2015-16 dated July 1, 2015 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

2.73 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.*

2.74 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.

2.75 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.

2.76 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.

2.77 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.

2.78 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.

2.79 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

2.80 The auditor is required to make comments on system relating to call money operations as under:

- *System related to inter-bank call money.*

2.81 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 Directions on "Master Direction on Money Market Instruments: Call/Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)" dated July 7, 2016 (FMRD. Master Direction No. 2/2016-17). 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

2.82 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

2.83 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.

2.84 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.

Liquidity Risk Management by Banks

2.85 The final guidelines issued in circular no RBI No 2012-13/285 DBOD.BP.No. 56/ 21.04.098/ 2012-13 November 7, 2012. The guidelines consolidate the various instructions/guidance on liquidity risk management that the Reserve Bank has issued from time to time in the past, and where appropriate, harmonise and enhance this instructions / guidance in line with the BCBS's Principles for Sound Liquidity Risk Management and Supervision. They include enhanced guidance on liquidity risk governance, measurement, monitoring and the reporting to the Reserve Bank on liquidity positions. The enhanced liquidity risk management measures are required to be implemented by banks immediately.

Reporting to the Reserve Bank of India

2.86 The existing liquidity reporting requirements have been reviewed. Banks will have to submit the revised liquidity return to the Chief General Manager-in-Charge, Department of Banking Supervision, Reserve Bank of India, Central Office, World Trade Centre, Mumbai as detailed below.

Statement of Structural Liquidity

2.87 At present banks are furnishing statement of structural liquidity for domestic currency at fortnightly interval and statement of structural liquidity for overseas operations at quarterly interval. In addition, statement for structural liquidity for the consolidated bank under consolidated prudential returns (CPR) is prescribed at half yearly intervals. However, under the revised requirements, this statement is required to be reported in five parts viz. (i) 'for domestic currency, Indian operations'; (ii) 'for foreign currency, Indian operations'; (iii) 'for combined Indian operations'; (iv) 'for overseas operations' and for (v) 'consolidated bank operations'. While statements at (i) to (iii) are required to be submitted fortnightly, statements at (iv) and (v) are required to be submitted at monthly and quarterly intervals, respectively. The Maturity and Position statement (MAP) submitted by the banks at monthly intervals is discontinued as the same is now addressed by statement for foreign currency, Indian operations. The periodicity in respect of each part of the return is given in the Table below:

Sl. No.	Name of the Liquidity Return (LR)	Periodicity	Time period by which required to be reported
	Structural Liquidity Statement		
(i)	Part A1 - Statement of Structural Liquidity – Domestic Currency, Indian Operations	Fortnightly*	within a week from the reporting date
(ii)	Part A2 – Statement of Structural Liquidity – Foreign Currency, Indian Operations	do	do
(iii)	Part A3 – Statement of Structural Liquidity – Combined Indian Operations	do	do
(iv)	Part B – Statement of Structural Liquidity for Overseas Operations	Monthly#	within 15 days from the reporting date
(v)	Part C – Statement of Structural Liquidity – For Consolidated Bank Operations	Quarterly#	within a month from the reporting date

* Reporting dates will be 15th and last date of the month – in case these dates are holidays, the reporting dates will be the previous working day.
\# Reporting date will be the last working day of the month / quarter.

III. Internal Control

2.88 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*
- *Concurrent Audit*
- *Dealing Room Operations*
- *RBI Inspection*
- *Frauds/Vigilance*
- *Suspense Accounts, Sundry Deposits, etc.*

Written Guidelines/Instructions/Manual for Accounting Aspects

2.89 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

2.90 These are:

- *System of monitoring the position of balancing of books/ reconciliation of control and subsidiary records.*
- *Follow-up action.*

2.91 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.

2.92 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.

2.93 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.

2.94 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

2.95 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.*

2.96 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 environment the branch reconciliation is done of IT department at H.O. in most of the banks.

2.97 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

2.98 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.*

2.99 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.

Dealing Room Operations

2.100 The auditor should obtain and comment on the observations forming part of the System Audit Report of Dealing Room required to be conducted in terms of RBI guidelines

RBI Inspection

2.101 The auditor should obtain and comment on the observations forming part of Annual Financial Inspection u/s 35 of the Banking Regulation Act, 1949 conducted by RBI.

Frauds/Vigilance

2.102 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.)*

2.103 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.

2.104 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 Directions on "Frauds-Classification and Reporting" (RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016 - 17) dated July 1, 2016 (updated July 03, 2017). The directions / circulars require the banks to report to RBI complete information about frauds and the follow-up action taken thereon.

2.105 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.

2.106 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 by taking preventive steps to reduce/minimise incidence of frauds.

Suspense Accounts, Sundry Deposits etc.

2.107 These are:

- *System for clearance of items debited/credited to these accounts.*

2.108 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.

2.109 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.

2.110 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

2.111 The auditors are required to:

- *Enclose a copy of the capital adequacy certificate.*
- *The auditors should bring out their observations on the systems and processes being followed by the Bank for compilation of capital adequacy returns as well as on the efficacy of the internal control system over the computation of the Risk Weighted Assets.*

V. Automation and Computerisation

2.112 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 exists 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.

2.113 Pursuant to circular DBS.CO.PP.BC.11/11.01.005/2001-2002 dated 17 April 2002, 'Long Form Audit Report to the Management by Central Statutory Auditors of Banks', the Central Statutory Auditors should address their Long Form Audit Report to the Chairman of the Bank concerned and a copy thereof should be forwarded to the designated office of the Reserve Bank of India. Some of the key aspects as regards to automation and computerisation which should be covered are as follows. 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.*

2.114 The central statutory auditor may in addition to performing specific work to comment on the above points may also review the adequacy and appropriateness of the Information Security Policy and report any shortcomings or suggestions for improvement in the computerisation and automation in the LFAR based on the discussions with the Management and IT personnel and leveraging on the work performed whilst undertaking audit procedures. The auditor may also report in his LFAR whether the approved Information Technology Security Policy is in place and communicated to all the branches for implementation.

2.115 The auditor is also required to comment whether the critical areas are covered by automation and the application used therein together with the fact as to whether the systems are developed in-house or acquired from external vendors. Generally, critical areas like treasury and loans are supported by sub-systems which are interfaced to the General Ledger. The auditor needs to make sure that there is a formal process of reconciliation of these sub- systems with the GL on a periodical basis. Further, the relevant application and access controls as prevalent to the CBS should also be followed for these sub-systems.

2.116 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. In case of private sector banks and foreign branches, the central statutory auditor may inquire and verify about the level of branch automation when he conducts branch visits.

2.117 The bank should have a documented procedure for off-site backup. The auditor should enquire about the adequacy of the procedures followed for the recovery of data in case of contingency and disaster including details of the data backup policies for its systems and data, disaster recovery plans, periodicity of backups and details of offsite locations.

2.118 The auditor should report whether the bank has the system of conducting Systems audits periodically to assess the effectiveness of the software, hardware and operations to identify any changes required therein. The auditor also needs to review these reports to assess the impact of IT issues, if any, on the audit of the bank and his scope of work.

Reconciliation of Control and Subsidiary Records

2.119 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

VI. Profitability

2.120 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.*

2.121 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.

2.122 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

2.123 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;*

2.124 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.

2.125 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.

2.126 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.

2.127 Auditor should report whether there is a system of conducting Risk based audits – Auditor should comment on the system in place for closure of audit issue and to ensure that there are no repeat observations or there is a significant reduction in repeat audit issues. Auditor should examine whether there is a mechanism to remedy the underlying process gap by conducting Root- Cause analysis by testing the Control Process.

- *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.*

2.128 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

2.129 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.*

2.130 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 Compliances • Implementation of recommendation of Mitra Committee	• Legal departments (Details relating to suit filed and decreed accounts) • Merchant banking activity • Inter Office adjustments • Planning department • Raj Bhasha • Voluntary retirement scheme • Demat accounts and Loan

• Service Tax • Fringe Benefit Tax	against Shares • Legal Compliance Certificate • Stress Testing

2.131 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.

2.132 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.

2.133 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.

2.134 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 - VI

VI-1
Basel III

Introduction

1.01 Basel capital adequacy norms are meant for the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy, thereby evolving methods of determining regulatory capital and ensuring efficient use of capital.

1.02 Basel III accord strengthens the regulation, supervision and risk management of the banking sector. It is global regulatory standard on capital adequacy of banks, stress testing as well as market liquidity risk.

1.03 The Basel III accord, aims at:

a. improving the banking sector's ability to absorb shocks arising from financial and economic stress, whatever may be the source;

b. improving risk management and governance practices; and

c. strengthening banks' transparency and disclosure standards.

1.04 Basel II has been fully implemented in all commercial banks (except RRBs and LABs) in India by March 31, 2009. In this regard, the RBI has also issued a Master Circular no. DBR.No.BP.BC.4/21.06.001/2015-16 dated July 1, 2015 on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)".

1.05 The major changes made in Basel III over Basel II are as under:

(a) ***Quality of Capital:*** One of the key elements of Basel III is the introduction of much stricter definition of capital, which means the higher loss-absorption capacity, which in turn would lead to banks becoming stronger with enhanced capacity to withstand periods of stress.

(b) ***Capital Conservation Buffer:*** Beginning 31st March, 2016, Banks are required to hold capital conservation buffer of 0.625%, which will gradually increase to 2.5% by 31st March, 2019. This is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.

(c) ***Counter cyclical Buffer:*** The counter cyclical buffer ensures increased capital requirements in good times and decrease the same during bad times.

(d) ***Minimum Common Equity and Tier 1 Capital Requirement:*** The minimum requirement for common equity, the highest form of loss-absorbing capital, has been increased to 5.50% of RWA. The Minimum Tier 1 capital has been increased to 7%, which means that Additional Tier I (AT 1) capital can be maximum of 1.50% of RWA. Though, the minimum total capital (Tier I plus Tier II) requirement remains at 9%, which means that the Tier 2 capital can be admitted maximum of 2% of RWA. With the requirement of gradually maintaining 2.5% of RWA as Capital Conservation Buffer in the form of CET 1, the minimum total capital requirement shall increase to 11.50% of RWA by 31st March, 2019.

(e) ***Leverage Ratio:*** Analysis of 2008 financial crisis indicates that value of assets went down much more than what was perceived based on their risk rating, which leads to stipulation of Leverage Ratio. Therefore, under Basel III, a simple, transparent, non-risk based leverage ratio has been introduced. A Leverage Ratio is the relative amount of capital to total assets (not risk-weighted). The Basel Committee used the revised framework for testing a minimum Tier 1 Leverage Ratio of 3% during the parallel run period up to January 1, 2017. The final calibration, and any further adjustments to the definition, will be completed by 2017, with a view to migrating to a Pillar 1 treatment on January 1, 2018. Currently Indian Banking System is operating at a leverage ratio of more than 4.5%. The final minimum leverage ratio will be stipulated taking into consideration the final rules prescribed by the Basel Committee by end of 2017.

(f) ***Liquidity Ratios:*** Under Basel III, a framework for liquidity risk management has been set up. Liquidity Coverage Ratio (LCR) has become operational since 1st January, 2015.

1.06 Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it will be fully implemented as on March 31, 2019. In view of the gradual phase-in of regulatory adjustments to the Common Equity component of Tier 1 capital under Basel III, certain specific prescriptions of Basel II capital adequacy framework (e.g. rules relating to deductions from regulatory capital, risk weighting of investments in other financial entities etc.) will continue to apply till March 31, 2018 on the remainder of regulatory adjustments not treated in terms of Basel III rules. In this regard, the RBI has also issued a Master Circular no. DBR.No.BP.BC.1/21.06.201/2015-16 dated July 1, 2015 on "Basel III Capital Regulations".

Guidelines on BASEL III Capital Regulations

1.07 The RBI had issued a circular no. DBOD.No.BP.BC.98 /21.06.201/2011-12 dated May 2, 2012 on the subject "Guidelines on Implementation of Basel III Capital Regulations in India". *Vide* this circular, the RBI has prescribed the final guidelines on Basel III capital regulations. RBI issued a master circular no. DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on Basel III Capital Regulations. Following are main features of these guidelines:

- These guidelines became effective from April 1, 2013 in a phased manner. The Basel III capital ratios will be fully implemented as on March 31, 2019.
- 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.
- Liquidity Coverage Ratio has been introduced in a phased manner starting with a minimum requirement of 60% from January 01, 2015 and reaching minimum 100% on January 01, 2019.
- The banks are required to disclose capital ratios under Basel III from quarter ending June 30, 2013.

Components of Capital

1.08 Total regulatory capital will consist of the sum of the following categories:

(i) Tier 1 Capital (going-concern capital)

  (a) Common Equity Tier 1

  (b) Additional Tier 1

(ii) Tier 2 Capital (gone-concern capital)

Limits and Minima

	Regulatory Capital	**As % to RWAs**
(i)	Minimum Common Equity Tier 1 Ratio	5.5
(ii)	Capital Conservation Buffer (comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.0
(iv)	Additional Tier 1 Capital	1.5
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.0
(vi)	Tier 2 Capital	2.0
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.0

(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.5

Capital – What Constitutes Tier 1 and Tier 2 – a Representative Sample

1.09 The Master Circular on Basel III Capital Regulations discusses the capital funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India. The following table shows the components of the capital funds for Indian *vis a vis* foreign banks operating in India:

	Indian Banks	**Foreign Banks operating in India**
Tier I Capital		
Common Equity Tier I (CET 1)	Paid up equity capital (ordinary shares)[22]	Interest free funds from Head Office[23]
	Share premium on issue of common shares	
	Statutory reserves	Statutory reserves kept in Indian books
	Capital reserves representing surplus arising out of sale proceeds of assets	Capital reserves representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Revaluation reserves with discount of 55% (with effect from 1st March 2015), subject to meeting conditions prescribed in RBI circular dated 1st March 2016	Revaluation reserves with discount of 55% (till 29th February 2016), subject to meeting conditions prescribed in RBI circular dated 1st March 2016
	Foreign currency translation reserve arising due to	Foreign currency translation reserve arising due to translation

[22] Refer Annexure 1 to Master Circular on Basel III Capital Regulations for criteria.

[23] Refer Annexure 2 to Master Circular on Basel III Capital Regulations for criteria.

	translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25%, subject to meeting conditions prescribed in RBI circular dated 1st March 2016	of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25%, subject to meeting conditions prescribed in RBI circular dated 1st March 2016
	Balance in Profit & Loss Account at the end of the previous financial year	
	Profits of current financial year on a quarterly basis provided the incremental provisions made for NPA at the end of any of the four quarters of the previous financial year have not deviated more than 25% from the average of the four quarters with certain adjustments given in the Master Circular	
		Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books provided they are non-repatriable and have the ability to absorb losses regardless of their source
	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital
Additional Tier I (AT 1)	Perpetual non-cumulative preference shares[24]	Head office borrowings in foreign currency by foreign banks operating in India as per criteria[25]
	Share premium on	

[24] Refer Annexure 3 to Master Circular on Basel III Capital Regulations for criteria.

[25] Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

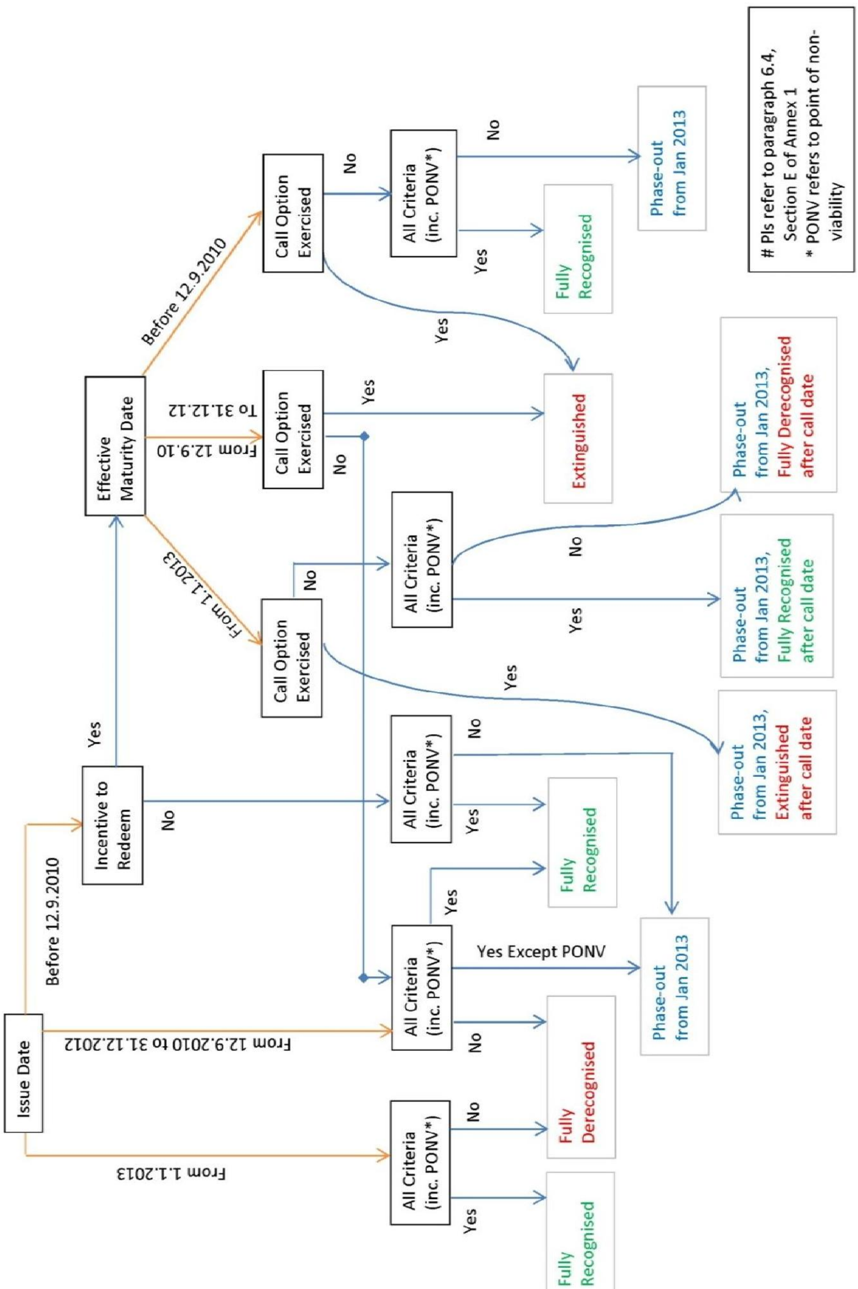
	instruments included in AT 1 capital	
	Debt Capital instruments including Perpetual Debt instruments[26]	
	Any other instrument notified by RBI from time to time	Any other instrument notified by RBI from time to time
	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital
Tier II Capital	Revaluation reserves with discount of 55% (till 29th February 2016)	Revaluation reserves with discount of 55% (till 29th February 2016)
	General provisions and loss reserves	General provisions and loss reserves
	Debt Capital instruments[27]	Head Office (HO) borrowings in foreign currency received as part of Tier 2 debt capital
	Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS) /Redeemable cumulative preference shares(RCPS)[28]	Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non- Cumulative Preference Shares (RNCPS)/ Redeemable cumulative preference shares (RCPS)[29]
	Premium on instruments included in Tier 2	
	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital

1.10 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.

[26] Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.
[27] Refer Annexure 5 to Master Circular on Basel III Capital Regulations for criteria.
[28] Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.
[29] Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

1.11 Capital instruments which no longer qualify as AT 1 capital or Tier 2 capital (e.g. IPDI and Tier 2 debt instruments with step-ups) will be phased out beginning January 1, 2013. Fixing the base at the nominal amount of such instruments outstanding on January 1, 2013, their recognition will be capped at 90% from January 1, 2013, with the cap reducing by 10% in each subsequent year. This cap will be applied to Additional Tier 1 and Tier 2 capital instruments separately and refers to the total amount of instruments outstanding which no longer meet the relevant entry criteria. The following chart graphically depicts the provisions relating to such instruments:

TRANSITIONAL ARRANGEMENTS FOR NON-EQUITY REGULATORY CAPITAL INSTRUMENTS



Deductions from CET I, AT I and Tier II

1.12 The deductions from CET I, AT I and Tier II are tabulated below:

Item	Extent of Deduction (in %)		
	CET I	**AT 1**	**Tier II**
Intangible assets including Goodwill	100	---	
Losses in the current period	100	---	
Losses brought forward from previous periods	100	---	
Deferred tax asset associated with accumulated losses	100	----	
Cash Flow hedge reserve	100	---	
Shortfall of provisions to expected losses	100	---	
Gains on sale related to securitisation transactions	100	---	
Cumulative Gains and losses due to changes in own credit risk on fair valued liabilities	100	---	
Defined benefit pension fund liabilities and un-amortised employees' benefits	100	-	
Investments in own shares (if not already netted off paid-up capital on reported balance sheet) including indirect investments	100	---	
DTAs which relate to timing differences (other than those related to accumulated losses)	Excess of 10% of CET-1	----	
DTAs on timing difference along with limited recognition of significant investments in the common shares of unconsolidated financial (i.e. banking, financial and insurance) entities taken together	Excess of 15% of CET-1		
Equity investments in insurance subsidiaries	100		
Investments in equity instruments of other subsidiaries and capital of other Banks, insurance companies etc. which is more than 10% of Bank's CET1	100		
Equity investments in non-financial subsidiaries	100		
Intra group transactions beyond permissible limits	100		

Reciprocal cross investments in capital of other banks in the same component of capital	Full	Full	Full
Securitization exposure	50	50	
Investment in financial subsidiaries and associates which is above 30 per cent in the paid up equity of entity and not consolidated for the capital adequacy purposes	50	50	
Shortfall in the regulatory capital requirements in the de-consolidated entity	50	50	
Such amount of investment in the following which is in excess of 10% of investing bank's capital funds: • 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	
If net overseas placements with Head Office/other overseas branches/other group entities exceed 10% of the bank's minimum CRAR requirement, the amount in excess of this limit would be deducted from Tier I capital	100	---	

Capital to Risk-weighted Assets Ratio (CRAR)

1.13 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.

1.14 The CRAR is computed as follows:

$$\frac{\text{Eligible Total Capital funds} \times 100}{\text{Credit Risk RWA + Market Risk RWA + Operational Risk RWA}}$$

1.15 The minimum CRAR is required to be maintained at consolidated level also as per Basel III guidelines. The requirements mentioned above relates to standalone Bank only. For the requirement for the consolidated capital, the readers may refer the Master Circular on Basel III Capital Regulations.

Board Oversight

1.16 The board of directors and senior management of each subsidiary/overseas branch should be responsible for conducting their own assessment of the subsidiary's/overseas branch's operational risks and controls and ensuring the subsidiary/overseas branch is adequately capitalised in respect of those risks.

Disclosure (Pillar 3)

1.17 Pillar 3 aims primarily at disclosure of a bank's risk profile and capital adequacy. It is recognised that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The banks in India have to follow Pillar 3 disclosure over and above the RBI master circular on "Disclosure in Financial Statements - Notes to Accounts". Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Pillar 3 disclosures will be required to be made by the individual banks on a standalone basis when they are not the top consolidated entity in the bank.

Role of Auditors of Banks

1.18 Based on RBI appointment letter, the external auditors of the bank are required to provide a certification on the capital adequacy ratio computation. The auditor 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 obtain an adequate understanding of the Basel III norms as prescribed by RBI and also deploy more senior members of its staff to audit the capital adequacy computations.

1.19 Further, some banks may also avail services of their external auditors to review the quality of internal controls and systems, and assess the scope and adequacy of the internal audit function.

1.20 In the concept of Basel III, the capital computation is primarily aimed from central/head office perspective. Basel III is not only about capital adequacy but is also 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 auditors also play a critical role in ensuring that the bank has adopted a consistent practice and as part of their attest function report on its appropriateness of risk management practice as well on the RWA.

Role of Branch Auditors

1.21 In case of credit risk management, the underlying computation for Basel III is based on credit ratings, which may be driven centrally and passed on to branches such that branches follow head office instructions in its entirety. This way the bank branch auditors check only the computation process and test check the source rather than getting into the credit rating process. 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.

1.22 It will not be practical to expect the branch to comprehensively understand the Basel III 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 level can have a cascading effect at the head office, especially when a large number of branches are involved.

1.23 The Statutory Central Auditors should primarily look into the computation of components of various capital as part of their attest function. As regards the overall capital adequacy computation, particularly with respect to RWAs, while the granular data may have been audited by the Branch Statutory Auditors, the Statutory Central Auditors, apart from verifying the consolidation of data emanating from branches/regions/zones/circles etc. should perform the test of reasonableness as well as completeness. As per requirements set by the RBI, the Statutory Central Auditors are required to certify the capital adequacy computation. 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. An Illustrative Audit Checklist for Capital Adequacy is given in ***Appendix XV*** of the Guidance Note.

VI-2

Special Purpose Reports and Certificates

Reporting of Frauds

2.01 The Reserve Bank of India *vide* its Master Direction No: DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 Dated July 01, 2016 (updated July 03, 2017) on “Frauds- Classification and Reporting”, issued guidelines for classification of frauds and reporting of frauds to RBI, Central Office as well as the concerned regional office of the Department of Banking Supervision / Financial Conglomerate Monitoring Division (FCMD) at Central Office under whose jurisdiction the bank’s Head Office/branch is situated. The reporting requirements for various categories of frauds based on financial exposure are specified in the aforesaid Master Directions.

Audit Approach

2.02 The SBAs may verify the contents of certificates to be issued at branch level. All the Returns submitted by branch to various higher authorities of the respective bank and also to various authorities of the regulators as per the Master Directions dated July 03, .2017 shall be verified. Branch Auditors should ensure the correctness of financial implication caused due to such frauds and confirm that the adequate provision for the same has been effected.

2.03 SCAs of the bank may verify the compilation of all such reports received from SBAs regarding the frauds and check whether adequate provision for the same is effected at Head Office. SCAs should also verify the returns submitted by the bank to regulators regarding such frauds during the year under audit.

2.04 SCAs may verify the methodology used by the bank in reporting of such frauds from branches to regional / zonal / circle offices and to head office. SCAs shall verify the existence of internal control mechanism in place to ensure completeness and correctness of such reporting and classification of frauds in the bank.

2.05 SCAs may also check the reporting and classifications of frauds at the Head Office level, where the cases other than those reported through reports SBAs are considered.

2.06 SCAs may also check that the Board of Directors and Audit Committee of bank are being regularly updated with reporting and classification on frauds throughout the year under audit.

Other Reports or Certificates

2.07 In addition to their audit reports, the SBAs and SCAs may also be required by their terms of engagement or statutory or regulatory requirements to issue other reports or certificates. For example, presently, the branch auditors are required to issue reports/certificates on the following matters besides their main audit report:

- Long Form Audit Report for Branch. (Discussed in Part V 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.
- Certificate relating to MOC entries of the previous years being accounted for.
- 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.
- Certificate on Capital Adequacy
- Certificate for Gold Stocks held for Sale of Gold/Metal Gold Loans.
- Certificate for Gold Coins Held.
- Certificate for Gold Deposit Scheme.
- Certificate for IRAC Status of Credit Exposure in respect of Non-Performing Investments.
- Certificates for IRAC Status of Credit Exposure in respect of borrowers having exposure with foreign offices.
- Certificate for agricultural interest subvention claim @2% for residual period of repayment of the loans disbursed during Financial Year.
- Certificate for agricultural interest subvention claim @2% for disbursements made during Financial Year.
- Certificate for additional interest subvention (Incentive @3%) for prompt repayment for short term production loans disbursed during Financial Year. Certain other certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.
- Certificate on Unhedged Foreign Currency Exposure in case of Borrowal having exposure of 1 crore or more.
- Certificate on exposure to sensitive sectors, i.e. exposure to Capital Market, Infrastructure & Real Estate Sector.

2.08 Besides this, SCAs 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.)
- Various ratios and statements in the "Notes on Accounts".
- Report on instances of adverse credit- deposit ratio in the rural areas.
- Certification on correctness of computation of DTL / NDTL
- Report on compliance with CRR and SLR requirements.
- 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.
- In line with the Master Directions on frauds, the SCAs to ensure that all the branches have complied with the reporting as required by the said circular and respective SBA certificates are being received. 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.
- Certain other certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.

2.09 While issuing a special purpose report or certificate, the auditors should bear in mind the recommendations made in the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI).

VI-3

Compliance with Implementation of Ghosh & Jilani Committee Recommendations

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 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 Deputy 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.

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.

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, (i) dealing with the EDP environment in the banks,(ii) dealing with the inspection/internal audit system in the bank and (iii) deal with other miscellaneous aspects of functioning of a bank. The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a ‘Implemented’ or ‘not implemented’ format. Some of the recommendations of Jilani Committee are to be implemented by the banks at the branch office level, whereas some others are applicable to the regional/zonal/head office level. However, some recommendations find applicability at all levels.

Responsibility of the Management

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 No. DBR. No. Dir. BC.11/13.03.00 /2015-16 dated July 1, 2015 on “Guarantees and Co-acceptances” has required that Banks should implement the following recommendations made by the Ghosh Committee:

(i) In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms.

(ii) Banks should, while forwarding guarantees, caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

3.13 RBI through its Master Circular “Loans and Advances – Statutory and Other Restrictions” (DBR.No.Dir.BC.10/13.03.00/2015-16) dated July 1, 2015 requires that banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees to obviate the possibility of frauds in the areas of issuance of Bank Guarantees in favour of Financial Institutions, credit facilities extending to bank against the guarantees issued by other banks/FIs and advancement of Gold (Metal) Loans.

3.14 In this regard, it may be noted that the RBI has also issued Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs (RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 updated July 03, 2017)). These directions deal with Classification of Frauds, Reporting of Frauds to RBI, Quarterly Returns, Reports to the Board, Fraud Monitoring Returns, etc. and the auditor should verify the compliance of the same.

3.15 The RBI has issued a Master Circular on "Willful Defaulters" (DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015) which also specifies the role of auditors including recommendations about action to be taken against negligent / deficient auditors wherein falsification of accounts on the part of borrower is observed. Further, it specifies that to monitor end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. In addition to this, banks are advised that with a view to ensuring proper end-use of funds and preventing diversion/siphoning of funds by the borrowers, lenders could consider engaging their own auditors for such specific certification purpose without relying on certification given by borrower's auditors. However, this cannot substitute bank's basic minimum own diligence.

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, are wrongfully denied credit facilities on such grounds, bank/FI have been advised to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to RBI/CIC.

3.17 In terms of Para 2.9 of Master Circular on Willful Defaulters as stated above, Banks / FIs have already been advised to submit the list of suit-filed accounts and non-suit filed accounts of willful defaulters of Rs. 25 lakh and above on a monthly or more frequent basis to all the four Credit Information Companies. This would enable such information to be available to the banks / FIs on a near real time basis.

3.18 Further, in terms of RBI Circular RBI / 2016-17 / 284 Ref. DBS.CO.PPD.BC.No.9/11.01.005/2016-17 dated April 20, 2017, compliance to the Ghosh Committee recommendation also need not be reported to Audit Committee of the Board of Directors (ACB). However, banks are advised to ensure that:

i) Compliance to these recommendations is complete and sustained,

ii) These recommendations are appropriately factored in the internal inspection/audit processes of banks and duly documented in their manual/ instructions, etc.

Audit 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 Statutory Central Auditors for certifying the compliance/ implementation status of the Ghosh and Jilani Committees recommendations.

- In case of the branch, the SBA shall enquire from the management of the branch whether it has prepared the prescribed report on the implementation status of the recommendations of the Ghosh and Jilani Committees. If yes, then whether the same has been forwarded to the Head Office for necessary action. If no, then the auditor should obtain necessary representation from the management as to why the report has not been prepared and/ or submitted and should appropriately qualify his report.
- In case of the Head Office, the SCA shall obtain a confirmation from the management whether it has received the report on the implementation status of the recommendations of the Ghosh and Jilani Committees from all the branches, regional/ zonal offices, etc. and also whether it has prepared the status report as applicable to the Head Office level. The SCA shall obtain a list of the branches, regional/ zonal offices which have not submitted the prescribed report. Such a list would help the SCA to have a broad idea as to the extent of implementation of the recommendations by the bank as a whole.
- The SCA should obtain and review a copy of the implementation status report(s) so prepared and submitted. Such a review would help the auditors identify areas which are susceptible to fraud/ malpractices. The results of such a review may also require the auditor to re-consider the nature, timing and extent of the procedures adopted by him for carrying out the audit as well as his audit findings.
- In case of Branch audit, where the concerned branch has been subjected to a concurrent audit, then the report of the concurrent auditor on the status of implementation of the recommendations of the Ghosh and Jilani Committees should also be obtained. In case, the branch is not subject to

a concurrent audit, the SBA should enquire whether it had been subjected to any inspection either by the in-house inspection department or by the inspectors of the RBI. The auditor should review the comments, if any, of the concurrent auditor or such inspectors on the said implementation status report.

- The SCA may also request the management to provide a list of branches which had been subject to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. He may, if considered necessary, select some such branches and review the comments of the concurrent auditors/ inspectors on the status of implementation of the recommendations. This would help to identify any common cause of concern among the bank branches.
- Where the status report, as prepared by the management indicates that any of the recommendations have not been implemented, the 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, auditors examination reveals that any of the recommendations indicated as having been implemented have in fact not been implemented by the management, or where there is a failure to comply with any of the recommendations of the two Committees, would not only indicate a weakness in the internal control system in the bank but also raise doubts as to the integrity of the management. The auditor may, accordingly, also need to re-consider the nature, timing and extent of other audit procedures as also the truth and accuracy of any other management re-presentations obtained by the auditor.

Certificate 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.

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 Committees.

Annexure A

Illustrative Format of Certificate w.r.t. Compliance/ Implementation Status of the Recommendations of the Ghosh and Jilani Committees

We have examined the attached Format of compliance/ implementation by _____________ *(name of bank/ bank branch)* with the recommendations of the Ghosh Committee relating to Frauds and Malpractices in Banks and Format of Progress in Implementation of Jilani Committee recommendations, as prepared by the management. The responsibility for compliance with/ implementation of the recommendations of the Ghosh and the Jilani Committees is that of the management of the ___________ *(name of the bank/ bank branch)*. Our responsibility is to examine the report on the status of compliance therewith as contained in the attached Formats, as prepared by the management, thus far and no further.

We have not carried out an investigation into the status of compliance by/ implementation of the management with the recommendations of the Ghosh and Jilani Committees. Our examination is limited to inquiries and obtaining confirmations from the management and other appropriate persons and test checks of the attached status of recommendations.

Based on our above examination, subject to the matter highlighted below, we certify that to the best of our knowledge and belief and according to the information and explanation given to us and as shown by the records examined by us, the attached Formats of compliance with the recommendations of the Ghosh and Jilani Committees, as prepared by the management is correct.

1. ………………………
2. ……………………….

Date:

Place:

For and on behalf of
Chartered Accountants
(Firm Registration No.)

……………………………….
(Name and Designation)
(Membership Number)

VI-4
Other Aspects

Head Office

4.01 Apart from examination of consolidation of branch returns, verification of capital and reserves, and verification of investments and provisioning in respect thereof, the Statutory Central Auditors also usually deal with the following items:

- 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, leave encashment, pension and other retirement benefits;
- provision for taxation;
- provision for audit fee;
- provisions to meet any other specific liabilities or contingencies the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc; and
- Dividends.

Provisioning for Non-performing Assets

4.02 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.2/21.04.048/2015-16) dated July 1, 2015. The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines. It may be emphasised that the percentages prescribed by the RBI reflect the minimum proportion of an advance that a bank ought to provide for to comply with the guidelines. A bank can, at its discretion, make a higher provision than that required under the prudential guidelines. Further, the bank needs to ensure that the bank complies with the PCR (Provision Coverage Ratio) as prescribed by RBI.

4.03 As per RBI Circular RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/ 2016-17 dated April 18, 2017 issued under the provisions of Section 35A of the Banking Regulation Act, 1949, Banks are required to make disclosures as per Annexure to the said circular, wherever either (a) the additional provisioning requirements assessed by RBI exceed 15 percent of the published net profits after tax for the reference period or (b) the additional Gross NPAs identified by RBI exceed 15 percent of the published incremental Gross NPAs1 for the reference period, or both. The disclosures, as above, shall be made in the Notes to Accounts in the ensuing Annual Financial Statements published immediately following communication of such divergence by RBI to the bank. The disclosures in the Notes to Accounts to the Annual Financial Statements may be included under the sub-head Asset Quality (Non-Performing Assets) as referred to in paragraph 3.4 of Master Circular - Disclosure in Financial Statements - Notes to Accounts Ref. DBR.BP.BC No.23 /21.04.018/2015-16 dated July 1, 2015. RBI has further stated that any contravention / non-compliance of the above instructions shall attract penalties under the Act. While the requirement is to make disclosures in the annual financial statements, auditors of listed banks may consider including such disclosures in the quarterly financial results in the quarter in which the RBI inspection report is received.

4.04 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.

4.05 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.

4.06 The Third Schedule to the Banking Regulation Act, 1949 lays down the requirements of disclosure concerning advances. Accordingly, advances are required to be classified under various heads (Notes and Instructions for Compilation of Balance Sheet and Profit and Loss Account, issued by the RBI require that provisions made to the satisfaction of the auditors should be excluded from advances under each head). The concern of the auditor is with the overall adequacy of provisions in respect of each of the heads under which advances are required to be shown in the balance sheet of a bank. Thus, for example, the auditor has to examine the adequacy of the overall provisions recommended by the bank separately in respect of (a) bills purchased and discounted, (b) cash credits, overdrafts and loans repayable on demand, and (c) term loans. Similarly, the auditor should examine the overall adequacy of the provisions recommended under each of the other heads of advances in the balance sheet. If, in his opinion, the overall provision recommended by the bank in respect of any of the heads is inadequate, 'the auditor should consider if his report needs to be modified with reference to the requirements of Standard on Auditing (SA) 705, Modifications to the Opinion in the Independent Auditor's Report.

4.07 The RBI has specified that advances against book debts may be included under the head 'secured by tangible assets'.

Recognition of Certain Expenses

4.08 Certain expenses, such as the following, are usually recognised at the head office level (or at zonal or regional level):

(a) Directors' fees, allowances and expenses;
(b) Insurance;
(c) Auditors' fees and expenses; and
(d) Service tax, GST, etc.

Directors' Fees, Allowances and Expenses

4.09 This item includes sitting fees and all other items of expenditure incurred in relation to directors. The daily allowance, hotel charges, conveyance charges, etc., though in the nature of reimbursement of expenses incurred, may be included under this head. Similar expenses of local Committee members may also be included under this head. Under the Companies Act, 2013 a director may receive remuneration by way of a fee for each meeting of the Board or a Committee attended by him. Local Committees are appointed by banks as advisory bodies in respect of the areas allotted to them. Their members are also paid fees or allowances.

4.10 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

4.11 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.

4.12 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.

4.13 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

4.14 This item includes the fees paid to the statutory auditors and auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services, the expenses incurred in that context including fees incurred for such assignments may not be included under this head but shown under 'other expenditure'.

Provision for Depreciation

4.15 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 Chapter 2 of Part IV on “Fixed Assets 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

4.16 Provisions for certain employee costs such as bonus/ex-gratia in lieu of bonus, and gratuity, leave encashment, pension and other retirement benefits are usually made at the head office level.

4.17 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.

4.18 The auditor should examine whether provisions in respect of employee benefits are made in accordance with the requirements of Accounting Standard (AS) 15, "Employee Benefits". The auditor should particularly examine whether provision for leave encashment has been made by the bank. As per AS 15, employee benefits include all forms of consideration given by an enterprise in exchange for services rendered by employees. It includes short-term employee benefits such as wages, salaries and social security contributions and non-monetary benefits, post-employment benefits, other long-term employee benefits and termination benefits. The auditor should examine the adequacy of the provisions made with reference to such documentary evidence such as reports of actuaries or certificates from the Life Insurance Companies, as appropriate under the facts and circumstances of the case.

4.19 In the case of employee benefits, the Master Circular on "Disclosure in Financial Statements – Notes to Accounts" (DBR.BP.BC No. 23 /21.04.018/2015-16) dated July 1, 2015 issued by the RBI with reference to Accounting Standard 15, specifies that Banks may follow the disclosure requirements prescribed under AS 15 (revised), 'Employees Benefits' issued by ICAI.

Provision for Taxation

4.20 Provision for taxation relates to income-tax, (including corporate dividend tax). The auditor must ensure compliance with AS 22, "Accounting for Taxes on Income".

Income-tax

4.21 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.

The Statutory Auditor should consider impact of Income Computation and Disclosure Standards (ICDS) issued vide notification dated 31 March 2015 by CBDT while calculating provision of Tax. The notification requires income computation and disclosure standards to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources".

ICDS No.	Name
I	Accounting Policies
II	Valuation of Inventories
III	Construction Contracts
IV	Revenue Recognition
V	Tangible Fixed Assets
VI	Effects of Changes in Foreign Exchange Rates
VII	Government Grants
VIII	Securities
IX	Borrowing Costs
X	Provisions, Contingent Liabilities & Contingent Assets

Vide Notification dated 29th September 2016, the Central Government notified amended ICDS which are applicable with effect from the assessment year 2017-18.

Bad Debts and Provision for Bad and Doubtful Debts

4.22 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. 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.

4.23 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.

4.24 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".

4.25 Section 36(1)(vii) requires the amount of any bad debt or part thereof to be written off as irrecoverable in the accounts of the assessee for the previous year. It is sufficient compliance of the section if the write off is done at Head Office level.

Special Reserve

4.26 Deduction in respect of a special reserve created and maintained by a banking company –

(a) Section 36(1)(viii) provides deduction in respect of any special reserve created and maintained by a specified entity, which includes a banking company.

(b) The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and gains of business or profession" (before making any deduction under this clause) carried to such reserve account.

(c) The eligible business, in case of a banking company, means the business of providing long-term finance for –

   (i) industrial or agricultural development or development of infrastructure facility in India; or

   (ii) development of housing in India.

(d) However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

(e) The Reserve Bank of India has issued circular No.: DBOD. No.BP.BC.77/21.04.018/2013-14 dated December 20, 2013 for creation of deferred tax liability on special reserves created under section 36(1)(viii) and entire Special Reserves may be reckoned for the purpose computation of Tier-I Capital.

Interest on Non-Performing Accounts (NPAs)

4.27 According to section 43D, read with Rule 6EA of the Income-tax Rules, 1962, the income of a scheduled bank by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, shall be chargeable to tax only in the previous year in which it is credited to the Profit and Loss Account or in the year of actual receipt, whichever is earlier.

Transactions with Foreign Banks/Foreign branches of Indian banks

4.28 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.

4.29 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.

4.30 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

4.31 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.

4.32 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.

4.33 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.

4.34 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

4.35 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.

4.36 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

Pending Proceedings

4.37 The auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal.

Method of Accounting

4.38 Many banks account for commission, exchange, brokerage, interest on bills, locker rent and other fees as income upon realisation. Section 145 of the Income-tax Act, 1961 provides, *inter alia*, that income chargeable under the head "Profits and Gains of Business and Profession" shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Auditors of banks to whom the Companies Act applies are required to follow accrual basis of accounting. Further, accrual being a fundamental accounting assumption, the auditor would need to consider modification/ reference to/ in the auditors report wherever cash basis of accounting is followed.

Reversal of Earlier Year's Provision

4.39 It is possible that subsequent judicial pronouncements/ appellate orders may make the provisions of earlier years excessive.

4.40 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.

4.41 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.

4.42 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

4.43 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, including implication of ICDS VIII, should be considered while provisioning.

Notional Gain/Loss on Foreign Exchange Translations

4.44 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. While recognising gains or loss for tax purposes the following decisions may be considered by the auditor along with FEDAI Guidelines:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* has held that notional profits on translation of foreign exchange forward contracts is not taxable.
- The Madras High Court in the case of *Commissioner of Income-tax Vs. Indian Overseas Bank (1985) 151 ITR 446* has held that notional loss on translations of foreign exchange contracts is not tax deductible.

Broken Period Interest

4.45 The RBI, vide its Master Circular No. DBR No.BP. BC. 6/ 21.04.141 / 2015-16 on, "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks" dated July 1, 2015, advised that banks should not capitalise the Broken Period Interest paid to seller as part of cost, but treat it as an item of expenditure under P&L 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 the tax implications and, hence, the banks should comply with the requirements of Income Tax Authorities in the manner prescribed by them.

4.46 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

4.47 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.

4.48 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)].

4.49 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.

4.50 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 -

4.51 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.

4.52 '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.

4.53 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 “Guidance Note on Tax Audit under Section 44AB of the Income-tax Act, 1961” issued by ICAI for detailed discussion.

Share Issue Expenses

4.54 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.

4.55 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.*

4.56 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, 2013;
- (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.

4.57 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

4.58 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.

4.59 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.

4.60 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

4.61 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.

4.62 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.

4.63 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.

4.64 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.

FATCA /CRS

4.65 Foreign Account Tax Compliance Act (known in short as FATCA) is a legislation to counter tax evasion in the United States of America (USA) FATCA was introduced by US Dept of Treasury (Treasury) and US Internal Revenue Service (IRS) to encourage better tax compliance by preventing US persons from using banks and other financial organisations to avoid US taxation on their income and assets.

4.66 As on 13th July 2015, 112 countries have agreed to comply with FATCA agreements (67 signed IGAs, 45 IGAs agreed in substance). As on 4th June 2015, 61 countries are signatories of Multilateral Competent Authority Agreement (MCAA) committed to reciprocal tax information exchange.

4.67 India and the USA have signed the reciprocal version of model 1 IGA for FATCA on 9th July 2015.

4.68 India signed the OECD's CRS (Common Reporting Standards) on 3rd June 2015.

4.69 The IGA has 2 models – India has signed Model 1 IGA wherein banks will have to report information to the prescribed authority who in turn will submit information to the IRS.

4.70 In Model 1 IGA, the Foreign Financial Institution (FFI) has to report all FATCA related information to their governmental agencies, which would then report the FATCA related information to the IRS. Some Model 1 IGAs are reciprocal, requiring the US to provide certain information about residents of the Model 1 country to the Model 1 country in exchange for the information that country provides to the USA. An FFI covered by a Model 1 IGA will not need to sign an FFI agreement but needs to register on the IRS's FATCA Registration Portal or file Form 8957.

4.71 Like FATCA, Common Reporting Standard (CRS) is a reciprocal exchange of information on financial accounts on an automatic basis with other countries/ non-sovereign territories so as to combat the menace of offshore tax evasion and avoidance and stashing of unaccounted money abroad.

4.72 India would be obligated to get its financial institutions to share financial account information of accountholders who are tax residents in any of these countries. Likewise, India would also get similar information through financial institutions of such treaty countries.

4.73 CBDT has notified Rule 114H for Due Diligence Requirement under FATCA, major requirements for the Bank as under:

All the concerned financial institutions should register on the related e-filling portal of Income Tax Department as Reporting Financial Institution by submitting the requisite details. Thereafter, the reports can be submitted online by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report.

4.74 As per RBI Circular RBI/2015-16/165 DBR.AML.BC.No.36 /14.01.001/2015-16, dated August 28, 2015, for the new accounts opened after September 1, 2015, the due diligence procedures specified in Rule 114H (4) and 114H (6) would be applicable.

4.75 All the FIs have to submit reports online using the digital signature of the designated director by either uploading Form 61B or Nil Report by September 10, 2015. The first reporting will be with respect to calendar year 2014 if an account has been identified as US reportable account consequent to completion of due-diligence procedures as laid down in Rule 114H. Therefore, the reasons for the Nil report should be captured as under:

a. For pre-existing accounts:

Option 1: Due diligence procedure not completed

Option 2: Due diligence procedure completed but no reportable US account identified

b. For new accounts:

Option 1: Alternative procedure invoked

Option 2: Due diligence procedure as applicable to new accounts completed but no reportable US account identified

4.76 All the regulated entities should take action appropriately for the implementation of due diligence and reporting requirements as laid down in the Rules and ensure compliance in a manner that lends itself to credible auditability including audit of the IT system which should be suitably upgraded to not only maintain the information required under the Rules but also to record and store the due diligence procedures. In due course, the detailed guidelines for carrying out audit of IT system for ascertaining the degree and level of compliance with due diligence procedures as laid down in the Rules will be issued.

4.77 Statutory Auditor should verify whether the Bank has put a process in place for complying with guidelines under FATCA/CRS and submitted reports as required by FATCA.

VI-5

Other Aspects - Service Tax/ Goods and Services Tax

Brief History of Applicability of Service Tax on Banks

(A) Position under Positive List of Taxation

5.01 Some of the banking services have been brought under the Service Tax purview. Banks need to ensure that all unpaid service tax liability is adequately provided. It is worth highlighting here that, Service Tax was introduced in India on 01.07.1994. However, Banking and Other Financial Services had been brought within the ambit of Service Tax w.e.f. 16.07.2001. Services mentioned in clause (a) of section 65 (12) of the Finance Act, 1994 are taxable, if provided by:

(a) Banking company and financial institution including NBFCs from July 16, 2001; or

(b) Any other body corporate from August 16, 2002; or

(c) Any other commercial concern from September 10, 2004.

5.02 Services mentioned in clause (b) of section 65 (12) of the Finance Act, 1994 are taxable, if provided by:

(a) Banking companies, financial institutions including NBFCs and other body corporates from July 1, 2003; or

(b) Commercial Concerns from September 10, 2004.

5.03 With effect from May 16,2008, section 65(12) has been amended to levy service tax on foreign exchange broking and purchase or sale of foreign currency, including money changing, provided by a foreign exchange broker or an authorised dealer in foreign exchange or an authorised money changer also.

(B) Position under Negative List of Services which is applicable w.e.f. July 1, 2012

5.04 After the introduction of Negative List i.e. with effect from July 1, 2012, Service Tax is applicable on all services provided by banks except followings:

- Services by the Reserve Bank of India;

- 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 authorised dealers of foreign exchange or amongst banks and such dealers.

5.05 In addition, Banks are also required to pay service tax under reverse charge mechanism in following cases:

a) *Full Reverse Charge i.e. 100% amount of Service Tax*

- Services provided by recovery agent;
- Sponsorship Services;
- Arbitral Tribunal and Legal Services;
- Services provided by Director;
- Import of Services;
- Services of Transport of Goods by a Goods Transport Agency;
- Services by way of supply of manpower for any purpose;
- Security Services;
- Services by way of renting of a motor vehicle designed to carry passengers after availing prescribed abatement and
- Services by Government or a Local Authority excluding Renting of Immovable Property Services, Services by Department of Posts by way of speed post, express parcel post, life insurance and agency services, Services in relation to an aircraft or a vessel and Services of transport of goods or passengers.

b) *Partial Reverse Charge*:

In respect of the following taxable services 50% amount of applicable Service Tax is to be paid by Bank under Partial Reverse Charge. The remaining 50% of the applicable Service Tax shall be charged by the Service Provider in his invoice.

- Works Contract Services.
- Services by way of Renting of a motor vehicle designed to carry passengers without availing the prescribed abatement i.e. on gross amount charged.

Point of Taxation for Service Tax payable under reverse charge is when, payment is made to service provider. Where the payment is not made within a period of three months from the date of invoice, the point of taxation shall be the date immediately following the said period of three months.

5.06 Rate of Service Tax on Banking & Other Financial Services during different periods

Period	Service Tax	EC	SHEC	SBC	KKC	Total Rate
16.07.2001 to 13.05.2003	5%	-	-	-	-	5%
14.05.2003 to 09.09.2004	8%	-	-	-	-	8%
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 to 31-05-2015	12%	2%	1%	-	-	12.36%
01.06.2015 to 14-11-2015	14%	-	-	-	-	14%
15.11.2015 to 31.05.2016	14%	-	-	0.5%	-	14.5%
With effect from 01.06.2016	14%	-	-	0.5%	0.5%	15%

5.07 Many banks have gone for centralised registration under service tax, but few have taken registration at their zonal office/branch office level also. This will require the respective auditor's to ensure compliance.

5.08 An Illustrative Audit Checklist in respect of Service Tax for the period April 1, 2017 to June 30, 2017 is given in ***Appendix XVI*** of the Guidance Note.

Goods and Services Tax

Applicability of GST on Banks w.e.f 1st July, 2017

(A) Taxability

5.09 Goods and Services Tax ("**GST**") is levied on all forms of supply of goods or services or both and therefore, Banking Company and/or Financial Institutions including NBFCs have been covered under the GST regime. Thus, the services provided by them will be attract levy of GST except some specified services which are exclusively exempted similar to the Service Tax regime.

(B) Registration Requirement

5.10 Most of the banks have centralized registration under the Service Tax laws for all its branches in multiple States & Union Territories (UT), however they will now be required to obtain separate registrations in each such State & Union Territory in the GST regime. Such a requirement will have huge compliance burden on the banks. Since, it will be difficult for the Banks to cope up with such radical change of taking State-wise registrations, filing multiple returns State-wise, multiple audits and assessments; especially in a scenario where banks have presence in almost every State and Union Territory of the country and with each state, each city, each locality has a branch of the bank.

Further, even State-wise regional banks do not have capabilities to coordinate and receive information from all the branches within the State and comply with the tax requirements. With so many branches, the entire coordination and assimilation of information at one place for compliance by each State regional bank shall also be a challenge.

(C) Rate Increase

5.11 There is an increase in the tax rate from 15% in service tax (erstwhile indirect tax) to 18% under GST on the transaction charges levied on the financial services provided by the banks in relation to credit card, fund transfer, ATM transactions, processing fees on loans etc. which becomes more expensive, particularly for retail customers.

(D) Input Tax Credit

5.12 Bank branches provide services to each other, which will be taxable under GST. Even, business consumers who are traders are now benefitted with the claim of ITC on the banking services paid on their business accounts as credit for services, which were not available to traders in earlier service tax regime.

Option to avail Input Tax Credit

5.13 Where the goods or services or both are used by a banking company or a financial institution including a non-banking financial institution engaged in supplying services by way of accepting deposits, extending loans or advances, partly for effecting taxable supplies including zero-rated supplies under the Central Goods and Services Tax Act,2017 ("**the CGST Act**") or under the Integrated Goods and Services Tax Act,2017 ("**the IGST Act**") or under the State/Union Territory Goods and Service Tax Act, 2017 ("**the SGST/UTGST Act**") and partly for effecting exempt supplies under the said Acts, shall have the option to either comply with any of the two provisions:-

a) Avail the amount of input tax credit that shall be attributable to the taxable supplies including zero-rated supplies.

b) Avail of, every month, an amount equal to fifty per ent of the eligible input tax credit on inputs, capital goods and input services in that month and the rest shall lapse.

Accordingly, option has been given to bankers to reverse 50% of the CENVAT credit instead of reversing based on the input service partly attributable to the taxable supply and exempted supplies. Similar provision also prevailed in Service Tax law. However, restriction of 50% shall not apply to the tax paid on supplies made by one registered branch to another registered branch of that bank having same PAN Number.

(E) Exemptions

5.14 GST is applicable on all services provided by the banks except followings:

- Services by the Reserve Bank of India;
- Services by way of—
  - (i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services);
  - (ii) *inter se* sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers.
- Services by an acquiring bank, to any person in relation to settlement of an amount upto two thousand rupees in a single transaction transacted through credit card, debit card, charge card or other payment card service.

  Explanation. — For the purposes of this entry, "acquiring bank" means any banking company, financial institution including non-banking financial company or any other person, who makes the payment to any person who accepts such card.

In addition to the above Services provided by the banks, services provided by the business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch is also exempted under GST.

The above service has been exempted *vide Notification No. 12/2017- Central Tax (Rate) dated 28th June, 2017*.

(F) Reverse Charge Mechanism

5.15 Central Government *vide Notification No. 13/2017- Central tax (Rate) dated 28th June, 2017* notified the categories of services where the whole of central tax leviable under section 9(3) of the CGST Act, shall be paid on reverse charge basis by the recipient of the such services and among the notified categories of services, following services needs to be considered by banking and/ or financial institution including non- banking financial company:-

- Services supplied by a recovery agent to a banking company or a financial institution or a non-banking financial company
- Services provided by way of sponsorship to any body corporate or partnership firm
- Services supplied by an arbitral tribunal to a business entity.
- Services supplied by an individual advocate including a senior advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity.
- Services supplied by a director of a company or a body corporate to the said company or the body corporate.
- Supply of Services by a goods transport agency (GTA) in respect of transportation of goods by road to any body corporate established, by or under any law

In addition to above banking and/or financial institution including non-banking financial company is liable to pay GST on reverse charge basis [under Section 9(4)] on supply of taxable goods or service or both by a supplier, who is not registered if aggregate value exceeds Rs. 5000/- is a day (**upto 12th October, 2017**)[vide Notification No.8/2017-Central Tax (Rate) dated 28.06.2017]

However, the aforesaid limit of 5000/- has been deleted vide Notification No.38/2017-Central Tax (Rate) dated 13.10.2017 apart from the deferment provided till 31.03.2018 of the provisions of section 9(4).

5.16 From 13th October, 2017, all intra-state and interstates supplies made by unregistered suppliers to a registered person are exempted till March 31, 2018 vide Notification No.38/2017-Central Tax (Rate) dated 13.10.2017 and Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017 respectively. ….

(G) Time of Supply

5.17 The time of supply of services provided by the banks shall be determined in reference to section 13 of the CGST Act, 2017 as the earliest of the following dates, namely: —

a) the date of issue of invoice by the supplier, if the invoice is issued within the period prescribed under sub-section (2) of section 31 or the date of receipt of payment, whichever is earlier; or

b) the date of provision of service, if the invoice is not issued within the period prescribed under sub-section (2) of section 31 or the date of receipt of payment, whichever is earlier; or

c) the date on which the recipient shows the receipt of services in his books of account, in a case where the provisions of clause (a) or clause (b) do not apply

Explanation: -

- "The date of receipt of payment": The date on which the payment is entered in the books of account of the supplier or the date on which the payment is credited to his bank account, whichever is earlier
- Date of issue of invoice: If the supplier of services is an insurer or banking company or financial institution including NBFC, invoice is to be issued within 45 days from the date of supply of service.

It is pertinent to mention that where the supplier of taxable service receives an amount up to one thousand rupees in excess of the amount indicated in the tax invoice, the time of supply to the extent of such excess amount shall, at the option of the said supplier, be the date of issue of invoice relating to such excess amount.

Time of supply in case of reverse charge

5.18 In case of supplies in respect of which tax is paid or liable to be paid on reverse charge basis, the time of supply shall be the earlier of the following dates, namely:-

(a) the date of payment as entered in the books of account of the recipient or the date on which the payment is debited in his bank account, whichever is earlier; or

(b) the date immediately following sixty days from the date of issue of invoice or any other document, by whatever name called, in lieu thereof by the supplier:

Provided that where it is not possible to determine the time of supply under clause (a) or clause (b), the time of supply shall be the date of entry in the books of account of the recipient of supply.

Provided further that in case of supply by associated enterprises, where the supplier of service is located outside India, the time of supply shall be the date of entry in the books of account of the recipient of supply or the date of payment, whichever is earlier.

(H) Place of supply

5.19 The place of supply of banking and other financial services, including stock broking services to any person shall be the location of the recipient of services on the records of the supplier of services.

Provided that, if the location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.(Section 12(12) of IGST Act, 2017)

(I) Returns

5.20 Every registered banking and/or financial institution including non-banking financial company is liable to file following returns:

1.	Summary Returns	GSTR-3B
2.	Details of Outward Supply	GSTR-1
3.	Details of Inward Supply	GSTR-2
4.	Monthly Return	GSTR-3
5.	Return of Input Service Distributor	GSTR-6.

(J) Obligation to furnish information return

5.21 Any person, being a banking company within the meaning of clause (a) of section 45A of the Reserve Bank of India Act, 1934, who is responsible for maintaining record of registration or statement of accounts or any periodic return or document containing details of payment of tax and other details of transaction of goods or services or both or transactions related to a bank account or consumption of electricity or transaction of purchase, sale or exchange of goods or property or right or interest in a property under any law for the time being in force, shall furnish an information return of the same in respect of such periods, within such time, in such form and manner and to such authority or agency as may be prescribed.[Section 150(1)(e) of the CGST Act]

5.22 An Illustrative Audit Checklist for Goods and Services Tax is given in ***Appendix XVII*** of the Guidance Note.

Contents of Accompanying CD

Foreword and Preface of Past Years

Foreword to Twelfth Edition

Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk. Like all economic activities, the banking sector is also exposed to various risks in its operations. It is of utmost importance to ensure that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.

The Guidance Note on Audit of Banks brought out by the Auditing and Assurance Standards Board of the ICAI every year is an important resource which provides detailed guidance to the members on various aspects of bank audits. It is heartening that the Auditing and Assurance Standards Board has come out with this revised 2017 edition of the Guidance Note on Audit of Banks for the benefit of the members. The revised Guidance Note was initially developed by an expert group constituted by the Board for this project and thereafter it was finalised with the contribution of the Board members and the Central Council members of ICAI. I am happy that the Guidance Note is comprehensive and self-contained reference document for the members.

I wish to place my appreciation for CA. Shyam Lal Agarwal, Chairman, CA. Sanjay Vasudeva, Vice-Chairman and other members of the Auditing and Assurance Standards Board for bringing out this revised Guidance Note to help the members in maintaining quality in bank audits.

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

New Delhi
February 7, 2017

CA. M. Devaraja Reddy
President, ICAI

Preface to Twelfth Edition

Independent audit of financial statement of banks is important for a healthy, safe and sound banking system. Audit of banks involves a number of peculiarities e.g. huge volumes and complexity of transactions, wide geographical spread of banks' network, large range of products and services offered, extensive use of technology, strict vigilance by the banking regulator etc. All these factors make the task of the auditors quite challenging in maintaining quality in bank audits.

The Auditing and Assurance Standards Board of ICAI has been helping the members in maintaining quality in bank audits by bringing out its benchmark publication "Guidance Note on Audit of Banks" every year. Since the issuance of the last edition of the Guidance Note in 2016, apart from the Master Directions and Circulars issued by RBI, certain important developments have also taken place in the banking sector, including the recent demonetisation, warranting appropriate attention of the auditors. It is, therefore, essential that the members undertaking statutory audit of banks, both at the branch as well as the central level, keep themselves abreast with the latest developments in the banking sector.

I am happy to place in your hands this revised 2017 edition of the Guidance Note on Audit of Banks. The Guidance Note discusses in depth the various important items on the financial statements of banks, its peculiarities, manner of disclosure in the financial statements, the RBI prudential directions thereon, audit procedures, reporting on Long Form Audit Reports, Ghosh and Jilani Committee requirements, special purpose reports and certificates, etc. The Guidance Note, *inter alia*, has been updated for the impact of the Master Directions and other relevant circulars issued by RBI in 2016, guidance on demonetization at appropriate places, relevant pronouncements of the ICAI having bearing on bank audits. For the benefit of the members, the CD accompanying the Guidance Note contains Illustrative formats of engagement letter, auditor's report, written representation letter, updated bank branch audit programme for the year 2016-17, the text of Master Directions issued by RBI in 2016, the text of Master Circulars and relevant General Circulars issued by RBI.

At this juncture, I wish to place on record my gratitude to all the members of the Mumbai study group *viz.*, CA. Nihar Niranjan Jambusaria, Convenor, CA. Shriniwas Y. Joshi, CA. Sandeep D Welling, CA. Vipul K Choksi, CA. Vikas Kumar, CA Abhijit Sanzgiri, CA. Niranjan Joshi, CA. Kuntal Shah, CA. Dhananjay Gokhale, CA Ashutosh Pednekar, CA. Manish Sampat, CA. G. N. Sampath, CA

Zubin Billimoria, CA. Gautam Shah, CA. Giriraj Soni, CA. Shivratan Agarwal, CA. Parag Hangekar, CA. Sanjay Khemani, CA. Sanjay Rane, CA. Ketan Saiya, CA. Abhay Kamat and CA. Sanat Chitale for working on this herculean project despite the demands of their professional and personal lives. My sincere thanks to (i) all the Members of Jaipur Study Group under my convenorship, *viz.,* CA. Bhupendra Mantri, CA Vijay Kumar Jain, CA Vishnu Dutt Mantri, CA Vikas Gupta, CA Prahalad Gupta, CA Ajay Atolia, CA Jugal Agrawal, CA Mukesh Gupta, CA Sandeep Jhanwar, CA Ashok Singhal, CA Vijay Jain, CA. Abhishek Sharma, CA Shailendra Agarwal, CA Keshav Garg and CA Anil Jain (ii) all the Members of Delhi Study Group constituted under the convenorship of CA. Sanjay Vasudeva, Vice Chairman, AASB, *viz.,* CA. K.A. Balasubramanian, CA. V Rethinam, CA. Rajiv Puri, CA. Anil Sharma, CA. Rohit Mehta, CA. M M Khanna, CA. Simran Singh, CA. Pramod Kr Maheshwari, CA. Parveen Kumar, CA. Nitin Jain, CA. Anuj Dhingra and CA. Himanshu Garg (iii) all the Members of Kolkata Study Group constituted under the convenorship of CA. Debashis Mitra *viz.,* CA. Dipankar Chatterjee, CA. Santanu Ghosh, CA. Veena Hingarh, CA. Arif Ahmed, CA. Abhijit Bandyopadhyay, CA Vivek Newatia, CA. Rajendra Nath Basu, CA. Sukamal Chandra Basu, CA. Mrityunjay Ray and CA. Nirupam Haldar (iv) all the Members of Kolkata Study Group constituted under the convenorship of CA Ranjeet Kumar Agarwal *viz.*, CA. Krishanu Bhattacharya, CA. Jay Narayan Gupta, CA. Sunil Singhi, CA. Ajit Verma, CA. R K Roy Choudhary, CA. Vikash Banka, CA. Ajay Agarwal, CA. Niraj Jhunjhunwala, CA. Binay Singhania, CA. H K Verma, CA. Kshitiz Chhawcharia, CA. Mrityunjay Ray and CA M R Jain (v) all the Members constituted under the convenorship of CA. M P Vijay Kumar at Bengaluru Study Group, *viz.,* CA. K Raghu, CA. Madhukar Narayan Hiregange, CA. Cotha S Srinivas, CA. B. P. Rao, CA. Nityananda N, CA. Manohar Gupta P, CA. Ananthan, CA. R Shasidhara and CA. Gururaj Acharya and CA. Vivek Krishna Govind from Cochin to review the exposure draft of Guidance Note on Audit of Banks 2017 edition.

I wish to place on record my sincere thanks to CA. M. Devaraja Reddy, President ICAI and CA. Nilesh S. Vikamsey, Vice President ICAI for their whole hearted support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their all-time support and guidance to the activities of the Board. I also wish to place on record my gratitude to all the members and special invitees on the Board for the year 2016-17, *viz.*, CA. Sanjay Vasudeva, Vice Chairman, AASB, CA. Nandkishore Chidamber Hegde, CA. Nihar Niranjan Jambusaria, CA. Dhinal Ashvinbhai Shah, CA. Babu Abraham Kallivayalil, CA. Madhukar Narayan Hiregange, CA. G. Sekar, CA. K. Sripriya, CA. M P Vijay Kumar, CA. Ranjeet Kumar Agarwal, CA.

Sushil Kumar Goyal, CA. Debashis Mitra, CA. Manu Agrawal, CA. Kemisha Soni, CA. Sanjiv Kumar Chaudhary, CA. Mangesh Pandurang Kinare, Shri Vithayathil Kurian, Dr. P.C. Jain, Shri Vijay Kumar Jhalani, CA. Abhijit Bandyopadhyay, CA. Harinderjit Singh, CA. Murali Krishna, CA Vijay Kumar Jain, CA. Akhil Bhalla, CA. Sandeep Dinanath Welling, CA. V. Balaji, CA. Sandeep Sharma and CA. Khushroo B. Panthaky without whose support, the Guidance Note would not have been possible in the given time. I also wish to thank CA. Megha Saxena, Secretary, CA. Rajnish Aggarwal, Sr. Education Officer, CA. Nitish Kumar, Executive Officer to the Board and other officers and staff of AASB for their hard work.

I am sure that the members would find the Guidance Note useful as its earlier editions while conducting the audits of banks/ bank branches.

Jaipur
February 11, 2017

CA. Shyam Lal Agarwal
Chairman
Auditing and Assurance Standards Board

Foreword to Eleventh Edition

Banking industry plays a critical role in driving the economic growth. It is closely regulated and supervised to channelize the growth in the desired direction and keep economy in proper shape. The sector helps in overall social good by facilitating the growth that reaches all strata of society. In fact, the sector is helping in the financial inclusion so that the fruits of growth are enjoyed by the economically weaker sections and their overall interests are protected.

To monitor the sector and bring synergies with other sectors, the Government and the banking regulator need credible financial and non-financial information. This further enables them to fulfil the promise of "*greater good for greater number of people*" that democracy like India endeavours for.

The Government and the regulators require credible information from banks to be able to make informed decisions. In this context, statutory audits of banks' financial statements are highly crucial. For quality bank audits, it is essential that the statutory auditors are well equipped in terms of knowledge of the banking sector and keep themselves abreast with the latest developments.

The Guidance Note on Audit of Banks brought out by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India every year is an important resource that provides detailed guidance to the bank auditors on the basic tenets of a bank audit. I am, therefore, very happy to note that the Auditing and Assurance Standards Board has come out with the revised 2016 edition of the Guidance Note on Audit of Banks.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, CA. J. Venkateswarlu, Vice Chairman and other members of the Auditing and Assurance Standards Board for their zeal and commitment in bringing out this literature to help the members in maintaining quality in bank audits.

I am confident that the readers will find the 2016 Guidance Note highly useful in their professional assignments in a similar manner as its previous editions.

New Delhi
January 25, 2016

CA. Manoj Fadnis
President, ICAI

Preface to Eleventh Edition

The economic development of any country, especially an emerging economy like ours, depends significantly on the depth and reach of its banking sector. As the recent global experience amply shows, an economy would survive only so long as its banking sector stands on sound banking fundamentals and is supported by a regulatory environment that, on the one hand, provides a fair opportunity to the banks to promote economic activity and on the other hand provides control mechanism that ensures that public monies and public interest remain protected.

The statutory audit of banks forms an integral and important part of such control mechanism of the regulators. It provides the stakeholders a comfort with regard to credibility of the financial information that a bank generates at every year end. Given the nature, scope and volume of transactions undertaken by banks in India, coupled with their geographical spread and the various regulatory directions to which they are subject, audit of the financial statements of banks indeed becomes very challenging for their auditors.

The Auditing and Assurance Standards Board of ICAI 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. The Guidance Note on Audit of Banks has always been a benchmark publication in this context.

The Guidance Note is updated every year to reflect the important developments that have taken place in the banking sector, warranting attention of the statutory auditors, for example, RBI's master circulars, general circulars of relevance, consequential updation of guidance for the auditors, where required, various pronouncements of ICAI, etc.

I am, therefore, happy to place in your hands the 2016 edition of the Guidance Note on Audit of Banks. In addition to the updations required on account of Master Circulars issued in 2015, the Guidance Note, *inter alia*, has been revised to include the new developments in the banking industry, such as, introduction of payment and small finance banks, how RBI exercises control over banking industry, some international developments of importance in the global banking industry, risk assessment and controls related to products regulated by SEBI and other regulators, Red Flag Accounts and Early Warning System, developments in respect of anti money laundering provisions, additional examples of IT and related frauds, verification of IT assets, guidance on capitalization of assets, FIMMDA Trade Reporting and Confirmation System, explanation of terms commonly used in case of investments by banks, audit procedures for loss on derivative transactions and margins held with exchanges, margins held under credit support annex, additional guidance on consolidation of branch accounts, new chapter on consolidation of financial statements, etc.

The CD accompanying the Guidance Note contains Illustrative formats of the engagement letter, the auditor's report and the written representation letter, updated bank branch audit programme for the year 2015-16, the text of Master Circulars issued by RBI on July 1, 2015 and the text of General and Other Circulars of RBI.

At this juncture, I wish to place on record my gratitude to all the members of the Mumbai study group *viz*., CA. Shriniwas Y. Joshi, Convenor, CA. Gautam Shah, CA. Vikas Kumar, CA. Sandeep D. Welling, CA. Shivratan Agarwal, CA. N. Sampath Ganesh, CA. Vipul Choksi, CA. Niranjan Joshi, CA. Manish Sampat, CA. Sanjay Khemani, CA. Abhay V. Kamat, CA. Ashutosh Pednekar, CA. Dhananjay J. Gokhale, CA. Mrudul Gokhale, CA. Parag Hangekar, CA. Sanjay Rane, CA. Kedar Mehendale, Mr. Prabhat Gupta, CA. Rukshad Daruvala, CA. Abhijit Sanzgiri, CA. Nilesh Joshi and CA. Nitant Trilokekar for their dedication in taking up this herculean project despite the demands of their professional and personal lives.

I take this opportunity to place on record my sincere thanks to CA Manoj Fadnis, President ICAI and CA M Devaraja Reddy, Vice President ICAI for their support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their support and guidance to the activities of the Board. I also wish to place on record my gratitude to all the members and special invitees on the Auditing and Assurance Standards Board for the year 2015-16, *viz*., CA. J. Venkateswarlu, Vice Chairman, AASB, CA. Prafulla Premsukh Chhajed, CA. Pankaj Inderchand Jain, CA. Nihar Niranjan Jambusaria, CA. Dhinal Ashvinbhai Shah, CA. Nilesh S. Vikamsey, CA. Babu Abraham Kallivayalil, CA. K. Raghu, CA. G. Sekar, CA. Sumantra Guha, CA. Shyam Lal Agarwal, CA. Sanjiv Kumar Chaudhary, CA. Naveen N.D. Gupta, CA. Charanjot Singh Nanda, Shri P.K. Mishra, Shri Salil Singhal, Shri R.K. Jain, CA. V. Balaji, CA. Radha Krishna Agrawal, CA. Kamlesh Amlani, CA. Aseem Trivedi, CA. Krishna Kumar T., CA. Rajeevan M., CA. Sanjay Vasudeva, CA. Vijay Sachdeva, Dr. Sanjeev Singhal, Shri Narendra Rawat, CA. Aniruddh Sankaran and Shri R. Kesavan without whose support, the Guidance Note would not have been possible.

I am sure that the members would find this edition of the Guidance Note as useful as its earlier editions. I would, however, be happy to have your feedback on the Guidance Note.

Kolkata **CA. Abhijit Bandyopadhyay**
January 25, 2016 Chairman, Auditing & Assurance Standards Board

Foreword to Tenth Edition

The banking sector 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. Like all economic activities, the banking sector is also exposed to various risks in the conduct of their operations. For safe and sound banking sector, one of the most important factors is reliable financial information supported by audits performed in accordance with the established performance benchmarks.

I am happy that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India, in order to help the members in maintaining quality in bank audits, has come out with the revised 2015 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, provisions of the Companies Act, 2013 and certain important pronouncements of the Institute which would be relevant to bank audits for the financial year ending March 31, 2015.

At this juncture, I wish to place my appreciation for 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.

I am confident that the members would find the 2015 edition of the Guidance Note immensely helpful.

New Delhi
February 19, 2015

CA. Manoj Fadnis
President, ICAI

Preface to Tenth Edition

Banking is a very dynamic industry. Its contours are always on the change, in tandem with the changes in the sentiments of the national as well as global economy. On the other hand, it is a tool in the hands of the policy makers to create the desired sentiments and level of activity in the economy as also social development.

Given the huge spread of the banking sector in terms of nature of activities undertaken, client profile, geography, etc., as also the fact that the banking industry is inextricably linked to the various players in the economy, it is also exposed to a large number of risks that can affect their financial stability. Banks, therefore, function under the tight supervisory and regulatory directions of the Reserve Bank of India to minimise these internal and external risks that face the banking industry. Accordingly, banks also have extensive systems for internal controls to comply with these directions and to otherwise also protect them from these risks.

These aspects make audit of the financial statements of banks extremely typical. For example, understanding the bank and its operating environment, its controls environment at macro and micro levels, risk of misstatements in the financial statements, etc., can be very challenging and time consuming. As a corollary, the audit planning too would require considerable attention of the auditor. Similarly, deciding audit materiality, sample size, application of analytical procedures too would need careful exercise of professional judgment by the auditors. I would not hesitate to add that audit of a bank is one of the best example how application of Standards on Auditing, including the concept of exercise of professional scepticism by the auditors, ensures audit quality.

I am, therefore, happy to place in your hands this 2015 Guidance Note on Audit of Banks. The Guidance Note provides an insight into the banking industry in India and how they carry out their day to day functions. It also discusses in depth the various important items on the financial statements of a bank, its peculiarities, manner of disclosure in the financial statements, the RBI prudential directions thereon, audit procedures, etc. Similarly, the Guidance Note has Chapters on audit procedures for reporting on long form audit reports for banks and bank branches, reporting under Ghosh and Jilani Committee requirements, special purpose reports and certificates, etc. At this juncture, I may also mention that, as the members may be aware, the Auditing & Assurance Standards Board has been working closely with the Reserve Bank of India for bringing out revised and more contemporary Long Form Audit Reports (LFARs) for banks and bank branches. As and when the revised LFARs are notified by the RBI, we will separately bring out relevant guidance for the auditors. Accordingly, as of now, this edition of the Guidance Note contains the existing LFARs and auditors' guidance relevant thereto.

The Guidance Note, *inter alia*, has been updated for the impact of RBI Master Circulars issued in 2014, Basel III, service tax requirements, etc. Importantly, the auditors of the banking companies, in addition to the reporting requirements under the Banking Regulation Act, 1949, would also need to report pursuant to section 143 of the Companies Act, 2013. The auditors would accordingly need to amend their audit engagement letters and the auditor's report. Illustrative formats of an engagement letter and an auditor's report for a banking company, meeting the requirements of the Banking Regulation Act, 1949 as well as the Companies Act, 2013, have also been given in the Appendices given in the CD. Similarly, an updated bank branch audit programme for 2014-15 audits is also given.

I am sure the readers appreciate that updating this Guidance Note is a herculean task. Accordingly, my thanks are due to the Mumbai study group viz., CA Shriniwas Y Joshi, convenor, CA Abhay Kamat, CA Ashutosh Pednekar, CA Ganesh Sampath, CA Gautam Shah, CA Manish Sampat, CA Niranjan Joshi, CA Sandeep Welling, CA Sanjay Khemani, CA Shivratan Agarwal, CA Shrawan B Jalan, CA Vikas Kumar, CA Vipul Choksi, CA Zubin Billimoria and CA Sandeep Sarawgi, for their dedication in taking up this task despite the demands of their professional and personal lives.

I take this opportunity to place on record my sincere thanks to CA Manoj Fadnis, President ICAI and CA M Devaraja Reddy, Vice President ICAI for their support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their support and guidance extended by them at all junctures. I also wish to place on record my gratitude to all the members and special invitees on the Auditing & Assurance Standards Board (2014-15), *viz*., CA. K. Raghu, CA. Rajkumar S. Adukia, CA. Nihar Niranjan Jambusaria, CA. Sanjeev K. Maheshwari, CA. Nilesh S. Vikamsey, CA. Shiwaji Bhikaji Zaware, CA. V. Murali, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Subodh Kumar Agrawal, CA.

Mukesh Singh Kushwah, CA. Sanjiv Kumar Chaudhary, CA. Atul Kumar Gupta, Shri P Sesh Kumar, Shri Bhaskar Chatterjee, CA. Sanjay Kumar Jain, CA. Sunil Ramakant Bhumralkar, CA. K. Sai Ram, CA. Navin Tilakraj Gupta, CA. Ravi Prasad, CA. Uttam P. Agarwal, Shri R Kesavan, RBI, Shri Anindya K Das, SEBI, CA. Vijay Sachdeva, ASSOCHAM, CA. Sanjay Vasudeva and CA Amit Roy, CII without whose support, the Guidance Note would not have been possible.

I am sure that the members would find the 2015 edition of the Guidance Note as useful as its earlier editions. I would, however, be happy to have your feedback on the Guidance Note.

Kolkata
18th February 2015

CA ABHIJIT BANDYOPADHYAY
Chairman,
Auditing & Assurance Standards Board

Foreword to Ninth Edition

The banking industry in India has a huge canvas of history, which covers the traditional banking practices from the time of Britishers to the reforms period, nationalization to privatization of banks and now increasing numbers of foreign banks in India. Therefore, the banking industry in India has been through a long journey and has also achieved new heights with the changing times. The use of technology brought a major revolution in the working system of the banks. Nevertheless, the fundamental aspects of banking i.e. trust and confidence of the people on the institution remains the same, which comes on the back of strong quality of audit system and practices in place.

Since the issuance of the last edition of the Guidance Note on Audit of Banks, a number of important developments have taken place in the banking sector, warranting attention of the auditors. It is, therefore, essential that the members undertaking statutory audit of banks, both at the branch as well as the central level, keep themselves abreast with the latest developments in the banking sector.

I am pleased that in order to help the members maintain the quality in bank audits, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India under the able and dynamic Chairmanship of CA. Abhijit Bandyopadhyay, has come out with a completely revised and edited 2014 edition of the Guidance Note on Audit of Banks. The revised edition incorporates the guidance for the statutory auditors at branch as well as central level w.r.t. the various circulars of the Reserve Bank of India as well as important pronouncements of the Institute. I am also happy that the 2014 Guidance Note has been totally revamped to make it more reader-friendly.

I hope that the members would find the 2014 edition of the Guidance Note immensely helpful.

New Delhi — **CA. K. Raghu**
February 24, 2014 — President, ICAI

Preface to Ninth Edition

Independent audit of financial statements of banks is one of the important tools for throwing light on their financial health, the state of their affairs, the results of their operations and the position of their cash flows. Financial statement audit therefore is important for a strong and resilient banking industry. Audit of banks, however, involves certain typicalities which make the task of the auditors quite onerous. Most significant of these being volume and complexity of transactions, geographical spread, client portfolio, wide variety of products and services offered, extensive use of technology and above all, high sensitivity to the slightest of changes in the social, economic or political environment. As a result, the risks faced by banks vary in nature and quantum with the all these aspects.

Obtaining an appropriate and adequate understanding of these aspects and the resultant risks, particularly, their impact on the truth and fairness of a bank or its component's financial statements becomes a humungous but nonetheless essential task for the auditors. Every year, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India brings out the Guidance Note on Audit of Banks to help the common members understand the important aspects of the banking industry so that they can understand these risks and plan and perform their audits effectively and efficiently against the strict time deadlines.

It is, therefore, my great pleasure to place in your hands, the 2014 Guidance Note on Audit of Banks. The 2014 edition of the Guidance Note has been written to not only reflect the important regulatory changes that have been brought about by the Reserve Bank of India since 2013 through its Master and other general circulars issued till 23rd February 2014 as usual but also implementation of Core Banking Solutions at almost all levels in the banks. The guidance to the auditors has been suitably revised to reflect the impact of CBS on financial reporting system. Besides, in sync with the requirements of the current suite of Standards on Auditing, the Guidance Note has also been given the flavour of risk-based audit approach. Further, guidance has also been included on aspects on which members have frequently posed queries. We have also identified and removed repetitive guidance and shifted certain conceptual and basic level aspects to the accompanying CD to reduce the volume of the publication and make the Guidance Note more user-friendly. In addition to the text of the Guidance Note, this CD also contains important data such as text of RBI's Master Circulars as well as other important circulars issued till 23rd February 2014, appendices, illustrative checklists, etc.

At this juncture, I wish to place on record my gratitude to each and every member of the Mumbai study group *viz.,* CA. Shriniwas Y Joshi, CA. Abhay Kamat, CA. Ashutosh Pednekar, CA. Ganesh Sampath, CA. Gautam Shah, CA. Manish Sampat, CA. Neville Daruwalla, CA. Niranjan Joshi, CA. Sandeep Kumar Sarawgi, CA. Sandeep Welling, CA. Sanjay Khemani, CA. Shivratan Agarwal, CA. Shrawan Kumar B Jalan, CA. Ulhas Chitale, CA. Vikas Kumar, CA. Vipul Choksi, CA. Zubin Billimoria for taking time out of their pressing professional and personal preoccupations to work on this herculean project .

I also place on record my sincere thanks to CA K Raghu, President, ICAI and CA. Manoj Fadnis, Vice President, ICAI for their constant support to the activities of the Board.

I am also thankful to all my Council colleagues, for their unstinted support and helpful guidance that I have always been fortunate to receive in the activities of the Board. I also wish to express my gratitude to all the members and special invitees on the Auditing and Assurance Standards Board for 2013-14, *viz.,* CA. Naveen N.D. Gupta, the then Vice Chairman, CA. Rajkumar S. Adukia, CA. Subodh K Agrawal, CA. Jay Ajit Chhaira, CA. Sanjeev K. Maheshwari, CA. Shiwaji Bhikaji Zaware, CA. M. Devaraja Reddy, CA. Dhinal Ashvinbhai Shah, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Vijay Kumar Gupta, CA. Sanjiv K Chaudhary, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Sanjay Vasudeva, CA. Niraj Kumar Jhunjhunwala, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra, CA. Harinderjit Singh, CA. Saunak Ray, Shri Anindya Kumar Das, CA. Nilesh S. Vikamsey, CA. Jitendra K Agarwal, CA. Amit Roy, CA. Vijay Sachdeva and CA. Aniruddh Sankaran without whose support this publication would not have been possible. 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 the 2014 edition of the Guidance Note on Audit of Banks would also be as warmly received by the members as its earlier editions. I look forward to the readers' feedback on the publication.

Kolkata
February 24, 2014

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

Foreword to Eighth Edition

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 14, 2013

CA. Subodh Kumar Agrawal
President, ICAI

Preface to Eighth Edition

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.

Kolkata
March 14, 2013

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	**Sunil H. Talati**,
February 4, 2008	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
March 16, 2006

Sunil Goyal
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 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 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 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

I

Knowledge of the Banking Industry

1
Banking in India

A. An Overview of Banking Institutions in India

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

02. As per Section 5(b) of the Banking Regulation Act 1949, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, or otherwise. Further, as per Section 5(c) of the said Act, “banking company" means any company which transacts the business of banking and by way of Explanation, states that ‘any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business such as manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause’.

03. Further, section 6 of the said Act lists down the forms of business in which banking companies may engage. The text of the section is reproduced in ***Appendix I*** of the Guidance Note.

B. Presently, the following types of banking institutions prevail in India:

(a) Commercial Banks;

(b) Regional Rural Banks;

(c) Co-operative Banks;

(d) Development Banks (more commonly known as ‘Term-Lending Institutions’);

(e) Foreign Banks;

(f) Payment Banks;

(g) Small Finance Banks; and

(h) EXIM Banks.

(a) Commercial Banks

04. 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.

05. Public sector banks comprise the State Bank of India, IDBI Bank Ltd. and the nationalized banks. While the majority stake in the Share Capital of all Public Sector Banks is with the Government of India, there are private individual/institutional shareholders also. The majority stake in the share capital of associate banks of State Bank of India has been subscribed to by the parent i.e. State Bank of India. All the Associate Banks of the SBI have been merged with itself.

06. The ownership of private sector banks is with institutional shareholders, private individuals and bodies corporate. Private Sector Banks are of the following types:

(a) Indian scheduled commercial banks other than public sector banks. These include the 'old' private banks which were in existence before the guidelines for floating new private banks were issued in 1993, the 'new' generation private banks, and the 2 banks that were granted licenses by RBI in March 2014. (The term 'scheduled commercial banks' refers to commercial banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934.) Under Section 2(e) of the RBI Act, a scheduled bank is conferred two main privileges (a) availing of refinance from RBI and (b) permission to participate in the call/notice money market. 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 (now the Companies Act, 2013), or an earlier Indian Companies Act.

(b) Non-scheduled banks.

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

07. Some of the banks have set up subsidiaries – wholly-owned or partly owned – to operate in some specialized spheres of activity such as merchant banking,

funds management, housing finance, primary dealership, pension fund management, insurance business, stock broking, credit card activity, factoring, etc. These subsidiaries do not carry on all the principal functions of a commercial bank. Modern commercial banks function as universal banks. According to the Financial Times, universal banks are financial service conglomerates that combine retail, wholesale and investment banking services under one roof and reaping synergies between them which is made possible from economies of scale in information technology and access to capital to serve companies and retail customers around the world.

Branch Network of Commercial Banks

08. 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.

09 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.
- *Branches in International Financial Services Centers* - Indian banks *viz.* banks in the public sector and the private sector authorized to deal in foreign exchange will be eligible to set up IFSC Banking Units (IBUs). Minimum capital of US$ 20 million or equivalent is required for opening of a branch at IBU. Operations from IBU are governed by operational guidelines issued by RBI time to time.
- *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. Further, for operational reasons, commercial banks may prefer to operate through subsidiaries, if permitted, instead of opening branches.
- *Representative offices* – Such offices do not transact any banking business. The objective behind setting up of such offices is to maintain close liaison with the important bodies there to promote mutual business interests.

10. Generally, branches of banks conduct a variety of banking business under one roof. The trend of creating ‘thrust-based’ or ‘focus-based’ branches/ market segmentation has led to setting up of branches by banks exclusively for a specified segment of their clients. Presently, such specialized 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 nonperforming 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 Banking/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 / treasury branches, dealing only with the securities portfolio of the bank.

Commercial Banks: Services & Products

11. 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 External Commercial Borrowings (ECB) on behalf of bank/borrower, securitization of receivables, etc.

(c) *Remittances*: Remittances involve transfer of funds from one place to another. Common modes of remittance of funds are drafts, telegraphic/mail transfers (TT/MT) and Electronic Funds Transfer (EFT). 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 remitting branch.

    Generally, the payee of both the TT and the MT is an account holder of the paying branch. In the case of Electronic Funds Transfer (EFT), as the name suggests, the funds are transferred electronically between two banks. The common modes of EFT are Real Time Gross Settlement (RTGS), which can be used for remittance of an amount within a prescribed limit of Rs. 2 Lakhs and above and National Electronic Funds Transfer (NEFT), which can be used for transfer of any amount. Another form of EFT is Immediate Payment Service (IMPS).

    Pay Orders/Demand Drafts issued against amounts received by a bank, comprise instruments, the liability in respect whereof is discharged at the same or another branch of the bank or other banks.

(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.

Clearing house (CH) 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 for CTS (Cheque Truncation System) and non-CTS 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 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 cheques. It implemented Cheque Truncation System (CTS) in phase wise manner starting from February 1, 2008. In CTS, the presenting bank (or its branch) captures the data (on the MICR band) and the images of a cheque using their Capture System (comprising of a scanner, core banking or other application). The collecting bank

(Presenting Bank) sends the data and captured images duly signed and encrypted to the central processing location (Clearing House) for onward transmission to the paying bank (destination or drawee bank). For the purpose of participation, the presenting and drawee banks are provided with an interface / gateway called the Clearing House Interface (CHI) that enables them to connect and transmit data and images in a secure and safe manner to the Clearing House (CH). The Clearing House processes the data, arrives at the settlement figure and routes the images and requisite data to the drawee banks. This is called the presentation clearing. The drawee banks through their CHIs receive the images and data from the Clearing House for payment processing. The drawee CHIs also generates the return file for unpaid instruments, if any. The return file / data sent by the drawee banks are processed by the Clearing House in the return clearing session in the same way as presentation clearing and return data is provided to the presenting banks for processing. The clearing cycle is treated as complete once the presentation clearing and the associated return clearing sessions are successfully processed. The entire essence of CTS technology lies in the use of images of cheques (instead of the physical cheques) for payment processing.

(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 receiving foreign contribution 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'.

(f) *Cash Management Product*: It is 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 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 authorized 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/Head office of a bank. The dues against credit cards are collected by specified branches, preferably by direct debit to accounts of the credit card holders. 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*: Banks also provide internet banking services and phone banking services. The fast changing technology has synchronized 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 for 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/redemptions*: Many entities require facilities for distribution of funds to their shareholders and others. Direct electronic transmission of funds is made to the accounts of the recipients. In other cases, warrants are issued in favour of shareholders/others, including those payable at designated branches of specified banks. The aggregate amount of the liability to be discharged by the constituent, including warrants or other instruments issued, is funded to the bank by such constituent.

(l) *Safe-keeping Services*: Banks provide services for safe keeping/custody of the scrips and valuables of customers in their vaults. Appropriate records are maintained in evidence of receipts/delivery and evidence of holdings is verified from time to time.

(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 *bona fide* representative, duly authorized 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 of RBI for receipts and payments on behalf of various government departments. There are authorized 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 by Government 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 dematerialized 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 credit by the branch with the securities sold by the account holder and debit with the purchases.

(p) *Automated Teller Machines (ATMs) and Cash Deposits Machines / Recyclers*: 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. RBI has permitted banks to install Cash Deposit Machines (CDM) with specific guidelines w.r.t. security arrangements, handling of suspect / counterfeit notes and availability of audit trail. The recycler machines accept as well as dispense cash from the same machine.

(q) *Exchange of Notes*: Following the 'clean note policy' RBI provides the facility of exchange of soiled/mutilated /unusable notes.

(r) *Debit Cards*: Debit cards are issued by the bank to its account holders to provide facility of access to cash at ATMs/ purchase of goods and services there against, where the debit to the bank account of the holder is simultaneous.

(s) *Auto Sweep facility in saving accounts*: Banks offer auto sweep facility in saving accounts of their customers where the balances in excess of those stipulated limit, automatically get transferred to term deposit accounts to avail of a higher rate of interest and also automatically get reversed to replenish any shortfall in such stipulated limits.

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

(u) *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 Prepaid Payment Instruments or PPI hereafter). The pre-paid payment instruments that can be issued in the country are classified under three categories viz. (i) Closed system PPI (ii) Semi-closed system PPI and (iii) Open system PPI. Issuer may be the persons operating the payment systems issuing prepaid 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.

[1] RBI vide its circular no. DPSS.CO.PD.PPI.No.01/02.14.006/2016-17 dated July 1, 2016 on "Policy Guidelines for issuance and operation of Prepaid Payment Instruments in India" provides the broad guidelines on this subject.

Banks who comply with the eligibility criteria are permitted to issue all categories of pre-paid payment instruments. However, only those banks which have been permitted to provide Mobile Banking Transactions by the Reserve Bank of India shall be permitted to launch mobile based pre-paid payment instruments (mobile wallets & mobile accounts).Banks are also permitted to issue prepaid instruments to principal agents approved under the Money Transfer Service Scheme (MTSS) of the Reserve Bank of India or directly to the beneficiary under the scheme for loading of the funds from inward remittances.

Further, the regulatory guidelines require that other non-bank persons issuing PPI need to maintain their outstanding balance in an escrow account with any scheduled commercial bank subject to the following conditions:

- The amount so maintained be used only for making payments to the participating merchant establishments.
- No interest is payable by the bank on such balances with an exception that the entity can enter into an agreement with the bank where escrow account is maintained, to transfer "core portion" of the amount, in the escrow account to a separate account on which interest is payable, subject to the certain conditions.
- A quarterly certificate from the auditors 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 be made available for scrutiny to the Reserve Bank or the bank where the account is maintained on demand.

Further, RBI *vide* its Master Circular No. DPSS.CO.PD.PPI. No. 01/ 02.14.006/ 2016-2017 dated July 1, 2016 Policy Guidelines on “Issuance and operation of Prepaid Payment Instruments in India – Auditor Certificate on the balances in Escrow account” requires 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

12. 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) *Investment in Venture Capital Funds (VCFs):* Bank should obtain prior approval of RBI for making strategic investment in venture capital funds i.e. investment equivalent to more than 10% of the equity/unit.

(iii) *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[2] in return.

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".

(iv) *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.

(v) *Entry of banks into insurance business*: Banks intending to set up insurance joint ventures with equity contribution on risk participation basis or making investments in the insurance companies for providing infrastructure and services support should obtain prior approval of Reserve Bank of India before engaging in such business. However, insurance business will not be permitted to be undertaken departmentally by the banks.

[2] 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.

(vi) *Primary Dealership (PD) 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%.

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).

(vii) *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 and Development Authority (PFRDA) for Pension

Fund Managers. PFM cannot be undertaken departmentally. Banks intending to undertake pension funds management should follow the guidelines set out in the RBI Master Circular No.DBR.No. FSD.BC. 19/ 24.01.001/ 2015-16 dated July 1, 2015 on "Para – Banking Activities".

(viii) *Portfolio Management Services (PMS):* The general powers vested in banks to operate Portfolio Management Services and similar schemes have been withdrawn vide RBI circular DBOD.No.BC.73/27.07.001/94-95 dated June 7, 1994 on Acceptance of Deposits/Funds under Portfolio Management Scheme. No bank therefore is permitted to, 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. The banks operating PMS or similar scheme with specific prior approval of RBI have to strictly observe the conditions given in RBI Master Circular No.

DBR.No.FSD.BC.19/24.01.001/2015-16 dated July 1, 2015 on "Para Banking Activities".

(ix) *Referral Services:* Banks can offer referral services to their customers for financial products subject to the following conditions:

a) The bank/third party issuers of the financial products should strictly adhere to the KYC/AML guidelines in respect of the customers who are being referred to the third party issuers of the products.

b) The bank should ensure that the selection of third party issuers of the financial products is done in such a manner so as to take care of the reputational risks to which the bank may be exposed in dealing with the third party issuers of the products.

c) The bank should make it explicitly clear upfront to the customer that it is purely a referral service and strictly on a non-risk participation basis.

d) The third party issuers should adhere to the relevant regulatory guidelines applicable to them.

e) While offering referral services, the bank should strictly adhere to the relevant RBI guidelines.

(x) *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.

(xi) *Underwriting of bonds of Public Sector Undertakings:* Banks can play a supportive role in relation to issue of bonds by Public Sector Undertakings (PSUs) by underwriting a part of these issues. They may also subscribe outright initially but sell them later to the public with the aid of their wide branch network. It should, however, be ensured that the increase in the holdings of public sector bonds by banks arising out of their underwriting or subscription is kept within reasonable limits. While undertaking the underwriting of bonds of PSUs, banks should formulate their own internal guidelines as approved by their Boards of Directors on investments in and underwriting of PSU bonds, including norms to ensure that excessive investment in any single PSU is avoided and that due attention is given to the maturity structure of such investments.

(xii) *Retailing of Government Securities:* Banks are permitted to undertake the business of retailing of Government securities with non-bank clients subject to the following conditions:

a) Banks are free to buy and sell Government Securities on an outright basis at prevailing market prices without any restriction on the period between sale and purchase.

b) Banks shall not undertake ready forward transactions in Government Securities with non-bank clients.

c) The retailing of Government Securities should be on the basis of ongoing market rates / yields emerging out of secondary market transactions.

d) No sale of Government Securities should be effected by banks unless they hold the securities in their portfolio either in the form of physical scrips or in the Subsidiary General Ledger (SGL) Account maintained with the Reserve Bank of India.

e) Immediately on sale, the corresponding amount should be deducted by the bank from its investment account and also from its (Statutory Liquidity Ratio (SLR) assets.

f) Banks should put in place adequate internal control checks/ mechanism in this regard.

g) These transactions should be subjected to concurrent audit as per RBI's extant instructions and should also be looked into by the auditors at the time of bank's statutory audit.

(xiii) 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 are regulated by SEBI, IDF-NBFCs are regulated by RBI.

Banks can sponsor IDF-MFs and IDF-NBFCs with prior approval from RBI subject to the conditions given in the RBI Master Circular No. DBR.No.FSD.BC.19/24.01.001/2015-16 dated July 1, 2015 on “Para - Banking Activities”.

(xiv) *Membership of currency derivative segment of SEBI approved Stock 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 net worth 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.

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

(xv) *Partner in Financial Inclusion programme – Pradhan Mantri Jan Dhan Yojna:* Pradhan Mantri Jan-Dhan Yojana (PMJDY) is National Mission for Financial Inclusion to ensure access to financial services, namely, Banking/ Savings & Deposit Accounts, Remittance, Credit, Insurance, Pension in an affordable manner. Bank Account can be opened in any bank branch or Business Correspondent (Bank Mitr) outlet. PMJDY accounts are being opened with Zero balance and certain other benefits.

(xvi) *MUDRA Loans -* MUDRA loans are extended by banks, NBFCs, MFIs and other eligible financial intermediaries as notified by MUDRA Ltd. The Pradhan Mantri MUDRA Yojana (PMMY) announced by the Hon’ble Prime Minister on 8th April 2015, envisages providing MUDRA loan, upto Rs. 10 lakh, to income generating micro enterprises engaged in manufacturing, trading and services sectors. The overdraft amount of Rs. 5000 sanctioned under PMJDY has been also classified as MUDRA loans under Prime Minister MUDRA Yojana (PMMY). The MUDRA loans are extended under different categories.

(b) Regional Rural Banks (RRBs)

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.

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 56[3]. Further, the Government of India has issued a notification dated May 17, 2007 specifying 'Regional Rural Bank' as 'bank' for the purpose of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

15. In the 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

[3] As per the information available from the website of the Reserve Bank of India at the following URL: http://www.rbi.org.in/scripts/AboutUsDisplay.aspx?pg=RegionalRuralBanks.htm.

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.

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.

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).

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).

(c) Co-operative Banks

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). 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.

20. Each co-operative bank operates within a specific geographic jurisdiction as determined by its bye-laws. Co-operative banks can lend monies only to their members or to registered societies. The single most important regulatory and supervisory feature in the co-operative banking sector is the prevalence of dual control. While incorporation/registration and management-related activities are regulated in the states by the Registrar of Co-operative Societies or the Central Registrar of Co-operative Societies (for multi-state co-operative banks), banking

related activities are under the regulatory/supervisory purview of the Reserve Bank of India or NABARD (in the case of rural co-operatives).

(d) Development Banks

21. Development banks also known as 'term-lending institutions' are specialized financial institutions that provide medium and long-term finance to the industrial, agricultural, housing, and export-import sectors. As multipurpose financial institutions, they provide financial assistance to both private and public sectors. Development banking was started primarily to provide financial assistance to war-ravaged industries essentially to reconstruct their buildings and equipment which were destroyed in the war.

22. In India, development banks are classified into four groups such as Industrial Development Banks which include Industrial Finance Corporation of India (IFCI) set up in 1948, Industrial Development Bank of India (IDBI) set up in 1964, and Small Industries Development Bank of India (SIDBI) set up in 1990, Agricultural Development Banks which include National Bank for Agriculture & Rural Development (NABARD) set up in 1982, Export-Import Development Banks which include Export-Import Bank of India (EXIM Bank) set up in 1982 and Housing Development Banks which include National Housing Bank (NHB). In addition, the Industrial Investment Bank of India (IIBI) which was set up in 1991and the MUDRA Bank which was set up in 2016 are also in existence apart from State Industrial Development Corporations (SIDCs) and State Financial Corporation (SFC) which function as part of 'development banks'.

23. Development Banks came to be established to with the objective of providing financial assistance to entrepreneurs to establish and expand their businesses and helping companies to raise money from the capital market. Major functions of Development Banks include raising capital for the companies, providing loans and advances, performing underwriting of new issues, providing guarantee for loans, etc.

24. The major difference between Development Bank and Commercial Bank is that development Banks's main emphasis lies on development through various promotional activities while commercial banks are mere credit suppliers. Similarly, development banks do not accept deposits from public while commercial banks accept deposits. Further, it is also important to note that development banks are normally viewed to provide medium and long-term finance while commercial banks provide short term finance.

25. Two development institutions viz.: ICICI and IDBI have been since converted in to full-fledged commercial banks whereas IFCI is now categorised as a NBFC, SIDBI, NHB and EXIM Bank are the existing term lending institutions.

(e) Foreign Banks

26. 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 functions with a CEO or a Country Head as the highest decision making authority based in India. This position generally reports to the regional management Board or the global Board of the bank 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., the various boards and committees stipulated by RBI for Indian banks are not mandatory.

27. Foreign banks operate with limited branch network in the country and in a structure wherein most of their operations are centralized. 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.

28. In the aftermath of the global financial crisis and building on the lessons therefrom, RBI issued a Discussion Paper in January 2011 on the mode of presence of foreign banks in India. Taking into account the feedback received on the Discussion Paper, a Scheme for setting up of locally incorporated Wholly Owned Subsidiary (WOS) by foreign banks in India was finalized in November 2013. The scheme provided, as hitherto, allowing foreign banks to operate in India either through branch presence or setting up a wholly owned subsidiary (WOS) with near national treatment. The foreign banks in India have to choose one of the above two modes of presence and shall be governed by the principle of single mode of presence. The policy is guided by the two cardinal principles of (i) reciprocity and (ii) single mode of presence. As a locally incorporated bank, the WOS will be given near national treatment which will enable them to open

branches anywhere in the country at par with Indian banks (except in certain sensitive areas where RBI's prior approval would be required). They would also be able to participate fully in the development of the Indian financial sector. The policy incentivizes the existing foreign bank branches which operate within the framework of India's commitment to the World Trade Organisation (WTO) to convert into WOS due to the attractiveness of near national treatment. Such conversion is also desirable from the financial stability perspective. To provide safeguards against the possibility of the Indian banking system being dominated by foreign banks, the framework has certain measures to contain their expansion if the share of foreign banks exceeds a critical size. Certain measures from corporate governance perspective have also been built in so as to ensure that the public interest is safeguarded.

(f) Payment Banks

29. Payment Banks have been introduced in the Indian financial system since November 2014, with the basic objective of furthering financial inclusion by providing (i) small savings accounts and (ii) payments/ remittance services to migrant labour workforce, low income households, small businesses, other unorganised sector entities and other users. Their scope of activities include the acceptance of demand deposits, presently restricted to holding a maximum balance of Rs. 100,000 per individual customer, payments and remittance services through various channels, acting as Business Correspondents (BC) of another bank etc. Payments Banks cannot undertake any lending activities. Apart from amounts maintained as Cash Reserve Ratio (CRR) with RBI on its outside demand and time liabilities, they are required to invest a minimum of 75 per cent of their "demand deposit balances" in Statutory Liquidity Ratio (SLR) eligible Government securities/treasury bills with maturity up to one year and hold maximum 25 per cent in current and time/fixed deposits with other scheduled commercial banks for operational purposes and liquidity management.

30. Payments banks are new model of banks conceptualized by Reserve Bank of India (RBI) to meet government's financial inclusion target. They are being set up as differentiated bank and its activities are confined to acceptance of demand deposits, remittance services, internet banking and other specified services but not lending services.

31. This differentiated banking model allows mobile firms, supermarket chains and others to cater to banking requirements of individuals and small businesses.

32. Payments banks can accept deposits upto Rs. 1 lakh per account from individuals and small businesses. They can issue ATM/debit cards but not credit cards. They can also issue other prepaid payment instruments. They can also

distribute non-risk sharing simple financial products like mutual funds and insurance products.

33. Operating guidelines have been issued vide Circular No. RBI/2016-17/80 DBR. NBD. No.25/16.13.218/2016-17 Dated October 6, 2016.

34. Recently, the Union Government has announced that India Post Payments Bank (IPPB) will become operational in all 650 districts of the country by April 2018 to facilitate financial inclusion.

35. These banks will be linked to 1.55 lakh rural post offices for its operations and carry out banking services. This will be largest banking network in the country.

36. IPPB has been set up as a Public Limited Company under Department of Posts with 100% Government of India (GOI) equity. It leverages DoP's network, resources and reach to make low-cost, quality and simple financial services easily accessible to customers in the country. Its purpose is to further cause of financial inclusion by providing basic banking, remittance services and payments services to customers. It will facilitate spread of financial services like insurance, pensions, mutual funds to customers especially from rural areas and the unbanked and under-banked segments.

37. It will also generate opportunities for propagating financial literacy across the country by using state of the art banking and payments technology. It will also generate new employment opportunities for skilled banking professionals. It will encourage citizens to move towards a cashless economy.

(g) Small Finance Banks

38. Small Finance Banks have also been introduced in the Indian financial system since November 2014, with the basic objective of furthering financial inclusion by (a) provision of savings vehicles, and (b) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations. Their scope of activities primarily include undertaking basic banking activities of acceptance of deposits and lending to unserved and under-served sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities.

39. Operating guidelines have been issued vide Circular No. RBI/2016-17/81 DBR. NBD.No.26/16.13.218/2016-17 dated October 6, 2016. Guidelines w.r.t. Investment Classification, Restrictions on Loan and Advances, Income Recognition and Asset Classification as applicable to Scheduled Bank will be applicable to Small Finance Banks. In addition to it, specific guidelines have been

issued for Capital Adequacy Framework, Leverage Ratio, Liquidity Coverage Ratio and Net Stable Funding Ratio, etc.

(h) EXIM Bank

40. EXIM Bank (Export – Import Bank of India) was set up by the Government of India under Export-Import Bank of India Act, 1981 and it started its functioning in January 1982. It was established with the objective of providing financial assistance to exporters and importers, functioning as the principal financial institution for coordinating the working of institutions engaged in financing export and import of goods and services with a view to promoting the country's international trade.

41. It also provides refinance facilities to the commercial banks and financial institutions against their export-import financing activities.

42. As on 31st march 2017, the net funded loan assets of the bank stood at Rs. 10264.10 Crore and non- funded advances were Rs. 1223.10 Crore.

43. Functions of EXIM Bank:

1. Financing of export and import of goods and services both of India and of outside India.
2. Undertaking merchant banking functions of companies engaged in foreign trade.
3. Providing finance for joint ventures in foreign countries.
4. Offering buyers' credit and lines of credit to the foreign governments and banks.
5. Providing technical and administrative support to the parties engaged in export and import business.
6. Providing business information and advisory services to Indian exports in respect of multilaterally funded projects overseas.

C. Organizational Structure of Banks

44. While the exact organizational 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.

45. 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 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.

46. 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.

47. 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.

48. 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.

49. Branches are lowest in the hierarchy of the banking organization 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.

50. 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 locality.

D. Role of the Reserve Bank of India as the Central Bank

51. The Reserve Bank of India (hereinafter referred to as RBI) acts as the monetary authority and the central bank of the country. In an effort to bring greater coordination among financial regulators, the Government of India has constituted an over-arching body - the Financial Stability and Development Council ("FSDC" or "Council") in December 2010. The Council is headed by the Honorable Finance Minister and composed of the Governor of the RBI, the chairs of the SEBI, the IRDA and the PFRDA, and other Ministry of Finance ("MoF") officials. It envisages strengthening and institutionalizing the mechanism of maintaining financial stability, financial sector development, inter-regulatory coordination along with monitoring macro-prudential regulation of the Indian economy. On February 20, 2015 the RBI and Government signed the Monetary Policy Framework Agreement. In addition to it after amendment in RBI Act, the Monetary Policy Committee (MPC) headed by Governor was setup. The MPC is entrusted with the task of fixing the benchmark policy interest rate (repo rate) to contain inflation within the target level.

52. 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. Banks can commence business by opening the branches as per branch opening policy of RBI. The RBI also has the power to inspect any bank. The Banking Regulation Act, 1949 provides the legal framework for regulation and supervision of banks. This statute, together with some provisions in the Reserve Bank of India Act, 1934, State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959 and Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 & 1980, empowers the RBI to prescribe standards and

monitor liquidity, solvency and soundness of banks, so as to ensure that depositors' interests are protected at all times.

53. Periodic inspections of banks under section 35 of the Banking Regulation Act, 1949 are undertaken as a follow-up of the bank licensing regulation and objectives as laid down in section 22 of the Banking Regulation Act, 1949. The substantive objective of the statutory inspections has been to verify whether the conditions subject to which the bank has been issued license to undertake banking business in terms of sub-section (3) of section 22 [including sub-section (3A) for foreign banks] continue to be fulfilled by it. The conditions include:

(a) the bank "is or will be in a position to pay its present or future depositors in full as their claims accrue" (i.e. it is solvent and has adequate liquidity);

(b) the bank "has adequate capital structure and earning prospects";

(c) "the affairs of the (banking) company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors"; and

(d) "the general character of the management of the bank is not prejudicial to the public interest or the interest of its depositors" (i.e. it has sound operational systems and adequate controls operated by a prudent management).

Section 22(4) of the Banking Regulation Act, 1949 authorizes the RBI to cancel the banking license "if at any time, any of the conditions referred to in sub-section (3) and sub-section (3A) is not fulfilled".

54. Based on the recommendations of a High Level Steering Committee (HLSC) for Review of Supervisory Processes of Commercial Banks, the Reserve Bank of India had in September 2012, introduced a Supervisory Program for Assessment of Risk and Capital (SPARC) for commercial banks. This Risk Based Supervision (RBS) approach, helps the regulator in focusing on evaluating both present and future risks, identifying incipient issues and facilitating prompt intervention/ early corrective action - as against the earlier compliance-based and transaction testing approach (CAMELS) which was more in the nature of a 'point in time' assessment. The RBS approach also benefits the regulator by optimizing its use of supervisory resources and assisting the regulated entities in improving their risk management systems, oversight and controls.

55. 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.

56. 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.

57. Under Base Rate system which came into effect from July 1, 2010, all categories of domestic rupee loans of banks are priced only with reference to the Base Rate, subject to certain conditions. For monetary transmission to occur, lending rates have to be sensitive to the policy rate. At present, banks follow different methodologies for computing their Base Rate like average cost of funds method, marginal cost of funds, blended cost of funds (liabilities) etc.

58. 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*.

59. 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.

60. A major development that has implications for banks throughout the world is the "International Convergence of Capital Measurement and Capital Standards" generally known as the Basel Accord. Basel III ensures better quality of capital and robust liquidity risk management.

61. The smooth functioning of the payment and settlement systems is a prerequisite for stability of the financial system. In order to have focused attention on payment and settlement systems, a Board for Regulation and Supervision of Payment Systems (BPSS) was set up in March, 2005. The launch of the Real Time Gross Settlement System (RTGS) and NEFT (National Electronic Funds Transfer) has led to a reduction of settlement risk in large-value payments in the country. Similarly, IMPS (Inter bank Mobile Payment Service/Immediate Payment Service) is a mobile based payment mechanism introduced by the National Payments Corporation of India to allow customers to transfer money instantly, facilitating instant remittance across multiple platforms. The setting up of NSDL

and CDSL for the capital market settlements and CCIL for G-sec, forex and money market settlements have improved efficiency in market transactions and settlement processes. A series of legal reforms to enhance the stability of the payment systems have been carried out. With the introduction of the Payments and Settlement Act in 2008, the Reserve Bank has the legislative authority to regulate and supervise payment and settlement systems in the country.

62. In India, deposit insurance is provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly owned subsidiary of the Reserve Bank of India. Deposit insurance in India is mandatory for all banks (commercial/cooperative/ RRBs/LABs). It covers all kinds of deposits except those of foreign governments, Central/State Governments, inter-bank, deposits received abroad and those specifically exempted by DICGC with prior approval of the Reserve Bank. The premium charged for deposit insurance is on a flat rate basis, which is currently 10 paise per Rs.100 of assessable deposits with a statutory ceiling on premium at 15 paise. The premia to be paid by the insured banks are computed on the basis of their assessable deposits. Insured banks pay advance insurance premia to the Corporation semi-annually within two months from the beginning of each financial half year, based on their deposits as at the end of previous half year. The amount of coverage is presently limited to Rs.1 lakh per depositor and extends to deposits held in the same right and in the same capacity.

63. Banks and financial institutions (FIs) have also been advised by RBI to follow certain customer identification procedure for opening of accounts and monitor transactions of suspicious nature for the purpose of reporting the same to appropriate authority. These ‘Know Your Customer’ (KYC) guidelines have been revisited in the context of the recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards and on Combating Financing of Terrorism (CFT). Detailed guidelines based on the recommendations of FATF and the paper issued on Customer Due Diligence (CDD) for banks by the Basel Committee on Banking Supervision (BCBS), with suggestions wherever considered necessary, have been issued. Banks/FIs have been advised by RBI to ensure that a proper policy framework on ‘Know Your Customer’ and Anti-Money Laundering measures is formulated and put in place with the approval of their Boards. The objective of KYC/AML/CFT guidelines is to prevent banks/FIs from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. KYC procedures also enable banks/FIs to know/understand their customers and their financial dealings better and manage their risks prudently. Foreign Account Tax Compliance Act (FATCA) is a US law, which was enacted in March 2010 by the US Government which was aimed at preventing tax evasion through off shore assets by US citizens and US residents. Foreign Financial Institutions (FFIs)

such as the Bank that enter into a FATCA FFI agreement with the US government are required to conduct certain due-diligence to identify its US clients (individual and entity) and report on their accounts to the US Internal Revenue Service (IRS).

64. India has signed the Inter-Governmental Agreement (IGA) with USA for improving international tax compliance and implementing the Foreign Account Tax Compliance Act (FATCA). India has also signed a multilateral agreement on June 3, 2015, to automatically exchange information based on Article 6 of the Convention on Mutual Administrative Assistance in Tax Matters under the Common Reporting Standard (CRS), formally referred to as the Standard for Automatic Exchange of Financial Account Information (AEoI).

65. 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.

Prompt Corrective Action (PCA) framework for NPAs

66. Reserve Bank of India under its supervisory frame work uses various measures/ tools to maintain sound financial health of the bank. PCA frame work is one of such supervisory tools which involve monitoring of certain performance indicators of the banks as early warning exercise and is initiated once such thresh holds as relating to capital, asset quality etc. are breached.

67. Its objective is to facilitate the banks to take corrective measures including those prescribed by RBI, in a timely manner to realize financial health of the bank.

68. PCA frame work is in operations since December 2002 & the guidelines have been issued from time to time and recently on 13th April 2017, revised frame work has been issued by the Bank.

69. RBI has come up with a notification titled “Revised Prompt Corrective Action (PCA) framework for banks.” The revised framework would apply to all banks operating in India including small and foreign banks. The new set of provisions will be effective from April 1 based on the financials of banks as of March 2017. The revised framework will override the existing PCA framework. The revised framework will be again reviewed after three years.

Need for revised framework

70. RBI had promised to revise the PCA framework at its first monetary policy review of the current fiscal held on April 6, as the bad loans including those

already restructured reached USD 80 billion or 15% of the system as of March 2017.

Salient guidelines of revised PCA

71. Capital, Asset Quality and profitability would be the basis on which the banks would be monitored. Banks would be placed under PCA framework depending upon the audited annual financial results and RBI's supervisory assessment. RBI may also impose PCA on any bank including migration from one threshold to another if circumstances so warrants. RBI has defined three kinds of risk thresholds and the PCA will depend upon the type of risk threshold that was breached

72. If a bank breaches the risk threshold, then mandatory actions include the restriction on dividend payment/remittance of profits, restriction on branch expansion, higher provisions, restriction on management compensation and director's fees. Specifically, the breach of 'Risk Threshold 3' of CET1 (common equity tier 1) by a bank would call for resolution through tools like amalgamation, reconstruction, winding up among others.

73. RBI in its discretion can also carry out the following actions:

- Recommend the bank owner be it government/promoters/parent of foreign bank branch to bring in new management/board.
- Advise bank's board to activate the recovery plan as approved by the supervisor.
- Advise bank's board to carry out a detailed review of business model, the profitability of business lines and activities, assessment of medium and long term viability, balance sheet projections among others.
- Review short term strategies and medium-term business plans and carry out any other corrective actions like the removal of officials and supersession or suppression of the board.

Legal Entity Identifier (LEI) mandatory for all large corporate borrowers

74. Recently, Reserve Bank of India (RBI) has made 20-digit Legal Entity Identifier (LEI) compulsory for companies having aggregate fund-based and non-fund based exposure over Rs. 5 crore.

75. The move is aimed at improving risk management in wake of huge stressed assets in banking system. Before this, RBI had made LEI mandatory for transactions in interest rate, forex and credit derivative market

76. LEI mechanism will help banks to effectively monitor debt exposure of corporate borrowers. It will also enable banks in preventing multiple loans to companies against the same collateral.

77. LEI is a 20-digit unique code to identify parties to financial transactions worldwide. It is a global reference number that uniquely identifies every legal entity or structure that is party to a financial transaction, in any jurisdiction. LEI code has been conceived as key measure to improve quality and accuracy of financial data systems for better risk management post the global financial crisis.

78. The LEI system was developed by G20 in response to inability of financial Institutions to identify organizations uniquely, so that their financial transactions in different national jurisdictions can be fully tracked. The first LEIs were issued in December 2012.

79. Legal Entity Identifier India Limited (LEIL), a wholly-owned subsidiary of Clearing Corporation of India (CCI), acts as a local operating unit (LOU) for issuing globally compatible legal entity identifiers (LEIs) in India. Besides, entities can also obtain LEI from any of local operating units (LOUs) accredited by Global Legal Entity Identifier Foundation (GLEIF) – the entity tasked to support implementation and use of LEI.

80. Borrowers with fund and non-fund exposure of Rs 1,000 crore and above will have to get LEI by March 2018. Those having exposure between Rs 500 crore and Rs. 1,000 crore have to obtain LEI code by June 2018 and those having between Rs. 100 crore and Rs 500 crore by March 2019.

E. Role of the Union Government for strengthening and improving the Banking Sector in India

81. The Union Government is also initiating various measures from time to time in order to strengthen the Banking Sector in India.

82. As a part of measure, Union Government has launched a seven pronged plan called Indradhanush Mission to revamp functioning of public sector banks (PSBs).

83. The seven shades of Indradhanush mission include appointments, de-stressing PSBs, capitalisation, empowerment, framework of accountability and governance reforms.

84. It seeks to achieve the objective of economic growth revival through improving credit and minimising the political interference in the functioning of PSBs.

85. One of the shed of mission Indradhanush, Bank Board Bureau (BBB) was earlier announced in the 2015-16 budgets and which was implemented with the announcement of the Indradhanush Mission. It is the first step used to make bank as a full fledged bank holding company.

- BBB replaced all the earlier procedure of appointment of whole time directors and non executive chairman of Public Sector Banks and formalized the appointment procedures by comprising the eminent professionals and officials, who will follows the proper election methodology for appointment of CEO and MD for the required posts in banks.
- BBB consists of a chairman and six members team in which three officials and three experts, who will constantly involve themselves with the Board of Directors of the other Public Sector Banks to formulate the growth and development strategies

86. The Bank Board Bureau (BBB) has recommended that Government should bring in reforms in the compensation process in public sector banks (PSBs) on the lines of Central Public Sector Enterprises (CPSEs).

87. BBB has suggested compensation reforms in PSBs so that best practices can be introduced 'on the lines already prevalent in CPSEs.

88. It will play important role in attracting high-quality talent for non-executive directors and chairmen. It will also maintain a level-playing field with the private sector with respect to role, responsibility and remuneration.

- BBB is the super authority (autonomous body) of eminent professionals and officials for public sector banks (PSBs). It had replaced the Appointments of Board of Government.
- It is set up in April 2016 as part of seven point Indradhanush Mission to revamp the Public Sector Banks (PSBs).
- *Functions:* Give recommendations to Government for appointment of fulltime Directors as well as non-Executive Chairman of PSBs.
- Give advice to PSBs in developing strategies for raising funds through innovative financial methods and instruments to deal with stressed assets.
- Guide banks on mergers and consolidations and also ways to address the bad loans problem and among other issues.

Bank Recapitalization Plan

89. Indian PSBs are saddled with high, non-performing assets (NPAs) and facing prospect of having to take haircuts on loans stuck in insolvency proceedings.

Due to this, PSBs were unable to give fresh loans. Under the Indradhanush roadmap introduced in 2015, Central Government had announced to infuse Rs 70,000 crore in PSBs over four years to meet their capital requirement in line with global risk Basel-III norms to keep these banks fully solvent.

90. The Union Government has announced Bank Recapitalization Plan to infuse Rs. 2.11 lakhs crore ($32.4 billion) capital over next two years into public sector banks (PSBs) and prioritized financing support for MSMEs in 50 clusters. The capital infusion will be accompanied by a series of banking sector reforms that will be revealed in the coming months. Key Facts Under this plan, PSBs will get Rs 1.35 lakhs crore from Recapitalization Bonds, Rs. 18,000 crore from Budgetary support and remaining Rs 58,000 crore will be raised through sale of share of banks. The nature of recapitalization bonds will be decided in coming months and these bonds will be frontloaded over next four quarters with maximum timeframe of two years.

91. It will increase lending capacity of PSBs which will in turn boost economy and improve private sector investment especially when International Monetary Fund (IMF) projected growth to 5.7% which is lowest in three-year and create jobs. The supply of money to PSBs will enable banks lend lower interest rates. Depending on nature of recapitalization bonds, their issuance can also impact the government's fiscal deficit target i.e. government's total expenditures may exceed the revenue that it generates (apart from money from borrowings).

Consolidation of Banks

92. During the year, era of consolidation of banks started with merger of 5 association of State Bank of India, namely State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore & Bharatiya Mahila Bank. With this merger, SBI joined the league of top 50 banks globally in terms of assets.

93. The idea of bank mergers was around since 1991, when former Reserve Bank of India (RBI) governor M. Narasimham had recommended the government to merge banks into three-tiered structure, with three large banks with an international presence at top. In 2014, PJ Nayak Committee also had suggested that government either merge or privatize state-owned banks.

94. Significance of PSBs consolidation

- Reduce their dependence on government for capital.
- Open up more capital generation avenues, both internally and from market, for the merged entity.

- From a government point of view, it will increase stream of dividends which forms part of their non-tax revenue.
- Increase the role of internal and market resources and thus reduce dependence of merged bank on government for the future capital infusion
- It will lead to greater concentration of payment and settlement flows as there will be fewer parties in the financial sector.
- Operational risks could increase post-merger as size of operations grows and distance between management and operational personnel is greater as the administrative systems become more complex.
- It will help to deal better with their credit portfolio, including stressed assets. Consolidation will also prevent multiplicity of resources being spent in the same area and strengthens banks to deal with shocks.

95. With the merger, SBI's market share has increased to 22.5-23% from 17% with total business of over 37 lakh crore rupees. The merged entity now has a deposit base of more than Rs. 26 lakh-crore and advances level of Rs 18.50 lakh crore accounting for one-fourth of the deposit and loan market in the country. SBI now has 2.77 lakh employees, 50 crore customers and more than 25,000 branches and 58,000 ATMs. Its total customer base has reached to 37 crore across the country and these all customers will enjoy the benefits of a wide array of digital products and services offered by SBI.

96. Thereupon the Union Government has constituted Alternative Mechanism Panel headed by Union Finance Minister Shri Arun Jaitley to oversee merger proposals of public sector banks (PSBs). The other members of the panel include Railway and Coal Minister Shri Piyush Goyal and Defence Minister Smt. Nirmala Sitharaman.

97. This alternative mechanism has been set up by the government to fast-track consolidation among public sector banks to create strong lenders. The mechanism will oversee the proposals coming from boards of PSBs for consolidation.

- Alternative mechanism being created to give in-principle approval to proposals of banks to prepare schemes of amalgamations.
- After in-principle approval, the banks will take steps in accordance the law and SEBI's requirements.
- The final scheme will be notified by Central Govt. in consultation with Reserve Bank of India.

- Alternative mechanism aims to create strong and competitive banks in public sector space to meet the credit needs of a growing economy, absorb shocks and have the capacity to raise resources without depending unduly on the state exchequer.
- The decision regarding creating strong and competitive banks would be solely based on commercial consideration.

Amendments in the Banking Regulation Act, 1949

98. The banking sector in India is saddled with non-performing assets. The Union Government in May 2017 had promulgated an ordinance authorizing the RBI to issue directions to banks to initiate insolvency resolution process under the Insolvency and Bankruptcy Code, 2016. The RBI in June 2017 had identified 12 accounts each having more than Rs. 5000 crore of outstanding loans and accounting for 25% of total NPAs of banks for immediate referral for resolution under the bankruptcy law. Further in August, 2017, the RBI identified 28 accounts those were materially NPA as on June 30, 2017, i.e. where more than 60 percent of the total outstanding was classified as NPA on CRILC, shall be given time till December 13, 2017 for resolution outside IBC. In the event that a viable resolution plan is not finalized and implemented before that said date, insolvency proceedings under the provisions of the IBC may be initiated before December 31, 2017, unless already initiated. The bulk of the NPAs are in certain sectors including power, steel, road infrastructure and textiles.

99. The Union Government has notified the Banking Regulation (Amendment) Act, 2017. The Parliament had approved the Banking Regulation (Amendment) Bill, 2017 which replaced an ordinance in this regard.

100. It amended the Banking Regulation Act, 1949 by adding provisions for handling cases related to stressed assets or non-performing assets (NPAs) of banks.

101. The Act empowers the Central government to authorize the Reserve Bank of India (RBI) to direct banking companies to resolve specific stressed assets by initiating insolvency resolution process under the Insolvency and Bankruptcy Code, 2016.

102. The RBI can specify authorities or committees to advise banks on resolution of stressed assets. The members on the committees will be appointed or approved by the RBI. The Act also makes these provisions applicable to the SBI and its subsidiaries and also Regional Rural Banks (RRBs).

2
Accounting and Auditing Framework

PART A

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

02. Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949, deal 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.

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. As per Accounting Standard 3, the bank should prepare the cash flow statement also. Hence the financial statements of the bank shall include the cash flow statement along with the balance sheet and profit and loss account as well.

Salient Features of the Third Schedule

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. The text of the Third Schedule to the Banking Regulation Act, 1949 is given in ***Appendix II*** of this Guidance Note.

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

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

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

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.

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

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

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. DBR.BP.BC No 23/21.04.018/2015-16 dated July 1, 2015 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. Further the RBI vide its Circular No. DBR.BP.BC.No.63/21.04.018/2016-17 has prescribed an additional disclosure to be made in the Notes to Accounts from the Financial Year 2016-17 with respect to divergences observed by the RBI in the asset classification and provisioning. The disclosures in connection with Accounting Standards as mentioned in the circular is only the minimum required and other disclosures as prescribed by the Accounting Standards is mandatory to the extent they are not inconsistent with RBI circular.

Disclosures Required Under Accounting Standards

12. The disclosure requirements under the various Accounting Standards, as specified under Section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or Accounting Standards issued by the ICAI are also to be complied with.

Requirements of the Banking Regulation Act, 1949, *vis-a-vis* Companies Act, 2013

13. The requirements of the Companies Act, 2013, relating to the balance sheet, profit and loss account and cash flow statement of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the financial statements, as the case may be, of a banking company [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.

14. The Union Budget for 2014-15 emphasised the urgent need for convergence of the current Indian accounting standards with International Financial Reporting Standards (IFRS). The Ministry of Corporate Affairs (MCA),

Government of India notified the rules for IFRS converged Indian Accounting Standards (Ind AS) along with its implementation road map for corporates in a phased manner from 2016-17 onwards. Pursuant to Companies (Indian Accounting Standards) (Amendment) Rules, 2016 the following roadmap for Ind AS implementation in case of insurance companies, banking companies and non-banking financial companies (NBFCs) has also been announced:

"Roadmap drawn-up for implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) for Scheduled Commercial Banks (Excluding RRBs), Insurers/Insurance Companies and Non-Banking Financial Companies (NBFCs)"

15. In pursuance to the Budget Announcement by the Union Finance Minister Shri Arun Jaitley, after consultations with Reserve Bank of India (RBI), Insurance Regulatory and Development Authority (IRDA) and Pension Fund Regulatory and Development Authority (PFRDA), the following roadmap for implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) for Scheduled commercial banks (excluding RRBs), insurers/insurance companies and Non-Banking Financial Companies (NBFCs) has been drawn up:

(I) Scheduled commercial banks (excluding RRBs) Scheduled commercial banks (excluding Regional Rural Banks (RRBs) and All-India Term-lending Refinancing Institutions (i.e. Exim Bank, NABARD, NHB and SIDBI) would be required to prepare Ind AS based financial statements for accounting periods beginning from April 1, 2018 onwards, with comparatives for the periods ending March 31, 2018 or thereafter. Ind AS would be applicable to both consolidated and individual financial statements.

(a) Notwithstanding the roadmap for companies, the holding, subsidiary, joint venture or associate companies of Scheduled commercial banks (excluding RRBs) would be required to prepare Ind AS based financial statements for accounting periods beginning from April 1, 2018 onwards, with comparatives for the periods ending March 31, 2018 or thereafter.

(b) Urban Cooperative Banks (UCBs) and Regional Rural Banks (RRBs) shall not be required to apply Ind AS and shall continue to comply with the existing Accounting Standards, for the present.

(II) NBFCs

NBFCs will be required to prepare Ind AS based financial statements in two phases:

(a) Under Phase I, the following categories of NBFCs shall be required to prepare Ind AS based financial statements for accounting periods beginning from April 1, 2018 onwards with comparatives for the periods ending March 31, 2018 or thereafter. Ind AS would be applicable to both consolidated and individual financial statements.

   (i) NBFCs having net worth of Rs.500 crores or more.

   (ii) Holding, subsidiary, joint venture or associate companies of companies covered under (a)(i) above, other than those companies already covered under the corporate roadmap announced by the Ministry of Corporate Affairs (MCA), Government of India (GoI).

(b) Under Phase II, the following categories of NBFCs shall be required to prepare Ind AS based financial statements for accounting periods beginning from April 1, 2019 onwards with comparatives for the periods ending March 31, 2019 or thereafter. Ind AS would be applicable to both consolidated and individual financial statements.

   (i) NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than Rs.500 crores.

   (ii) NBFCs other than those covered in (a)(i) and (b)(i) above, that are unlisted companies, having net worth of Rs.250 crores or more but less than Rs.500 crores.

   (iii) Holding, subsidiary, joint venture or associate companies of companies covered under (b) (i) and (b)(ii) above, other than those companies already covered under the corporate roadmap announced by the MCA, Government of India.

Unlisted NBFCs having net worth below Rs. 250 Crores and not covered under the above provisions shall continue to apply Accounting Standards specified in Annexure to Companies (Accounting Standards) Rules, 2006 as amended by the Companies (Accounting Standards) Amendment Rules 2016."

(III) Scheduled commercial banks (excluding RRBs)/NBFCs/insurance companies/insurers shall apply Indian Accounting Standards (Ind AS) only if they meet the specified criteria, they shall not be allowed to voluntarily adopt Indian Accounting Standards (Ind AS). This, however, does not preclude an insurer/insurance company/NBFC from providing Ind AS compliant financial statement data for the purposes of preparation of consolidated financial statements by its parent/investor, as required by the parent/investor to comply with the existing requirements of law.

The RBI vide its circular dated 23rd June 2016 has requested the banks to submit the Performa Ind AS Financials statement (both standalone and consolidated) as on 30th September 2016 and subsequently asked for the Performa Ind AS Financials statement as on 31st March 2017 by 30th October, 2017.

Banks Listed on a Stock Exchange

16. 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.

Consolidated Financial Statements in case of one or more Subsidiaries

17. Banks are required to prepare Consolidated Financial Statements incorporating the Financial Statements of all the subsidiaries in the same form and manner as that of its own. In case the Bank is a Company, then such Consolidated Financial Statements shall also be laid before the annual general meeting of the company along with the laying of its financial statement by virtue of sub – section (3) of section 129 of Companies Act, 2013.

Further a separate statement containing the salient feature of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed shall also be attached along with its financial statement.

Notes and Instructions Issued by RBI

18. 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

19. 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.

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.

Auditor's Report

20. In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which the auditor 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.

21. 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.

22. 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

23. The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of SA 700, "Forming an Opinion and Reporting on Financial Statements", and where required with the SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and/or SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", as may be applicable. 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.

24. Further, in accordance with the 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 adjustments suggested by the 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.

25. An illustrative format of report of the auditor of a Nationalised Bank is given in ***Appendix III*** to this Guidance Note.

26. The auditor of a banking company is required to state in his report the followings in terms of provisions of Section 30(3) of The Banking Regulation Act, 1949:

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

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

(c) whether or not the returns received from the branch offices of the Bank have been found adequate for the purpose of 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 the auditor considers should be brought to the notice of the shareholders of the company.

In addition to the aforesaid, the auditor of a banking company is also required to state in his report in respect of matters covered by Section 143(2) & (3) of the Companies Act, 2013.

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

i) whether the bank has disclosed the impact, if any, of the pending litigations on its financial position in its financial statements

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

iii) whether there has been any delay in transferring amounts, required to be transferred to the Investment Education and Protection Fund by the bank

28. An illustrative format of report of the auditor on the Standalone Financial Statements of a banking company is given in ***Appendix IV*** to the Guidance Note.

Long Form Audit Report

29. 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.

30. The LFAR is to be submitted before 30th June every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

Reporting to RBI

31. 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".

32. 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."

33. 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.

34. Thus, auditors while reporting such a matter to 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.

35. Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". Para A19 of the said Standard explains that the duty of confidentiality may be 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).

36. RBI has issued a Master Direction on Fraud no. DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 (updated July 03, 2017) on "Frauds – Classification and Reporting by Commercial banks and select FIs" on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As per the said direction, 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.

37. 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, "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, "Risk Assessment and Internal Control" of Part II of the Guidance Note.

38. 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.

Reporting of Frauds to Central Government under the Companies Act, 2013

39. In case of a banking company, in term of provision of section 143(12) of the Companies Act, 2013:

> "Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:
>
> Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:
>
> Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed".

The audit procedure in this regard would be guided by the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013, issued by ICAI.

Audit of Branches

40. Audit of branches of banking companies is required under sub-section

(8) of section 143 of the Companies Act, 2013. 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 guidelines of the RBI issued from time to time.

41. 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. An illustrative format of report of the branch auditor of a Nationalised Bank is given in the ***Appendix V*** of this Guidance Note. 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. An illustrative format of report of the branch auditor of a Banking Company is given in the ***Appendix VI*** of this Guidance Note.

42. 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 and regulations of the country concerned. The form of audit report is usually governed by the laws and regulations of the country in which the branch is situated.

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

43. 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.

44. 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.)

45. 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, furniture, fixture, computer assets, UPS 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.
- Provision for restructured assets, MTM for fair value etc.
- Provisions for gratuity, pension and other retirement benefits.
- Provision for payment of bonus or ex-gratia in lieu of bonus.
- Provision for Standard Assets.
- 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.

46. 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.

47. 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.

48. Generally, in case of private sector banks there are no separate branch auditors. The statutory auditors appointed are supposed to carry out the entire audit. RBI requires the auditors to mention about the number of branches visited and the coverage of business in the audit report.

Other Important Provisions Relating to Accounts and Audit

49. 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 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.

50. 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 137 of the Companies Act, 2013 also.

51. 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.

PART B

Accounting Policies

01. 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.

02. 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.

03. 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.

04. 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.

05. 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 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

06. 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[4] and Companies (Accounting Standards)Amendment Rules, 2016. 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 ICAI and notified by the Central Government as on 30.10.2017:

AS 1	Disclosure of Accounting Policies

[4]Rule 7(2) of Companies (Accounts) Rule 2014 has clarified that to facilitate proper administration of the notified sections of the Companies Act 2013, in respect of the Section 133, "Till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority, the existing Accounting Standards, notified under the Companies Act, 1956 shall continue to apply."

AS 2(R)	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4(R)	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 7	Construction Contracts (Revised-2002)
AS 9	Revenue Recognition
AS 10 (R)	Property, Plant and Equipment
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(R)	Accounting for Amalgamations
AS 15	Employee Benefits(Revised-2005)
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share
AS 21(R)	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 (R)	Provisions, Contingent Liabilities and Contingent Assets

07. Of the above Standards notified under the Companies (Accounting

Standards) Rules, 2006[5], 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.

08. 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). Further the RBI has issued Circular No.DBR.BP. BC.No.61/21.04.018/2016-17 which clarifies the accounting treatment for recognizing gains in profit & loss account from Foreign Currency Translation Reserve (FCTR) on repatriation of accumulated profits / retained earnings from overseas branch(es).

Audit of Accounts

09. 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".

10. 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

[5]Rule 7(2) of Companies (Accounts) Rule 2014 has clarified that to facilitate proper administration of the notified sections of the Companies Act 2013, in respect of the Section 133, "Till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority, the existing Accounting Standards, notified under the Companies Act, 1956 shall continue to apply."

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 12 to 18 below & paragraphs 20 to 39 of Part A above 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 in paragraphs 40 to 48 of Part A above.

11. 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 ICAI.

Qualifications of Auditor

12. According to sub-section (1) of section 141 of the Companies Act, 2013, a chartered accountant or a firm whereof majority of partner practicing in India are qualified for appointment as chartered accountants with their firm name may be appointed as an auditor of a company. Sub-section (2) of aforesaid Act provides where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm. However, the following persons shall not be eligible for appointment as an auditor of a company, namely:

(a) a body corporate other than limited liability partnership;

(b) an officer or employee of the company;

(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 or his relative or partner-

   i. is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company:

   ii. Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

   iii. is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or

iv. has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

As per sub-section (4) of section 141 of Companies Act, 2013 where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

13. 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) 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

14. 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.

15. 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

16. The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of sub-section (1) & (2) of section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). As per proviso of sub section (1) of section 142 remuneration of the first auditor may be fixed by the Board. Further remuneration under sub-section (1) shall, in addition to the fee payable to an auditor, included the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. 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

17. 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 thereat on any part of the business, which concerns him as an auditor.

18. 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 sub-section (8) of section 143 of the Companies Act, 2013. 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.

3

Accounting Systems

PART A

01. The accounting systems of different banks vary 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 accounting system that would describe all the features of such systems in operation in different banks.

02. 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.

03. The auditor of a bank needs to obtain an adequate 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 including an understanding of the flow of various kinds of transactions. He can gain such understanding through enquiries of appropriate personnel, corroborated by making reference to documents such as accounting and procedures manual, flow charts, underlying documentary evidence and by observing the actual conduct of operations.

Salient Features of Accounting Systems of Banks

04. Banks, like most other large-sized entities, 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 on a real time basis 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.

05. 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.

06. It is imperative to note that most of the banks in the private and public sector have now networked all or most of their branches in the country which has over a period of time led to operational and financial efficiencies. Accordingly the traditional practice of maintaining manual records has largely been discontinued by online processing of transactions.

07. The accounting system in an enterprise is designed keeping in view the nature and volume of operations and information needs of management, regulators and third parties with whom the enterprise has dealings. With the advent of technology every big bank has customized banking software as per its own requirement and as such, the accounting systems differ amongst different banks. 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.

Accounting and Financial Control Manual ('AFCM')

08. The General Ledger ('GL') is the comprehensive repository of the Bank's financial information and prime source of data for internal and external reporting. It is imperative that the GL be complete, accurate and all its data valid. Banks should be encouraged to frame and adopt an AFCM, the primary objective of which should be to set out comprehensive, unified and standardised GL controls, standard accounting and financial operating procedures, accounting policies with the ultimate objective of strengthening the financial reporting and monitoring processes.

09. The manual should be reviewed centrally at the Head office level on an on-going basis at-least annually.

10. The salient features of the AFCM should include:

- Defining roles and responsibilities for the accounting and finance reporting team across key departments/ branches;
- Laying out the process controls to be applied to processes, procedures and practices followed by accounting and finance teams; and

- Outlining escalation requirements for reconciliations and process exceptions.

Reconciliation of sub-systems and suspense accounts

11. A Bank uses multiple sub-systems managing certain instruments, products and offerings for recording business transactions. These subsystems are electronically interfaced and need to be reconciled with the GL on a daily basis. There has to be adequate process to review the reconciliation between GL and the sub-systems highlighting significant unreconciled items, if any, to the Head office.

12. All Sundry Suspense accounts should also be tracked by the Bank on a regular basis. The Bank should have defined procedures for reconciling and monitoring sundry/suspense accounts at periodical intervals and escalating issues, if any, to the concerned departments/ branches for speedy resolution of open items.

Regulatory reporting to the Reserve Bank of India ('RBI')

13. Large banks generally have a dedicated regulatory reporting team for the purpose of ensuring appropriate reporting to the RBI. The information for the purpose of regulatory reporting is sourced from the GL and other subsystems of the Bank. In case of specific disclosure requirement, information is sourced from the respective business divisions. The reporting team should maintain an RBI reporting schedule based on which various reports are compiled and submitted to the RBI after being subject to a maker-checker process.

Audit Considerations

Information Produced by the Entity ('IPE') and used as Audit Evidence

14. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information. Accounting records generally include the records of initial entries and supporting records, such as cheques and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries, and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations, and disclosures. The entries in the accounting records are often initiated, authorized, recorded, processed, and reported in electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations, and compliance objectives.

15. Management is responsible for the preparation of the financial statements based on the accounting records of the entity. The auditor should obtain audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, because accounting records alone do not provide sufficient appropriate audit evidence on which to base an audit opinion on the financial statements, the auditor should obtain other audit evidence. Other information that the auditor may use as audit evidence includes minutes of meetings; confirmations from third parties; industry analysts' reports; information obtained by the auditor from such audit procedures as inquiry, observation, and inspection; and other information developed by or available to the auditor that permits the auditor to reach conclusions through valid reasoning.

16. IPE is not only used for testing controls relating to assertions on material classes of transactions, account balances and disclosures but is also used when performing procedures to evaluate the operating effectiveness of general IT controls. When evaluating the IPE, it is important to first obtain an appropriate understanding of the IPE. The auditor should begin with understanding what the IPE is, how the IPE is generated, and how it is intended to use as audit evidence. This allows the auditor to design the most appropriate testing approach to determine whether the IPE is sufficient and appropriate for purposes of the audit. The auditor should also consider the matters referred in SA 500 – Audit Evidence whilst testing IPE.

Elements of IPE

17. Information Produced by the Entity (IPE) typically consists of three elements:

(1) *Source data:* The information from which the IPE is created. This may include data maintained in the IT system (e.g., within an application system or database) or external to the system (e.g., data maintained in an Excel spreadsheet or manually maintained), which may or may not be subject to general IT controls.

(2) *Report logic:* The computer code, algorithms, or formulas for transforming, extracting or loading the relevant source data and creating the report. Report logic may include standardized report programs, user-operated tools (e.g., query tools and report writers) or Excel spreadsheets, which may or may not be subject to the general IT controls.

For example, for the Advances Aging report, the report logic is typically a program in the advances application that contains the code and algorithms for creating the advances Aging (report) from the individual advances accounts detail (source data).

(3) *Report parameters:* Report parameters allow the user to look at only the information that is of interest to them. Common uses of report parameters including defining the report structure, specifying or filtering data used in a report or connecting related reports (data or output) together. Depending on the report structure, report parameters may be created manually by the user (user-entered parameters) or they may be pre-set (there is significant flexibility in the configuration of parameters, depending on the application system), and they may or may not be subject to the general IT controls.

Understanding the IPE

18. The following questions may assist the auditor in understanding the IPE:

- What is the purpose of the IPE?
  - If in connection with the operation of a control, does the user depend on the accuracy and completeness of the information? If not, how is the user able to validate that the information is accurate and complete?
- What is the nature of the IPE?
  - Is it a standard or custom report?
  - Is the IPE system-generated or manually created? If manually created, what is the process for creating it?
- How is it created?
  - What is the relevant source data and where does the source date reside? Is the source data subject to the general IT controls (e.g., access controls)?
  - Where does the report logic reside? If system-generated, is the report logic subject to the general IT controls (e.g. access and program change controls)?
  - Is the report generated through a report writer tool? Is the report writer tool subject to the general IT controls (e.g. access and program change controls)?
  - What functions are being performed by the report logic, including:
    - How is the data extracted, transformed or loaded?
    - Are algorithms or calculations performed on the source data?
    - Is the information further manipulated after the IPE is generated by the system?
    - Is there additional information that is manually added to the report?

- Does the user enter parameters when the IPE is generated? If so what are the user-entered parameters?

- Have any errors been identified in the IPE? If so, what type of errors?

19. When using information produced by the entity the auditor has to evaluate whether the information is sufficiently reliable for audit purposes, including as necessary in the circumstances obtaining audit evidence about the accuracy and completeness of the information. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

Segregation of Duties

20. A standard approach for preventing fraud and effective control governance mechanism is to separate employee responsibilities in such a way that the opportunity to commit fraudulent activities is not available. For particularly vulnerable functions, it is common to require at least two employees participate in the functions of initiating, authorizing, recording, processing, and reporting of transactions. Application owners are responsible for determining who should have access, and what access privileges are granted. When determining a user's access privileges, the application owner should validate that segregation of duties is maintained and that job requirements are fulfilled.

21. The bank may use procedures such as a manual review of access listings and spreadsheets to compare the access rights granted to users, or alternatively, may use complex application systems and databases built to extract, analyse, and identify potential segregation of duties conflicts within the organization. When new users are added or when current users' change responsibilities within the organization, these procedures and/or application systems should be used to evaluate that the user's new access capabilities do not include the combination of two or more job functions that should be segregated (representing a segregation of duties conflict).The configuration of the access privileges within segregation of duties applications and spreadsheets, and any changes to these privileges, should be approved by management. Management should periodically review access to these applications. Any issues noted during the review should be remediated on a timely basis.

22. The auditor can obtain the System Access Report, for each of the responsibilities defined for the General Ledger module to identify the functions, menus, and sub-functions by responsibility. The segregation of duties for a specific client should be determined by obtaining an understanding of the entity's business processes, including related manual processes and controls.

Journal Entry Testing

23. The term 'journal entry' usually refers to "journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements". Journal entry testing is frequently associated with tests for management override. SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" requires testing for management override, which includes:

- Testing appropriateness of journal entries.
- Reviewing accounting estimates for biases.
- Understanding the business rationale for significant transactions that are outside the normal course of business for the entity.

24. Journal entries may be tested as part of tests of controls or substantive procedures at assertion level or as part of audit procedures relating to financial closing process.

25. The auditor should use professional judgment to determine the nature, timing, and extent of testing of journal entries and other adjustments.

26. For the purposes of identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are relevant:

- The assessment of the risks of material misstatement due to fraud.
- Controls that have been implemented over journal entries and other adjustments.
- The entity's financial reporting process and the nature of evidence that can be obtained.
- The characteristics of fraudulent journal entries or other adjustments.
- The nature and complexity of the accounts.
- Journal entries or other adjustments processed outside the normal course of business.

27. 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. Chapter 3, "Special Considerations in a CIS Environment" of Part II contains further guidance on this.

PART B

Principal Books of Account

01. 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

02. 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

03. 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

04. 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.

05. 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

06. 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.

07. 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.

08. 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.

09. Outstanding entries are summarised at stipulated intervals and their

totals agreed with the balances of the respective control accounts in the general ledger.

Other Registers/Records

10. 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.

11. 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.

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

13. 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 12 of Part IV.

14. 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.

15. 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.

16. Separate registers are maintained to record and summarise the transactions relating to a particular head of account like Current Account, Savings Bank, Cash Credit, and 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

17. 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.

18. 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.

19. 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

20. 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

21. 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.

22. 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

23. 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

24. 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

25. 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

26. 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

27. 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

28. 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

29. 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

30. 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

31. 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).

32. 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.

33. 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.

34. For deposits of 'transfer' instruments, there is a designated counter which receives the pay-in-slips[6], 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

[6] 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.

35. 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.

36. 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.

37. 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.

38. 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.

39. 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.

40. 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.

41. 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.

42. 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

43. 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.

44. 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.

45. 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.

46. 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.

47. Paragraphs 43 to 45 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.

48. 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.

49. 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

50. 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.

51. 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.

52. 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.

53. 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.

54. 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.

55. 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.

56. 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

57. 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

58. 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

59. 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.

60. 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

61. 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.

62. 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

63. 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

64. 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.

65. 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.

66. 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

67. 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.

68. 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.

69. 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.

70. 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'.

71. 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.

72. 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

73. 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.

74. 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.

75. 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

76. 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

77. 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

78. 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

79. 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

80. 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.

81. 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.

82. 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

83. 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

84. 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

85. 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.

86. 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

87. 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.

88. 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.

89. 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

90. 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.

91. '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.

92. 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.

93. 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

94. 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.

95. 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.

96. 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.

97. 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.

98. 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

99. 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

100. 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

101. 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.

102. 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.

103. 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

104. 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.

105. 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)'.

106. 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

107. Each computerised branch has one or two designated officials to perform the role of the Systems Administrator. The computer operations every day begins 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[7], and list of stopped cheques/drafts[8].

Recording of Transactions

108. 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

109. 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:

- 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

[7] 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.

[8] 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.

110. 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

111. 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

112. 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

113. After all the transactions for the day have been inputted 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

114. After EOD, the stipulated numbers 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 backup 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

115. 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[9]
- 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.[10]

Computerised Accounting and Core Banking Solutions

116. 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.

117. 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.

118. SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" lays

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[9] 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.

[10] 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.

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.

119. 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.

4

Legal Framework

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, 2013.
- 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.
- Insolvency and Bankruptcy Code, 2016.

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 the Banking Regulation Act, 1949[11]

03. Of the above Acts, 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

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

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

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

[11] RBI *vide* its Circular No. DBOD.NO.PSBD.BC.62/16.13.100/2013-14 on "Amendments to Banking Regulation Act, 1949 –Banking Laws (Amendment) Act, 2012- Applicability to private sector banks" dated October 23, 2013 advised that amendments by Banking Laws (Amendment) Act, 2012 are binding on banks notwithstanding any clauses to the contrary contained in the Memorandum of Association (MoA) and Articles of Association (AoA) of the banks. Banks are therefore, advised to make necessary amendments in the MoA and AoA.

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

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.

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

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[12]. 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.

[12] 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".

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

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

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:

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

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 not less than 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

13. Every banking company, other than a schedule 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.

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

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(3), 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.

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

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 8 of the Companies Act, 2013; and

   (iii) a government company.

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

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.

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.

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.

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

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

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.

24. It may be noted that 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)

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.

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

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]

28. The above types of banks also have 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

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 along with 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, '*Accounting and Auditing Framework'* given in CD 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

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

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.

Pursuant to Banking Regulation (Amendment) Act, 2017 which has come into effect from May 4, 2017 has inserted two new section 35AA & Section 35AB by which the central government may authorise the Reserve Bank of India to direct banks to initiate recovery proceedings against loan defaulters under the Insolvency and Bankruptcy Code, 2016.

Reserve Bank of India Act, 1934

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 4% 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

33. Wide powers have been given to the RBI under section 35 of the (Banking Regulation Act, 1949) for inspection of any banking company and its books and accounts. The Central Government can also direct the RBI to cause such an inspection. RBI has embarked on a transformatory journey towards Risk Based Supervision (RBS) approach from the earlier transaction-centric CAMELS (capital adequacy, asset quality, management, earnings, liquidity, and systems)

and CALCS (capital adequacy, asset quality, liquidity, compliance and systems and controls) approaches. Significant improvements is being made in terms of the quality of data provided to RBI and understanding of the data requirements.

Power of the RBI to Give Directions

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 of the Banking Regulation Act, 1949). 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 of the Banking Regulation Act, 1949].

Applicability of Various Enactments to Different Types of Banks

35. As mentioned in paragraph 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

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.

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.

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

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.

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 38 above).

Regional Rural Banks

41. Regional rural banks are governed by –

(a) Regional Rural Banks Act, 1976; and

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

42. 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 38 above).

Co-operative Banks

43. 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.

44. 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

45. 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.

46. 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.

Companies Act, 2013

47. 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, 2013, 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, 2013. In case the provisions of these enactments are at variance, the provisions of the Banking Regulation Act, 1949, shall prevail.

Regulatory Directives

48. Section 35A of the Banking Regulation Act 1949 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 RBI's directions and RBI closely monitors such compliances. The circulars issued by RBI cover every facet of banking business.

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)* 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. Recently, RBI has started issuing Master Directions. Some of these master circulars/master Directions have been provided in the CD enclosed with this Guidance Note.

II

Appendices

APPENDIX I

Text of the Section 6 of the Banking Regulation Act 1949

(1) In addition to the business of banking, banking company may engage in any one or more of the following forms of business, namely:

(a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scripts and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling, of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a [managing agent or secretary and treasurer "managing agent" (w.e.f. 1st October, 1959)] of a company;

(c) contracting for public and private loans and negotiating and issuing the same;

(d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

(e) carrying on and transacting every kind of guarantee and indemnity business;

(f) managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) undertaking and executing trusts;

(i) undertaking the administration of estates as executor, trustee or otherwise;

(j) establishing and supporting or aiding in the establishment and support of association, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

(l) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

(m) acquiring and undertaking the whole or any part of the business of any person or company, when such business is of nature enumerated or described in this sub-section;

(n) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) any other forms of business 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) No banking company shall engage in any form of business other than those referred to in sub-section (1).

APPENDIX II

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 March_________

(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		

APPENDIX III

Illustrative Format of Report of the Auditor of a Nationalised Bank

Independent Auditor's Report

To the Members of ________________ (Name of Bank)

Report on the Financial Statements

1. We have audited the accompanying financial statements of XYZ Bank ('the Bank') as at 31 March 20XX, which comprise the Balance Sheet as at 31 March 20XX, and the 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 statutory 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 _________ percent 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 Banking Regulation Act 1949, Reserve Bank of India guidelines from time to time and accounting standards generally accepted in India. This responsibility includes design, implementation and maintenance of internal control relevant to the preparation of the financial statements that give true and fair view and 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 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 misstatements.

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 Bank's preparation and fair presentation 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 effectiveness of the bank's internal control. 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:

(a) 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 the state of affairs of the Bank as at 31 March 20XX in conformity with accounting principles generally accepted in India;

(b) the Profit and Loss Account, read with the notes thereon shows a true balance of profit/loss (as applicable), in conformity with accounting principles generally accepted in India, for the year covered by the account; and

(c) 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 accordance with Section 29 of 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; and
c) The returns received from the offices and branches of the Bank have been found adequate for the purposes of our audit.

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) the reports on the accounts of the branch offices audited by branch auditors of the Bank under section 29 of the Banking Regulation Act, 1949 have been sent to us and have been properly dealt with by us in preparing this report; and
c) 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
Firm Registration No. ________________
Signature
(Name of the Member Signing the Audit Report)
(Designation)[13]
Membership Number

Place of Signature:
Date of Report:

[13] Partner or proprietor as the case may be.

APPENDIX IV

Illustrative Format of Report of the Auditor on the Standalone Financial Statements of a Banking Company

SA 700 - Forming an Opinion and Reporting on Financial Statements

This Standard on Auditing (SA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

The auditor shall express an **unmodified opinion** when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the auditor: (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

SA 705 - Modifications to the Opinion in the Independent Auditor's Report

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	**Material and Pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

The auditor shall **disclaim an opinion** when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion", "Adverse Opinion", or "Disclaimer of Opinion", as appropriate, for the opinion paragraph

The format for Audit Report having an unmodified opinion for Banks applicable till FY 2017-18 is indicated below.

The audit report also requires the independent auditors to opine about the internal financial controls over financial reporting of an entity.

The sample format stated below for the said reporting, opines that the bank has an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting are operating effectively.

Note:

Auditors have no comments under Section 143(3)(f) and (h) of the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of _______ Bank*(name of the Bank)*

Report on the Standalone Financial Statements

1. We have audited the accompanying standalone financial statements of ____ Bank Limited ('the Bank'), which comprise the Balance Sheet as at 31 March 20XX, the Profit and Loss Account, the Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information [*which are incorporated the Returns*[14] *for the year ended on that date audited by the branch auditors of the Bank's branches at (location of branches)]*[15]

Management's Responsibility for the Standalone Financial Statements

2. The Bank's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ('the Act') with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Bank in accordance with the accounting principles generally accepted in India, including

[14] The auditors need to consider mentioning the coverage of branches based on directions, if any, provided by the RBI in their individual appointment letters issued to various Banks.

[15] Where applicable.

the Accounting Standards specified under section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 and provisions of Section 29 of the Banking Regulation Act, 1949 and circulars and guidelines issued by the Reserve Bank of India ('RBI') from time to time. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Bank and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

3. Our responsibility is to express an opinion on these standalone financial statements based on our audit.

4. We have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

5. We conducted our audit of the Bank including its branches in accordance with Standards on Auditing ('the Standards') specified under section 143(10) of the Act. 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 of material misstatements.

6. An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. The procedures selected depend on the auditor's judgment, 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 financial control relevant to the Bank's preparation of the financial statements that give a true and fair view 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 the Bank's Directors, as well as evaluating the overall presentation of the financial statements.

7. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the standalone financial statements.

Opinion

8. In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Banking Regulation Act, 1949 as well as the Companies Act, 2013 in the manner so required for banking companies and give a true and fair view in conformity with accounting principles generally accepted in India, of the state of affairs of the Bank as at 31st March, 20XX, and its profit/loss and its cash flows for the year then ended.

Report on Other Legal and Regulatory Requirements

9. 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 and Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014.

10. As required by sub-section (3) of section 30 of the Banking Regulation Act, 1949, 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.

11. Further, as required by section 143(3) of the Act, we report that:

a) we have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

b) in our opinion, proper books of account as required by law have been kept by the Bank so far as it appears from our examination of those books*[and* *proper returns adequate for the purposes of our audit have been received from branches not visited by us]*[16].

c) the reports on the accounts of the branch offices audited by branch auditors of the Bank under section 143(8) of the Companies Act 2013 have been sent to us and have been properly dealt with by us in preparing this report[19].

d) the Balance Sheet, the Profit and Loss Account and the Cash Flow Statement dealt with by this report are in agreement with the books of account*[and with the returns received from the branches not visited by us]*[19].

e) in our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014, to the extent they are not inconsistent with the accounting policies prescribed by RBI;

f) on the basis of written representations received from the directors as on 31 March 201Xand taken on record by the Board of Directors, none of the directors is disqualified as on 31 March 20XX from being appointed as a director in terms of Section 164(2) of the Act; *(or the requirements of section 164(2) of the Act are not applicable considering the Bank is a branch of ______, which is incorporated in _______)*; and

g) with respect to the adequacy of the internal financial controls over financial reporting of the Bank and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

h) with respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

   i. the Bank has disclosed the impact of pending litigations on its financial position in its financial statements - Refer Schedule XX - Note XX to the financial statements; *(or the Bank does not have any pending litigations which would impact its financial position*[17]*)*

   ii. the Bank has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts - Refer Schedule XX - Note XX to the financial statements; *(or the Bank did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.*[20]*)* and

[16] Where applicable.

[17] As may be applicable.

iii. there has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Bank *(or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Bank or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Bank[18])*.

For ABC and Co.
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation)[19]
Membership Number

Place of Signature:
Date of Report

[18] As may be applicable.
[19] Partner or proprietor, as the case may be.

Annexure A to the independent auditor's report of even date on the standalone* financial statements of _____ Bank Limited [Refer Paragraph 11(vii)]

Report on the Internal Financial Controls Over Financial Reporting under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013

1. We have audited the internal financial controls over financial reporting of ____ Bank Limited ('the Bank') as at 31 March 20XX in conjunction with our audit of the standalone financial statements of the Bank for the year ended on that date.

Management's Responsibility for Internal Financial Controls over Financial Reporting

2. The Bank's Board of Directors is responsible for establishing and maintaining internal financial controls based on _____ [for example, "the internal control over financial reporting criteria established by the Bank considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ('the Guidance Note') issued by the Institute of Chartered Accountants of India ('the ICAI')".] These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to Bank's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013 ('the Act').

Auditor's Responsibility

3. Our responsibility is to express an opinion on the Bank's internal financial controls over financial reporting based on our audit. We conducted our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ('the Guidance Note') and the Standards on Auditing ('the Standards'), issued by the ICAI and deemed to be prescribed under section 143(10) of the Act, to the extent applicable to an audit of internal financial controls, both issued by the ICAI. Those Standards and the

Guidance Note require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

4. Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. 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.

5. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the Bank's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

6. A bank's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A bank's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the bank; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the bank are being made only in accordance with authorizations of management and directors of the bank; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the bank's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

7. Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

8. In our opinion, the Bank has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at 31 March 20XX, based on ______ [for example, "the internal control over financial reporting criteria established by the Bank considering the essential components of internal control stated in the Guidance Note issued by the ICAI"].

For ABC and Co.
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation)[20]
Membership Number

Place of Signature
Date of Report

[20] Partner or proprietor, as the case may be.

APPENDIX V

Illustrative Format of Report of the Branch Auditor of a Nationalised Bank

Independent Branch Auditor's Report

To,
The Statutory Central Auditors
________ Bank

Report on the 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 1949, 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 give true & fair view and 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 misstatements.

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 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, but not for the purpose of expressing an opinion on effectiveness of the entity's internal control. 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 para 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, the Balance Sheet and Profit and Loss Account comply with the applicable accounting standards.

Other Matters Paragraph

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) Effect of adjustments that might arise upon the reconciliation/ matching of outstanding entries in the inter office accounts impact of which is presently not quantifiable.

(f) Interest on overdue term deposits;

(g) Depreciation on fixed assets;

(h) Auditors' fees and expenses;

(i) Taxation (Current Tax and Deferred Tax).

(j) Provision for Standard Assets including Restructured Accounts, Teaser Loan;

(k) Additional provision for sub-standard infrastructure loan accounts;

(l) Provision for unsecured portion and diminution in fair value in respect of Restructured accounts;

(m) Provision for Asset Doubtful of Recovery, Fraud etc.

(n) Provision for FITL

(o) Project where DCCO has been extended

(p) Provision for Clearing difference and Sundry Assets outstanding if any long pending.

(q) Provision for unhedged foreign exchange exposure of borrower entities.

(r) Any other provision made at Head office

11. The following is a summary of Memorandum of Changes submitted by us to the branch management[21].

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[22]			
g) In respect of Classification of Advances		XXX	XXX
h) In respect of Risk Weighted Assets			
i) Other items (if any)			

For ABC and Co.
Chartered Accountants
Firm Registration No.

Signature
(Name of the Member Signing the Audit Report)
(Designation)[23]
Membership Number

Place of Signature
Date

[21] Where Applicable.
[22] Applicable in cases where banks determine provision at Branch level.
[23] Partner or proprietor as the case may be.

APPENDIX VI

Illustrative Format of Report of the Branch Auditor of a Banking Company

Independent Bank Branch Auditor's Report

To,
The Statutory Central Auditors
________ Bank

Report on the 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 matters stated in section 134(5) of the Companies Act, 2013 ('the Act') with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position and financial performance of the Branch in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014 and provisions of Section 29 of the Banking Regulation Act, 1949 and circulars and guidelines issued by the Reserve Bank of India ('RBI') from time to time. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Branch and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and 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 have taken into account the provisions of the Act, the

accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.We conducted our audit of the branch in accordance with the Standards on Auditing ('the Standards')specified under section 143(10) of the Act. 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 misstatements.

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 para 11 below), the financial statements give the information required by the Banking Regulation Act, 1949 as well as the Act, in the manner so required for banking companies and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the branch as at March 31, 20XX and its profit/loss for the year then ended.

Report on Other Legal and Regulatory Requirements

7. The Balance Sheet and the Profit and Loss Account have been drawn up in accordance with the provision of Section 29 of the Banking Regulation Act, 1949 read with Section 133 of the Act read with Rule 7 of the Companies (Accounts) Rules, 2014.

8. As required by sub-section (3) of section 30 of the Banking Regulation Act, 1949, 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. Further, as required by section 143(3) of the Act, we report that:

a. we have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

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;

c. The Balance Sheet and the Profit and Loss account dealt with by this report are in agreement with the books of account.

d. in our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014, to the extent they are not inconsistent with the accounting policies prescribed by RBI;

e. with respect to the adequacy of the internal financial controls over financial reporting of the Branch and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

f. with respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

   a) the Branch has disclosed the impact of pending litigations on its financial position in its financial statements - Refer Schedule XX - Note XX to the financial statements; *(or the Branch does not have any pending litigations which would impact its financial position[24])*

   (b) the Branch has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts -Refer Schedule XX - Note XX to the financial statements; *(or the Branch did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses[27])* and

   (c) there has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Branch *(or, following are the instances of delay in transferring*

[24] As may be applicable.

amounts, required to be transferred, to the Investor Education and Protection Fund by the Branch or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Branch[25]).

Other Matters Paragraph

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 (Revised)–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).

(j) Any other provision made by Head Office

11. The following is a summary of Memorandum of Changes submitted by us to the branch management[26].

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			

[25] As may be applicable.

[26] Where Applicable.

e)	In respect of Gross NPAs			
f)	In respect of Provision on NPAs[27]			
g)	In respect of Classification of Advances		XXX	XXX
h)	In respect of Risk Weighted Assets			
i)	Other items (if any)			

For ABC and Co.
Chartered Accountants
Firm Registration No.______-_

Signature
(Name of the Member Signing the Audit Report)
(Designation)[28]
Membership Number

Place of Signature
Date

[27] Applicable in cases where banks determine provision at Branch level.
[28] Partner or proprietor as the case may be.

Annexure A to the independent auditor's report of even date on the financial statements of _____ Branch of ______Bank Limited [Referred to in Paragraph 8(e)]

Report on the Internal Financial Controls over Financial Reporting under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013

1. We have audited the internal financial controls over financial reporting of ____Branch of ______ Bank Limited ('the Branch') as at 31 March 20XX in conjunction with our audit of the financial statements of the Branch for the year ended on that date.

Management's Responsibility for Internal Financial Controls over Financial Reporting

2. The Management of the Branch is responsible for establishing and maintaining internal financial controls based on _____ [for example, "the internal control over financial reporting criteria established by the Branch considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ('the Guidance Note') issued by the Institute of Chartered Accountants of India ('the ICAI')".] These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to Branch's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013 ('the Act').

Auditor's Responsibility

3. Our responsibility is to express an opinion on the Branch's internal financial controls over financial reporting based on our audit. We conducted our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ('the Guidance Note') and the Standards on Auditing ('the Standards'), issued by the ICAI and deemed to be prescribed under section 143(10) of the Act, to the extent applicable to an audit of internal financial controls over financial reporting, both issued by the ICAI. Those Standards and the Guidance Note require that we comply with ethical

requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

4. Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. 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.

5. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the Branch's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

6. A branch's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A branch's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the branch; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the branch are being made only in accordance with authorizations of management and directors of the bank; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the branch's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls Over Financial Reporting

7. Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

8. In our opinion, the Branch has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at 31 March 201X, based on ______ [for example, "the internal control over financial reporting criteria established by the Branch considering the essential components of internal control stated in the Guidance Note issued by the ICAI"].

For ABC and Co.
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member Signing the Audit Report)
(Designation)[29]
Membership Number

Place of Signature
Date of Report

[29] Partner or proprietor, as the case may be.

APPENDIX VII

Illustrative Format of Engagement Letter in case of a Nationalised 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.............. *(name of the Bank).*

(Address)

[Date]

Subject: Engagement Letter

Dear Sirs,

We refer to the letter No. ……………. dated …….received from …………………………………..(Name of the relevant authority) informing us about our (re)appointment/ as the statutory central auditor of the Bank to carry out the statutory audit of the balance sheet, profit and loss account and cash flow ("financial statement) as per section 30 of Banking Regulation Act, 1949 ("the Act") for the financial year(s) beginning April 1, 20XX and ending 31st March 20YY, 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. The aforesaid financial statements of the Bank include, where applicable, consolidated financial statements of the Bank and all of its subsidiaries, associate companies and joint ventures. We are pleased to confirm our acceptance and understating of this engagement by means of this letter.

1. Scope and Objective

Our audit of the financial statements will be conducted with the objective of our expressing an opinion if the aforesaid financial statements give the information required by the Act in the manner so required, and give a true and fair view in conformity with the applicable accounting principles generally accepted in India, of the state of affairs of the Bank as at 31st March 20XX, and its profit/loss and its cash flows for the year ended on that date.

We will conduct our audit in accordance with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) and also in accordance with 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.

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 the Management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that some material misstatements due to fraud or error may occur and may not be detected, even though the audit is properly planned and performed in accordance with SAs.

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.

2. Management's Responsibility

Our assignment will be conducted on the basis that the Management and, where appropriate, those charged with governance of the Bank (Audit Committee/Board) acknowledge and understand that they have the 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:

- Compliance with the applicable provisions of the Act;
- Proper maintenance of accounts and other matters connected therewith;

- Preparation of financial statements on a going concern basis;
- Preparation of annual accounts in accordance with third schedule to the Banking Regulation Act, 1949, the applicable Accounting Standards and providing proper explanation relating to any material departures from those Accounting Standards;
- Selection of accounting policies and applying them consistently and 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;
- Taking proper care and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of assets of the Bank and preventing and detecting frauds and other irregularities;
- Laying down internal financial controls to be followed by the Bank and that such internal financial controls are adequate and were operating effectively; and
- Devising proper systems to ensure compliance with the provisions of all applicable laws including 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 that such systems were adequate and operating effectively.

(b) Informing me / us of facts that may affect the financial statements, of which Management may become aware during the period from the date of my / our report to the date the financial statements are issued.

(c) to provide us with:

i. access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Bank, whether kept at the Head office or elsewhere, of which the Management is aware, that are relevant to the preparation of the financial statements such as records, documentation and other matters. This will include books of account maintained in electronic mode;

ii. Access, at all times, to the records of all the subsidiaries (including associate companies and joint ventures

iii. Access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.),

iv. additional information that we may request from the 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

v. 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 Bank such information and explanations, as we may think necessary for the performance of our duties as auditor of the Bank;

vi. As part of our audit process, we will request from the 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.

3. Other Matters

My / Our report prepared in accordance with relevant provisions of the Act would be addressed to the shareholders/members of the bank for adoption of the accounts at the Annual General Meeting. In respect of other services, my / our report would be addressed to the Board of Directors. The form and content of my / our report may need to be amended in the light of my / our audit findings.

We also wish to invite your attention to the fact that, our audit process is subject to 'peer review'/ 'quality 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/quality review.

I / We may involve specialists and staff from my / our affiliated network firms to perform certain specific audit procedures during the course of my / our audit.

In terms of Standard on Auditing 720 – "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" issued by the ICAI, I / we request you to provide to me / us a Draft of the Annual Report containing the audited financial statements so as to enable me / us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor's report on the financial statements.

{Other relevant information}

{Insert Other information, such as fee arrangements, billings[30] and other specific terms, as appropriate.}

We look forward to full cooperation from your staff during our audit.

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.)

Date:

Place:

(name of the firm)
Chartered Accountants
…………………………
(Signature)
(name of the member)
(Designation[31])

Acknowledged on behalf of ……………… Bank

……………………..

(Signature)

Name and Designation

Date

Copy to: Chairman, Audit Committee

Attached: Letter of Acceptance duly signed by us.

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[30]For example, "My / Our fees and out-of-pocket expenses for the audit of the financial statements for the year have been fixed by the members at the Annual General Meeting at Rs.____________, plus out-of-pocket expenses and indirect taxes/ will be mutually agreed between the Board of Directors of the Company and me / ourselves.* I / We will bill as the work progresses. I / We will notify you promptly of any circumstances I / we encounter that could significantly affect my / our estimate of fees and discuss with you any additional fees, as necessary."

[31] Partner or proprietor, as the case may be.

APPENDIX VIII

Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor

{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.}

The Board of Directors

(or the appropriate representative of senior management).

[Date]

Subject: Engagement Letter

Dear Sirs,

I/We refer to the letter No. ……………. dated …….received from ………………………………….(Name of the relevant authority) informing me/us about my/our appointment to carry out the statutory audit of the (name of the branch) branches of your Bank for the financial year beginning April 1, 20XX and ending 31st March 20YY, 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 pertaining to these branches, as listed in your aforementioned letter.

1. Scope and Objective

We are pleased to confirm our acceptance for the aforementioned assignment through the Letter of Acceptance attached herewith and the following sets out the area of responsibility of the Branch Management and myself/ourselves 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 (Form A) and the Profit and Loss Account (Form B) (collectively referred as "Financial Statement") for the year ended 31st March 20XX.

ii) We will conduct our audit in accordance with the Standards on Auditing (SAs) and any other applicable pronouncement issued by Institute of

Chartered Accountants of India (ICAI), 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) We invite your attention to the fact that, in terms of RBI 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) we are required to report to the RBI anything susceptible to fraud or fraudulent activity or any act of excess power or any foul play in any transaction.

2. Management's Responsibility

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.

3. Other Matters

As part of our assignment, we will request from the branch management, written confirmation concerning representations made to us in connection with the audit, in accordance with Standard on Auditing 580 – "Written Representations", issued by the ICAI 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.

In terms of Standard on Auditing 720 – "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" issued by the ICAI, we request you to provide to us a Draft of the Annual Report containing the audited financial statements so as to enable us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor's report on the financial statements.

We also wish to invite your attention to the fact that, our audit process is subject to 'peer review'/ 'quality 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 / quality 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[32].

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)
(Name of the Member)
Designation[33]

[32] As may be appropriate.

[33] Partner or proprietor, as the case may be.

Date:
Place:

Acknowledged on behalf of ………………. Branch of …………………Bank

……………………..
(Signature)
Name and Designation
Date

Attached: Letter of Acceptance duly signed by us.

APPENDIX IX

Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Banking Company[34]

{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.............. *(name of the Bank).*

(Address)

[Date]

Subject: Engagement Letter

Dear Sirs,

We refer to the letter No. ……………. dated …….received from …………………………………(Name of the relevant authority) informing us about our (re)appointment/ ratification as the auditors of …………………(Name of the Bank) (hereinafter "the Bank")to carry out the statutory audit of the financial statements of the Bank as defined in section 2(40) of the Companies Act 2013 ("the Act") for the financial year(s) beginning April 1, 20XX and ending 31st March 20YY, 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. The aforesaid financial statements of the Bank include, where applicable, consolidated financial statements of the Bank and all of its subsidiaries, associate companies and joint ventures. We are pleased to confirm our acceptance and understating of this engagement by means of this letter.

1. Scope and Objective

Our audit of the financial statements will be conducted with the objective of our expressing an opinion if the aforesaid financial statements give the information required by the 2013 Act in the manner so required, and give a true and fair view in conformity with the applicable accounting principles generally accepted in

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[34] Presuming that there is/are no joint auditor/s and no separate branch auditors have been appointed.

India, of the state of affairs of the Bank as at 31st March 20XX, and its profit/loss and its cash flows for the year ended on that date.

We will conduct our audit in accordance with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with section 143(10) of the 2013 Act and also in accordance with 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.

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 the Management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override controls, there is an unavoidable risk that some material misstatements due to fraud or error may occur and may not be detected, even though the audit is properly planned and performed in accordance with SAs.

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.

2. Management's Responsibility

Our assignment will be conducted on the basis that the Management and, where appropriate, those charged with governance of the Bank (Audit Committee/Board) acknowledge and understand that they have the 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:

- Compliance with the applicable provisions of the 2013 Act;
- Proper maintenance of accounts and other matters connected therewith;
- Preparation of financial statements on a going concern basis;
- Preparation of annual accounts in accordance with the applicable Accounting Standards and providing proper explanation relating to any material departures from those Accounting Standards;
- Selection of accounting policies and applying them consistently and 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;
- Taking proper care and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding of assets of the Bank and preventing and detecting frauds and other irregularities;
- Laying down internal financial controls to be followed by the Bank and that such internal financial controls are adequate and were operating effectively; and
- Devising proper systems to ensure compliance with the provisions of all applicable laws including 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 that such systems were adequate and operating effectively.

(b) Identifying and informing us of financial transactions or matters that may have an adverse effect on the functioning of the Bank.

(c) Identifying and informing me / us of:

- All the pending litigations and confirming that the impact of the pending litigations on the Company's financial position has been disclosed in its financial statements;

- All material foreseeable losses, if any, on long term contracts including derivative contracts and the accrual for such losses as required under any law or accounting standards; and

- Any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.

(d) Informing me / us of facts that may affect the financial statements, of which Management may become aware during the period from the date of my / our report to the date the financial statements are issued.

(e) Identifying and informing me / us as to whether any director is disqualified as on March 31, 20YY from being appointed as a director in terms of Section 164(2) of the 2013 Act. This should be supported by written representations received from the directors as on March 31, 20YY and taken on record by the Board of Directors.

(f) to provide us with:

- access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Bank, whether kept at the Head office or elsewhere, of which the Management is aware, that are relevant to the preparation of the financial statements such as records, documentation and other matters. This will include books of account maintained in electronic mode;

- Access, at all times, to the records of all the subsidiaries (including associate companies and joint ventures as per Explanation to Section 129(3) of the 2013 Act) of the Company in so far as it relates to the consolidation of its financial statements, as envisaged in the 2013 Act;

- Access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the 2013 Act;

- additional information that we may request from the 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

- 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 Bank such information and explanations, as we may think necessary for the performance of our duties as auditor of the Bank;

- As part of our audit process, we will request from the 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.

Management's Responsibility on Internal Financial Controls over Financial Reporting

a. The management is responsible for establishing and maintaining adequate and effective internal financial controls for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

b. The management will make available to the auditor their evaluation and assessment of the adequacy and effectiveness of the company's internal financial controls, based on the control criteria.

c. The management is responsible to inform the auditor of any communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.

d. The management will provide its conclusion over the company's internal financial controls based on the control criteria set as of the balance sheet date.

e. The management is responsible to provide the component auditor's report under section 143(3)(i) in case of components that are covered under Companies Act, 2013 that form part of consolidated financial statements of the parent company.

The terms of reference for our audit of internal financial controls over financial reporting carried out in conjunction with our audit of the Company's financial statements will be as stated in the separate engagement letter for conducting such audit and should be read in conjunction with this letter.

3. Other Matters

My / Our report prepared in accordance with relevant provisions of the 2013 Act would be addressed to the shareholders of the Company for adoption of the accounts at the Annual General Meeting. In respect of other services, my / our report would be addressed to the Board of Directors. The form and content of my / our report may need to be amended in the light of my / our audit findings.

In accordance with the provisions of Section 143(12) and 143(13) of the 2013 Act, if in the course of performance of my / our duties as auditor, I / we have reason to believe that an offence involving fraud is being or has been committed against the Company by officers or employees of the Company, I / we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, *inter alia,* requires me / us to forward my / our report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me / us to forward the same to the Central Government. Such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

We also wish to invite your attention to the fact that, our audit process is subject to 'peer review'/ 'quality 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/quality review.

I / We may involve specialists and staff from my / our affiliated network firms to perform certain specific audit procedures during the course of my / our audit.

In terms of Standard on Auditing 720 – "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" issued by the ICAI and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, I / we request you to provide to me / us a Draft of the Annual Report containing the audited financial statements so as to enable me / us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor's report on the financial statements.

{Other relevant information}

{Insert Other information, such as fee arrangements, billings[35] and other specific terms, as appropriate.}

We look forward to full cooperation from your staff during our audit.

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.)

Date: (name of the firm)
Chartered Accountants

Place:

…………………………
(Signature)
(name of the member)
(Designation[36])

Acknowledged on behalf of ……………… …………………Bank

……………………..

(Signature)

Name and Designation

Date

Copy to: Chairman, Audit Committee

Attached: Letter of Acceptance duly signed by us.

[35]For example, "My / Our fees and out-of-pocket expenses for the audit of the financial statements for the year have been fixed by the members at the Annual General Meeting at Rs.____________, plus out-of-pocket expenses and indirect taxes/ will be mutually agreed between the Board of Directors of the Company and me / ourselves.* I / We will bill as the work progresses. I / We will notify you promptly of any circumstances. I / we encounter that could significantly affect my / our estimate of fees and discuss with you any additional fees, as necessary."

[36] Partner or proprietor, as the case may be.

APPENDIX X

Illustrative format of Engagement Letter to be Sent to the Appointing Authority of the Banking Company (Separate only for Internal Financial Control u/s 143(3)(i) of Companies Act, 2013)

Date:

The Board of Directors
__________________ Bank Limited
(Address)

Dear Sirs,

As per requirement of Section 143(3)(i) of the Companies Act, 2013 ("2013 Act"), we have to express our opinion on internal financial controls over financial reporting of (Name of Bank) (the 'Bank') as at March 31, XXXX in conjunction with our audit of the standalone and consolidated financial statements of the Bank for the year ended on that date.

We are pleased to confirm our understanding of the audit engagement by means of this letter.

Our audits will be conducted with the objective of expressing our opinion under Section 143(3)(i) of the Companies Act, 2013 ("2013 Act") on the adequacy of the internal financial controls system over financial reporting and the operating effectiveness of such controls as at March 31, 20X1 based on the internal control *criteria* established by you.

Audit of Internal Financial Controls Over Financial Reporting

We will conduct our audit of the internal financial controls over financial reporting in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ("the Guidance Note") and the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act 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, to the extent applicable to an audit of internal financial controls over financial reporting. These Guidance Note and Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness as at the balance sheet date.

An audit of internal financial controls over financial reporting involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness.

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.

Inherent Limitations in an Audit of Internal Financial Controls Over Financial Reporting

Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management's Responsibility

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

(a) For establishing and maintaining adequate and effective internal financial controls over financial reporting based on the internal control over financial reporting criteria established by the Bank considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India for ensuring the orderly and efficient conduct of its business, including adherence to Bank's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Act.

(b) To provide us with:

(i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Bank, whether kept at the head office of the Bank or elsewhere, of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) All information, such as records and documentation, and other matters that are relevant to our assessment of internal financial controls;

(iii) Management's evaluation and assessment of the adequacy and effectiveness of the Bank's internal financial controls, based on the control criteria established by the management and all deficiencies, significant deficiencies and material weaknesses in the design or operations of internal financial controls identified as part of management's evaluation.

(iv) Additional information that we may request from [management] for the purpose of the audit.

(v) 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 Bank such information and explanations as we may think necessary for the performance of our duties as auditor.

(vi) Any communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.

(vii) Management's conclusion over the Bank's internal financial controls based on the control criteria set above as at the balance sheet date [insert date].

(viii) Informing us of significant changes in the design or operation of the Bank's internal financial controls that occurred during or subsequent to the date being reported on, including proposed changes being considered.

(ix) Providing us with the component auditors' report under section 143(3)(i) in the case of components that are companies covered under the Companies Act 2013 for the purposes of our reporting in the case of the consolidated financial statements of the Bank.

(c) As part of our audit process, we will request from (management and, where appropriate, those charged with governance),written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' / ‘quality review’ under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of my / our working papers during the course of the peer review / quality review.

Reporting

Our audit report will be issued pursuant to the requirements of Section 143(3)(i) of the Act. The form and content of our report may need to be amended in the light of our audit findings.

Our opinion on the adequacy and operating effectiveness of internal financial controls over financial reporting in the case of the consolidated financial statements of the Bank, in so far as it relates to subsidiary companies, jointly controlled companies and associate companies incorporated in India, will be based solely on the reports of the auditors of such companies.

This letter should be read in conjunction with our letter dated ___ for the audit of the standalone and consolidated financial statements of the Bank under the Act.

We look forward to full co-operation from your staff during our audit.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the internal financial controls over financial reporting including our respective responsibilities.

Date: (name of the firm)

Chartered Accountants

Place:

…………………………

(Signature)

(name of the member)

(Designation[37])

Acknowledged on behalf of __________________{Insert Bank Name} Limited

Name and Designation:

Date:

[37] Partner or proprietor, as the case may be.

APPENDIX XI

Illustrative Format of Written Representation Letter[38] 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.

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[38] Kindly also refer Standard on Auditing (SA) 580, “Written Representations”.

2.3 In respect of assets other than fixed assets, the same have not been impaired and 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.

2.5 The Branch has not got any notice from the landlord for evacuation or redevelopment of the premises which may possibly necessitate shifting the branch premises in the near future.

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. Internal guidelines on periodic cash verification have been duly followed.

Fake notes received by the Bank have been duly impounded and relevant guidelines of RBI thereon have been complied.

Effective Dual custody of Cash has been maintained at all times during the financial year.

5. Liabilities

The branch has recorded all known and anticipated 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 or provisions in the books of accounts.

6.4 Frivolous claims from Customers / third parties have not been included in Contingent 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 2017-18.

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, 2017 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 (including all updated Internal Circulars issued till date, Receipt & disposal of Complaints & grievances) 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 along with necessary source documents as regards other matters which, as per the bank's letter of appointment, require certification, has been made available to you.

17. Demonetisation

The auditor should make an inquiry:

a) Whether the branch has any dealing in the demonetised currency during the year.
b) Whether the branch has any demonetised currency is in hand.
c) Whether there are any queries/issues pending with the Branch w.r.t. demonetisation and status of the compliance and whether it impacts the financial statements of branch/bank.
d) Whether any internal Audit / Special Audit / inspection has been conducted in respect of Demonetisation during the year and the outcome / compliance of such Audit / Inspection.

18. Information Provided

- We have provided you with:
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - Additional information that you have requested from us for the purpose of the audit; and
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.

- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
- Any other matters that the auditor may consider necessary.

19. 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.

20. 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.

21. FIMMDA guidelines have been followed, wherever applicable.

22. 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.

23. 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

APPENDIX XII

Illustrative Checklist on Audit Considerations in CIS environment

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, IT organization structure, IT Governance framework and control environment of the bank and the relation thereof to the preparation and presentation of financial statements?		
ii.	Have you obtained sufficient appropriate		

Sr. No.	Particulars	Yes/No/NA	Comments
	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, cyber frauds, frauds using computer etc. and root causes 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 used in sampling?		
ix.	Have you compared the outcome of testing		

Sr. No.	Particulars	Yes/No/NA	Comments
	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 the purpose of financial closure and subsequent accounting/reversal thereof?		

Sr. No.	Particulars	Yes/No/NA	Comments
	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 backup 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 of facilities? Special care needs to be taken while monitoring the excesses/over-limits in		

Sr. No.	Particulars	Yes/No/NA	Comments
	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 taken in case of new age products as, in some banks, these facilities may not fall		

Sr. No.	Particulars	Yes/No/NA	Comments
	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 capitalisation and amortisation thereof? (Due to voluminous transactions and internal processes involved in purchase of fixed assets, many banks		

Sr. No.	Particulars	Yes/No/NA	Comments
	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 verified that the same was error free and there are no pending issues having bearing on the preparation and presentation of financial statements with migration report?		
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.		

APPENDIX XIII

Illustrative Checklist on Bank Audit in Computerised Environment

I. Bank Audit in Computerised Environment

This Appendix is divided in two parts, viz., Part I deals with Bank Audit in Computerised Environment while Part II deals with Automatic Teller Machines. The checklists given therein is only illustrative in nature and members are expected to exercise their professional judgement while making its use 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 software 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 software, 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 software 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) were 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 almost over barring possibility few exceptions of 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 feedback 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 are 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 is important to check that the 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 to 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 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. Is bank staff 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 the 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 to not send confidential information via e-mail?
13. Are adequate summary-level reports 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 reviewed and vetted 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. Ensure that 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 Operating 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 in attempts.
g. Account lockout—reset the bad log in 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 a backup person.
3. Using the User Manager utility, review the following account property 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 to view and assess membership in the sensitive built-in groups: Administrators, Domain Administrators, and Account Operators. Assess the appropriateness of users assigned to these groups.
6. 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 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 of 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 log on 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 Net BIOS 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 Net BIOS 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 sine-qua-non of Banking in India. ATM houses one of the primary asset of the Bank i.e. 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 RBI.

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 of the ATMs. This can be a set policy or a contingent policy determined by the number of ATM units set up by the Bank. Cash replenishment can either be managed by the Bank itself or 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, 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 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. The 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 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?

APPENDIX XIV

Features of the Gold Monetization Scheme

The Broad features of the Gold Monetization Scheme are summarised below:

Acceptance of Deposits and Interest accretion	1. Deposits under the scheme are to be made at the a. Collection and Purity Testing Centre (CPTC) -the collection and assaying centres certified by the Bureau of Indian Standards (BIS) and notified by the Central Government for the purpose of handling gold deposited and redeemed under the Scheme, or b. designated bank branches, where, at their discretion, banks may accept the deposit of gold. 2. Minimum Deposits -With no maximum limit for deposit, the minimum deposit at any one time shall be raw gold (bars, coins, jewellery, excluding stones and other metals) equivalent to 30 grams of gold (of 995 fineness only). 3. Assaying of Gold - All gold deposited under the scheme, whether tendered at the CPTC or designated bank branches, shall, (except standard good delivery gold accepted at the designated branches), be assayed at CPTC for fire assaying. 4. Interest on such deposits accrues from the date of conversion of gold deposited into tradable gold bars after refinement or 30 days after the receipt of gold at the CPTC or the bank's designated branch, as the case may be, whichever is earlier. 5. Gold deposited to be treated as an item in safe custody - Between the date of acceptance of the gold and till commencement of the date of accretion of interest, the gold deposited shall be treated as an item in safe custody held by the designated bank.
Valuation	On the day the gold deposited starts accruing interest, the designated banks shall translate the gold liabilities and

	assets in Indian Rupees*. The prevalent custom duty for import of gold will be added to the above value to arrive at the final value of gold. This methodology will also be followed for valuation of gold at any subsequent valuation date(s) and for the conversion of gold into Indian Rupees under the Scheme. *(*by crossing the London AM fixing for Gold / USD rate with the Rupee-US Dollar reference rate announced by RBI on that day)*
Reporting to RBI	The designated banks will be required to submit a monthly report on GMS to the RBI in the prescribed format. However, as per RBI Circular No. DGBA GAD No 2294/15.04.001/2016-17 dated March 6, 2017, in order to have uniformity in reporting, reconciliation and accounting, agency banks may report the Gold Monetisation Scheme transactions i.e., receipt, payment, penalty, interest, commission for mobilisation, handing charges, etc., directly through the government account maintained for the purpose at Central Accounts Section, Reserve Bank of India, Nagpur, on a daily basis.
Opening of Gold Deposit Account *(opened with a designated bank under the Scheme and denominated in grams of gold)*	Customer identification criteria as applicable to any other deposit accounts*(KYC norms),*shall apply and non-customers can open a gold deposit account with zero balance at any time prior to tendering gold at the CPTC. The designated banks will credit/record the STBD or MLTGD, as the case may be (with the amount of 995 fineness gold as indicated in the advice received from CPTC), after 30 days of receipt of gold at the CPTC, *regardless of whether the depositor submits the receipt for issuance of the deposit certificate or not.* ***<u>Tendering of gold to CPTC</u>*** Before tendering the raw gold to a CPTC, the depositor shall indicate the name of the designated bank with whom he would like to place the deposit. After assaying the gold, the CPTC will issue a receipt

	signed by authorised signatories of the centre showing the standard gold of 995 fineness on behalf of the designated bank indicated by the depositor. Simultaneously, the CPTC will also send an advice to the designated bank regarding the acceptance of deposit. ***<u>Fee to CPTC</u>*** If in agreement with result of the fire assay test, the customer will exercise his option to deposit the gold with the bank and the fee charged by the CPTC will be borne by the bank. In case of any disagreement with the fire assay result, the customer will have the option to take back the melted gold after paying a nominal fee to the centre. ***<u>Documentation</u>*** Standard documentation (designed by IBA including application form for tendering raw gold to the assaying centers, the description of the physical appearance/ characteristics of gold, recording of the results of XRF by the assaying centre, customer's consent for melting the gold for fire-assaying and for making the final deposit, the final receipt to be issued to the depositor), are to be made known and available to the CPTCs and to the depositor upfront and should include all the terms and conditions of the Scheme including the schedule of charges. -- *(The 995 fineness equivalent amount of gold as determined by the CPTC will be final and any difference in quantity or quality found after issuance of the receipt by the CPTC including at the level of the refinery due to refinement or any other reason shall be settled among the three parties viz., the CPTC, the refiner and the designated bank in accordance with the terms of the tripartite agreement to be entered into.)*
Types of deposits	1.Short Term Bank Deposit (STBD) 2.Medium and Long Term Government Deposit (MLTGD)

Short Term Bank Deposit (STBD)	**Duration -** for a short term period of 1-3 years *(with a roll over in multiples of one year),* to be treated by banks as their on-balance sheet liability; the duration being subject to such minimum lock-in period and penalties, if any, as may be determined by the banks as per their laid down policy. Interest-banks are free to fix the interest rates; and the interest shall be credited in the deposit accounts on the respective due dates and will be withdrawable periodically or at maturity as per the terms of the deposit. Redemption of principal and interest at maturity will, at the option of the depositor be either in Indian Rupee equivalent of the deposited gold and accrued interest based on the price of gold prevailing at the time of redemption, or in gold. The option in this regard shall be made in writing by the depositor at the time of making the deposit and shall be irrevocable: Premature redemption, if any, shall be in Indian Rupee equivalent or gold at the discretion of the designated bank. ***Imports permitted by designated banks for redemption*** The designated banks other than the nominated banks shall be eligible to import gold only for redemption of the gold deposits mobilised under the STBD. *(Nominated bank – A Scheduled Commercial Bank authorized by RBI to import gold in terms* of RBI circular A.P.(DIR Series) Circular No.79 dated February 18, 2015) **CRR and SLR** CRR and SLR requirements apply (as per instructions of RBI) from the date of credit of the amount to the deposit account. However, the stock of gold held by banks in their books will be an eligible asset for meeting the SLR requirement in terms of RBI Master Circular - Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

	dated 1 July 2015. **<u>End use</u>** In respect of gold mobilised under the STBD, the designated banks may: ○ sell the gold to MMTC for minting India Gold Coins (IGC), to jewellers and to other designated banks participating in GMS; or ○ lend the gold under the GML scheme to MMTC for minting India Gold Coins (IGC) and to jewellers.
Medium and Long Term Government Deposit (MLTGD)	Deposits shall be accepted by the designated banks on behalf of the Central Government *and shall constitute the liability of Central Government; and the receipts issued by the* Collection and Purity Testing Centre (CPTC) - the collection and assaying centres certified by the Bureau of Indian Standards (BIS) and notified by the Central Government for the purpose of handling gold deposited and redeemed under the Scheme, *and the deposit certificate issued by the designated banks shall clearly state this.* *Accordingly,* such deposits shall not be reflected in the balance sheet of the designated banks. Reserve Bank of India will maintain the Gold Deposit Accounts denominated in gold in the name of the designated banks that will in turn hold sub-accounts of individual depositors. Control over the gold deposited - The designated banks will hold the gold deposited on behalf of Central Government until it is transferred to such person as may be determined by the Central Government. The gold received under MLTGD will be auctioned by the agencies notified by Government and the sale proceeds will be credited to Government's account held with RBI. The details of auctioning and the accounting procedure will be notified by Government of India. Duration - the deposit can be made for a medium term period of 5-7 years or a long term period of 12-15 years or

	for such period as may be decided from time to time by the Central Government. (*The designated banks may allow whole or part premature withdrawal* of the deposit subject to such minimum lock-in period and penalties, if any, as determined by the Central Government.) Redemption of the deposit including interest accrued - Redemption will be only in Indian Rupee equivalent of the value of the gold and accumulated interest as per the price of gold prevailing at the time of redemption. However, as per RBI Circular No. DGBA.GBD.No.1007/15.04.001/2017-18 dated October 17, 2017. - Reimbursement of payments made by banks, relating to Medium and Long Term Government Deposit (MLTGD), will be made by Central Account Section (CAS), Nagpur, RBI. - Accordingly, banks are advised to pay immediately the interest amount already due to the depositors and to take note that, in future, payment of interest to the depositors is to be made on the due dates. After making payments, the banks may raise claim to Government through RBI (CAS, Nagpur). ***<u>End Use:</u>*** Gold accepted under MLTGD will be auctioned by MMTC or any other agency authorized by the Central Government and the sale proceeds credited to the Central Government's account with RBI. The entities participating in the auction may include RBI, MMTC, banks and any other entities notified by the Central Government in this regard. Gold purchased by designated bank under the auction may be utilized by them and they may : o sell the gold to MMTC for minting India Gold Coins (IGC), to jewellers and to other designated banks participating in GMS; or o lend the gold under the Gold Metal Loan (GML)

	Scheme to MMTC for minting India Gold Coins (IGC) and to jewellers.
Tripartite agreement between the designated banks, refiners and CPTCs	The designated bank shall enter into a legally binding tripartite agreement with the refiners and CPTCs with whom they tie up under the Scheme; the refiners being refineries accredited by the National Accreditation Board for Testing and Calibration Laboratories(NABL) and notified by the Central Government for the purpose of handling gold deposited and redeemed under GMS. The agreement shall cover nature of services to be provided, standards of service, arrangements regarding movement of gold, payment of fees and rights and obligations of the parties.
Transfer of gold to the Refiners	The CPTCs will transfer the gold to the refiners as per the terms and conditions set out in the tripartite agreement. The refined gold may, at the option of the designated bank, be kept in the vaults maintained by the refiners or at the branch itself. For the services provided by the refiners, the designated banks will pay a fee as decided mutually. The refiners shall not collect any charge from the depositor.
Oversight over the CPTCs and Refineries	1. The Central Government: • in consultation with BIS, NABL, RBI and IBA, may put in place appropriate supervisory mechanism over the CPTCs and the refiners so as to ensure observance of the standards set out for these centres by Government (BIS and NABL). • may take appropriate action including levy of penalties against the non-compliant CPTCs and refiners. • may put in place appropriate grievance redress mechanism regarding any depositor's complaints against the CPTCs. 2. Complaints against the designated banks regarding any discrepancy in issuance of receipts and deposit

	certificates, redemption of deposits, payment of interest will be handled first by the bank's grievance redress process and then by the Banking Ombudsman of RBI.
Risk management	The designated banks should put in place suitable risk management mechanisms including appropriate limits to manage the risk arising from gold price movements in respect of their net exposure to gold. The designated banks are allowed to access the International Exchanges, London Bullion Market Association or make use of Over-the-counter contracts to hedge exposures to bullion prices subject to the guidelines issued by RBI.

APPENDIX XV

Illustrative Audit Checklist for Capital Adequacy

The checklist is only illustrative in nature. Members are expected to exercise their professional judgment while using the checklist depending upon facts and circumstances of each case.

Audit Procedures	
CET 1, AT 1 and Tier II	
1. Tally the balances in the various elements of Capital from the trial balance/ groupings/ draft financial statements	
2. Check whether various instruments comply with the guidelines as laid down in the Master Circular by referring to the Terms of Offer and whether the same are approved by the Board or other appropriate committee	
3. Check whether appropriate discounting has been applied in the case of instruments issued	
4. In case of foreign banks, examine whether the undertaking has been obtained that the bank would not remit abroad the funds received and shown as Capital Reserve or Remittable Surplus	
5. Examine whether various limits upto which individual elements are to be included in CET1, AT1 and Tier II capital as laid down in the Master Circular are adhered to.	
6. Verify various deductions with the balances in the audited accounts and check the same for limits and eligibility (e.g. securitisation exposure) as laid down in the Master Circular.	
7. Verify the correctness of progressive discount based on the remaining maturity of instruments eligible for AT1 and Tier II	
Capital Charge on Credit Risk	

The capital charge for credit risk is the sum total of the capital charge to be maintained in respect of the 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	
2. Review and document the process of compilation and mapping of the various items on balance sheet based on the categories and their risk weights together with the appropriate ratings and / or other conditions, as applicable.	
3. For a sample of transactions verify the ratings with the letters issued by the rating agencies and accordingly check the correctness of the risk weights assigned.	
4. In cases where the risk weights are	

dependent on the fulfilment of certain conditions (other than ratings) verify the compliance therewith based on the appropriate documentary evidence. (e.g. claims on banks, regulatory retail portfolio, claims against residential property etc.)	
5. Verify the validity of guarantees issued by Central or State Government. Verify whether the bank has properly classified claims on State Government and claims guaranteed by State Government due to difference risk weight.	
6. Verify the correctness of claims on CGTSI and ECGC	
7. Verify the classification of loans – restructured loans/ NPAs/ NBFC/ CRE/ CRE-RH etc.	
8. Verify LTV ratio on a test check basis in respect of housing loans	
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.	
5. Verify the classification of Financial and Performance Guarantee by perusing the sample guarantee issued by the branches	
6. Verify whether bills accepted under Letter of Credit is assigned 100% risk weight as CCF	
7. Verify whether the bank has proper control for accounting Buyer's credit/ Letter of Comfort	
8. Verify the correctness of undrawn exposures	
Capital Charge – Failed Transactions	
1. Review and document the procedures for tracking and monitoring the credit risk exposure arising from unsettled transactions, both on Delivery Versus Payment (DVP) and non DVP basis.	
2. For a sample of DVP transactions, examine	

whether the settlement has taken place on a timely basis. In case of delays, check the calculation of the capital charge by multiplying the positive current exposure by the prescribed factor depending upon the number of days delayed.	
3. For a sample of non-DVP transactions, examine whether the settlement has taken place as per the contracted maturity. In case of delays, ascertain whether any payment made is considered as a loan and the appropriate risk weight is considered. In case of settlement beyond five days ascertain whether the full amount is deducted from the capital.	
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, examine whether they meet with the qualifying criteria with regard to the LTV ratio and other factors and accordingly check the assignment of the risk weight for the unsecured portion depending upon the level of provisioning.	
3. For a sample of NPAs other than residential mortgages check the assignment of the risk weight based on the level of provisioning.	
4. In respect of 3 above for identifying the secured portion examine whether only eligible collateral are considered and the same are properly documented and the bank has a clear and marketable title to realise the same.	
5. Verify whether bucketing in difference risk weight in respect of NPAs based on NPA provision is carried out by the system and	

verify the correctness of classification on a test check basis	
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.	
Examine whether the securitisation transactions fulfil the requirements as prescribed in Master Circular on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework" (extract of the 'Revision to the Guidelines on Securitisation Transactions', issued vide circular DBOD.No.BP.BC.103/ 21.04.177/ 2011-12 dated May 07, 2012 on 'Revision to the Guidelines on Securitisation Transactions') to be eligible for deduction from capital.	
1. Based on the above, for a sample of transactions / deals examine whether the prescribed deduction from both CET 1, AT I and Tier II capital has been correctly done based on the rating and the level of provisions. Review the necessary documentation in support of the same.	
2. Based on the above ascertain whether the appropriate risk weights have been assigned.	
Collateral Risk Management and Credit Risk Mitigation	
The objective of collateral risk management is to ensure that only the eligible collateral are considered for netting off which are adjusted for volatility depending upon the nature of the capital and further subjected to various types of haircuts for different categories of mismatches like currency and tenor mismatches.	
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. Examine whether the bank has complete legal rights to enforce the security including specific lien and is subject to haircuts for residual tenor mismatch and currency mismatch. Check the necessary documentation in respect thereof.	
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 Exposure to Entities with Unhedged Foreign Exchange Exposures (UFCE)[39]	
1. Ascertain the amount of the UFCE: UFCE may exclude items which are effective	

[39] RBI/2013-14/448 DBOD.No.BP.BC. 85 /21.06.200/2013-14 dated January 15, 2014.

hedge against each other viz. financial hedge and natural hedge.

2. Estimate the extent of likely loss
3. Estimate the riskiness of the unhedged position and provide appropriately:

Likely Loss/EBID (%)	Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning	Incremental Capital Requirement
Upto15 per cent	0	0
More than 15 per cent and upto 30 per cent	20bps	0
More than 30 per cent and upto 50 per cent	40bps	0
More than 50 percent and upto 75 per cent	60bps	0
More than 75 per cent	80 bps	

Banks should calculate the incremental provisioning and capital requirements at least on a quarterly basis . However, during the periods of high USD-INR volatility, the calculations may be done on a monthly basis.

Capital Charge for Operational Risk

Currently banks are required to maintain capital charge for operational risk at 15% 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. Examine whether the various deductions from the net profit are appropriately considered.	

- For computing the gross income for determining the capital to be held against operational risk, there is a clarification that the same should be considered based on the average of the last three financial years. However, there is no clarity as to whether this includes the current financial year though the better practice would be to consider the average of the preceding three years.

APPENDIX XVI

Illustrative Audit Checklist for Service Tax

The checklist for auditors for the period April 1, 2017 to June 30, 2017 is only illustrative in nature. Members are expected to exercise their professional judgment while using the checklist depending upon facts and circumstances of each case.

Head Office

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 have 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? i.e. Centralised Registration
- Whether the head office have filed the return of service tax on half yearly basis, i.e., for the half-year ending on 30th September and on 31st March within 25 days from the end of each half-year? (Form ST-3 (format) was updated through Notification no. 43/2016-ST, dated 28th September, 2016).
- Whether the head office have filed the return of service tax for quarter ended on 30.06.2017 and the return has been filed upto 31.08.2017
- Whether the head office has made the payment of service tax so collected monthly, by 6th day of the following month. For the month of March, the payment should be made by 31st day of March. Online payment of Service Tax is mandatory since 1st October, 2014.
- Whether bank has discharged the interest liability under section 75 of the 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 on input services have been taken on the basis of proper documents containing all particulars as prescribed by rule 4A of Service Tax Rules, 1994 read with Rule 9 of the CENVAT Credit Rules, 2004, i.e., serially numbered invoice/bill, etc. containing the requisite information like, Name and address of the service provider, Service Tax Registration Number, Description of the services, Amount of the service tax, Name, address of the recipient 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 read with Rule 9 of the CENVAT Credit Rules, 2004, 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.?
- Whether the credit is taken in respect of input services at the time of receipt of invoice. Further, in case payment is not made within 3 months from the date of invoice, credit has to be reversed and bank will be eligible to re-avail credit after making payment to vendor.
- Whether the credit taken in respect of services covered under full as well as partial reverse charge mechanism is taken only after making payment of Service Tax.
- Whether the bank have not availed the credit in respect of reverse charge more than the payment made for service tax?
- Whether the banking company or a financial institution including a non-banking financial company has either paid for every month an amount equal to 50 % of the CENVAT credit availed on inputs and input services in that month or with effect from 01.04.2016 credit has been reversed in respect of exempted services on actual basis?
- Whether the Bank has made repayment of CENVAT Credit availed in respect of capital goods removed after being used? Bank is required to pay an amount equal to the CENVAT Credit taken on the said capital goods reduced by 2.5 per cent for each quarter (for computers 10%, 8%, 5% and 1% respectively for each quarter in the first year, second year, third year, fourth & fifth year) of a year or part thereof from the date of

taking the CENVAT Credit. In case, duty calculated on transaction value is more than amount calculated by way of % specified supra, Bank has to pay amount equal to excise duty on transaction value.

- In case, capital goods are cleared as waste and scrap, Bank has to pay an amount equal to duty leviable on transaction value.
- In case, value of inputs or capital goods before being put to use is written off/provision to write off fully or partially has been made in books, bank has to reverse amount equivalent to CENVAT Credit taken.
- In case of removal of goods as such, bank has to reverse 100% amount of CENVAT Credit availed.
- Whether return for the period April 1, 2017 to June 30, 2017 has been filed before August 31, 2017 and revised return, if any, is filed till October 15, 2017 pursuant to Circular No. 207/5/2017- Service Tax, Dated September 28, 2017?
- It is pertinent to mention that in case of reverse charge, since the ITC is available only after payment of service tax. Therefore-
    - Check whether, the details of payment are indicated in Part I of Form ST-3 in entries, 13.1.2.6, 13 2.2.6 and 13 3.2.6 and linked entries are made in Part H of Form ST-3 where service was received before 1-7-2017 and payment for the value of such services are made after 30.06.2017 but by 5 or 6.07.2017 (*vide above circular*)
    - Check whether revise return is filed till October 15,2017 where service was received before 1-7-2017 and payment for the value of such services was made after 30.06.2017 but by 5or 6.07.2017, indicating such payment in Part I of revised Form ST-3 in entries, 13.1.2.6, 13 2.2.6 and 13 3.2.6 and linked entries in Part H of revised Form ST-3?
- Whether the Bank has submitted (in compliance of requirement of provision of rule 5(2) of Service Tax Rules, 1994) a list of records maintained by Bank to the concerned Superintendent, Service Tax. Whether bank maintains the records specified by it in terms of Notification no. 45/2007-ST dated 28.12.2007?

Branch

- 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 has issued the proper guidelines in respect of taxable and exempted services?
- 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 so collected monthly, by 6^{th} day of the following month. For the month of March, the payment should be made by 31^{st} day of March. Online payment of service tax is mandatory since 1^{st} October, 2014.
- 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 return of service tax on half yearly basis, i.e., for the half-year ending on 30^{th} September and on 31^{st} March within 25 days from the end of each half-year, in Form ST-3? (Form ST-3 (format) is updated through Notification no. 43/2016-ST, dated 28^{th} September, 2016~~)~~
- Whether the branches have filed the return of service tax for quarter ended on 30.06.2017, and return for the quarter ended on 30.06.17 has been filed upto 31.08.2017?
- 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 on input services on the basis of proper documents containing all particulars as prescribed by rule 4A of Service Tax Rules, 1994 read with Rule 9 of the CENVAT Credit Rules, 2004, 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, Amount of the service tax, Name, address 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 read with Rule 9 of the CENVAT Credit Rules, 2004, 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.?

- Whether the credit is taken in respect of input services at the time of receipt of invoice. Further, in case payment is not made within 3 months from the date of invoice, credit has to be reversed and bank will be eligible to re-avail credit after making payment to vendor.
- Whether the credit taken in respect of services covered under full as well as partial reverse charge mechanism is taken only after making payment of Service Tax.
- Whether the bank have not availed the credit in respect of reverse charge more than the payment made for service tax?
- Whether the banking company or a financial institution including a non-banking financial company has either paid for every month an amount equal to 50% of the CENVAT credit availed on inputs and input services in that month or with effect from 01.04.2016 credit has been reversed in respect of exempted services on actual basis?
- Whether the Bank has made repayment of CENVAT Credit availed in respect of capital goods removed after being used? Bank is required to pay an amount equal to the CENVAT Credit taken on the said capital goods reduced by 2.5 per cent for each quarter (for computers 10%, 8%, 5% and 1% respectively for each quarter in the first year, second year, third year, fourth & firth year) of a year or part thereof from the date of taking the CENVAT Credit. Further, the aforesaid percentage is to be computed on Straight Line Method. In case, duty calculated on transaction value is more than amount calculated by way of % specified supra, Bank has to pay amount equal to excise duty on transaction value.*[Refer proviso to Rule 3(4) of the CENVAT Credit Rules, 2004*]
- In case, capital goods are cleared as waste and scrap, Bank has to pay an amount equal to duty leviable on transaction value.
- In case, value of inputs or capital goods before being put to use is written off/provision to write off fully or partially has been made in books, bank has to reverse amount equivalent to CENVAT Credit taken in respect of said input or capital goods.
- In case of removal of goods as such, bank has to reverse 100% amount of CENVAT Credit availed.
- Where any input or capital goods are removed outside the premises of the bank for providing Banking or Other Financial Services, no reversal of CENVAT Credit is required.
- Whether the banks (HO/ZO/RO) 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 branches are registered under single registration basis and HO/ZO/RO has availed some common services on behalf of branches? 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, challan, bill, invoice or any other documents issued to the customer for the services rendered by the Bank?
- 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?
- Whether return for the period April 1, 2017 to June 30, 2017 has been filed before August 31,2017 and revised return, if any, is filed till October 15, 2017 pursuant to Circular No. 207/5/2017-Service Tax, Dated September 28, 2017?
- It is pertinent to mention that in case of reverse charge, since the ITC is available only after payment of service tax. Therefore-
  - Check whether, the details of payment are indicated in Part I of Form ST-3 in entries, 13.1.2.6, 13 2.2.6 and 13 3.2.6 and linked entries are made in Part H of Form ST-3 where service was received before 1-7-2017 and payment for the value of such services are made after 30.06.2017 but by 5 or 6.07.2017 (vide above circular)
  - Check whether revise return is filed till October 15,2017 where service was received before 1-7-2017 and payment for the value of such services was made after 30.06.2017 but by 5or 6.07.2017, indicating such payment in Part I of revised Form ST-3 in entries, 13.1.2.6, 13 2.2.6 and 13 3.2.6 and linked entries in Part H of revised Form ST-3?

APPENDIX XVII

Illustrative Audit Checklist for Goods and Services Tax

The checklist for auditors is only illustrative in nature. Members are expected to exercise their professional judgment while using the checklist depending upon facts and circumstances of each case.

- Whether the registered person has properly availed the Input Tax Credit of the GST paid on the input services, input, capital goods as the case may be?
- Whether GST have been properly charged by the head office, regional offices, zonal offices in case of inter unit / branch transactions?
- Whether the registered person have filed the applicable returns on timely basis as notified by the Government?
- Whether the registered person has made the payment of GST on timely basis?
- Whether the head office has not availed depreciation u/s 32 of the Income Tax Act, 1961 on the amount of GST on the capital goods on which input tax credit has been availed?
- Whether GST have been paid on reverse charge basis on the services procured from supplier in terms of Section 9(3) of the CGST Act?
- Whether GST have been paid on reverse charge basis on the goods/services procured from the unregistered supplier in terms of Section 9(4) of the CGST/SGST Act, for the period July 1,2017 till October 12, 2017, if aggregate value of supplies of goods or services or both received by a registered person from any or all the suppliers, who is or are not registered, exceeds Rs. 5000/- in a day?
- Similarly, whether GST has been paid, in respect of each GST-registered location, on reverse charge basis on inter-State inward supplies from unregistered suppliers for the period July 1, 2017 till October 12, 2017?
- Whether sale or lease of vehicles procured prior to 1st July, 2017 and on which any Input Tax Credit has not been availed of Central Excise duty, VAT or any other taxes paid on such motor vehicles be subject to 65% of applicable GST rate?

- Whether IGST have been paid at the point of importation in case of high seas sales?
- Whether GST have been paid on advances paid by the banks to the unregistered persons under section 9(4) of the CGST Act till 12th October, 2017?
- Whether GST have been paid on advances paid by the banks to the specified registered persons under section 9(3) of the CGST Act such as sponsorship services, GTA services, etc.?
- Whether all inward supplies (whether creditable or not) flow into the books of the bank through the GSTR-1 of any registered supplier? If not, have such supplies been reported in GSTR-2 under section 9(3) of CGST Act / 5(4) of IGST Act, even if no tax is payable from 13th October, 2017?
- Whether in respect of each inward supply where no tax has been paid, is there is a clear disclosure made to the auditors as to the reasons for the tax position taken in each case? Auditor may examine, if the tax position taken requires to be reported in the audit report or other communication?
- Whether IGST has been paid on 'import of services'?
- Whether the GTA amount have been capitalised under the head Fixed Assets?
- 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 CGST Rules read with section 31 of the CGST Act, 2017, i.e., serially numbered invoice / bill not exceeding sixteen characters, containing the requisite information like, Name, address and GST Number of Bank, Name, address and Goods and Services Tax No. of recipient, date of issue, HSN Code of goods, etc.?
- Similarly, whether the bank has taken the CENVAT Credit in respect of services on the basis of proper duty paying documents, containing all particulars as prescribed by CGST Rules read with section 31 of the CGST Act, 2017, i.e., serially numbered invoice / bill not exceeding sixteen characters, containing the requisite information like, Name, address and GST Number of Bank, date of issue, amount of the credit distributed, etc.?

▪ Whether an amount equal to the input tax credit availed by the recipient added to output tax liability of supplier along with interest, where the recipient fails to pay supplier of goods or services an amount towards the value of supply along with tax payable within 180 days from the date of issue of invoice by the supplier?

- Whether the credit taken in respect of services covered under reverse charge mechanism is taken only after making payment of GST?
- Whether the banking company or a financial institution including a non-banking financial company has either availed of, every month, an amount equal to 50%. of the eligible input tax credit on inputs, capital goods and input services in that month OR has availed the amount of the input tax credit attributable to the taxable supplies including zero-rated supplies?
- Whether the banks have taken the Registration of GST within 30 days from the date on which he becomes liable to registration or the date of start of business of the branch, whichever is later?
- Whether the banks (HO/ZO/RO) have sought registration as input service distributor under CGST Rules, 2017 or whether the supplies centrally procured have been treated as outward supply from HO/ZO/RO to respective branches? Unlike earlier laws, GST permits registration as input service distributor to an office that does not have any outward supplies and is one that merely receives invoices for such supplies and distributes credit to recipient branches.
- In either case, auditor shall ensure that the returns are being regularly filed. Auditor shall also ensure that if the respective office is registered as 'input service distributor', whether invoice is issued for distributing the Input Tax Credit as per Rule 54 of the CGST Rules, 2017?
- 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 GST number on the statement, challan, bill, invoice or any other documents issued to the customer for the services rendered by the Bank?
- Whether bank maintains the records specified by Rule 56 of the CGST Rules, 2017?
- Whether the branches have made arrangements to ensure that GST is not collected on the interest amount?

III

Suggested Abbreviations used in the Banking Industry

Abbreviations have often been found to be used by the banking industry and in the Circulars/ guidelines/directions of the Reserve Bank of India. It is appropriate to understand what these abbreviations are:

Abbreviation	Expanded form
AACS	As Applicable to Co-operative Societies
ACF	Auto-Correlation Function
AD	Authorised Dealer
ADB	Asian Development Bank
ADR	American Depository Receipt
AE	Aggregate exposure
AFS	Annual Financial Statement
AFS	Available For Sale
AGM	Annual General Meeting
AICCCA	Association of Independent Consumer Credit Counseling Agencies
AIFI	All-India Financial Institution
AIRCSC	All India Rural Credit Survey Committee
ALM	Asset-Liability Management
AMC	Asset Management Company
AML	Anti-Money Laundering
AO	Additive Outliers
AR	Auto Regression
ARC	Asset Reconstruction Company
ARCIL	Asset Reconstruction Company (India) Ltd.
ARIMA	Auto-Regressive Integrated Moving Average
ASSOCHAM	Associated Chambers of Commerce and Industry of India
ATM	Asynchronous Transfer Mode
ATM	Automated Teller Machine

BCBS	Basel Committee on Banking Supervision
BCP	Business Continuity Planning Process
BCSBI	Banking Codes and Standards Board of India
BFS	Board for Financial Supervision
BG	Bank Guarantees
BIFR	Board for Industrial and Financial Reconstruction
BIS	Bank for International Settlements
BIS	Bureau of Indian Standards
BoP	Balance of Payments
BOS	Banking Ombudsman Scheme
BOT	Build-Operate-Transfer
BPLR	Benchmark Prime Lending Rate
BPM5	Balance of Payments Manual, 5th edition
BPSD	Balance of Payments Division, DESACS, RBI
BPSS	Board for Payment and Settlement Systems
BSC	Balanced Scorecard
BSCS	Basel Committee on Banking Supervision
BSE	Bombay Stock Exchange Ltd.
BSR	Basic Statistical Return
CAD	Capital Account Deficit
CAG	Controller and Auditor General of India
CALCS	Capital Adequacy, Asset Quality, Liquidity, Compliance and System
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and control
CAP	Corrective Action Plan
CBLO	Collateralised Borrowing and Lending Obligation
CBS	Core Banking Solutions
CBS	Consolidated Banking Statistics
CC	Cash Credit
CCCS	Consumer Credit Counseling Service
CCDM	Credit Counseling and Debt Management
CCIL	Clearing Corporation of India Ltd.
CCP	Central Counter Party
CD Ratio	Credit Deposit Ratio

CD	Certificate of Deposit
CDBMS	Central Data-base Management System
CDBS	Committee of Direction on Banking Statistics
CDF	Co-operative Development Fund
CDR	Corporate Debt Restructuring
CDRM	Corporate Debt Restructuring Mechanism
CEO	Chief Executive Officer
CF	Company Finance
CFMS	Centralised Funds Management System
CFRA	Combined Finance and Revenue Accounts
CFS	Consolidated Financial Statements
CFT	Combating Financing of Terrorism
CGFT	Credit Guarantee Fund Trust
CGRA	Currency and Gold Revaluation Account
CGTSI	Credit Guarantee Trust for Small Industries
CRGFTLIH	Credit Risk Guarantee Fund Trust for Low Income Housing
CGTMSE	Credit Guarantee Fund Trust For Micro And Small Enterprises
CIBIL	Credit Information Bureau of India Limited
CII	Confederation of Indian Industries
CIN	Corporate Identity Number
CLCC	Central Labour Co-ordination Committee
CLF	Collateralised Lending Facility
CME	Capital Market Exposure
CMP	Conflict Management Policy
CO	Capital Outlay
COBIT	Control Objectives for Information and related Technology
CP	Commercial Paper
CPC	Cheque Processing Centre
CPI	Consumer Price Index
CPI-IW	Consumer Price Index for Industrial Workers
CPOS	Central Point of Supervision
CPPAPS	Committee on Procedures and Performance Audit on Public Services
CPSS	Committee on Payment and Settlement System

CPTC	Collection and Purity Testing Centre
CR	Capital Receipts
CRAR	Capital to Risk-Weighted Asset Ratio
CRCS	Central Registrar of Co-operative Societies
CRE	Commercial Real Estate
CRE – RH	Commercial Real Estate – Residential Housing Sector
CRILC	Central Repository of Information on Large Credits
CRR	Cash Reserve Ratio
CSA	Co-operative Societies Act
CSD	Customer Service Department
CSGL	Constituent Subsidiary General Ledger
CSIR	Council of Scientific and Industrial Research
CSO	Central Statistical Organisation
CTR	Cash Transaction Report
CTS	Cheque Truncation System
CVC	Central Vigilance Commission
D&B	Dun & Bradstreet Information Services India (P) Ltd.
DAPs	Development Action Plans
DBOD	Department of Banking Operations and Development
DBS	Department of Banking Supervision
DCA	Debtor creditor agreement
DCB	Demand Collection and Balance
DCCB	District Central Co-operative Banks
DCCO	Date of Commencement of Commercial Operations
DCM	Department of Currency Management, RBI
DCRR	Department for Co-operative Revival and Reforms
DD	Demand Draft
DDS	Data Dissemination Standards
DEIO	Department of External Investments and Operations
DESACS	Department of Statistical Analysis & Computer Services, RBI
DFI	Development Finance Institution
DGBA	Department of Government and Bank Accounts, RBI
DGCI&S	Directorate General of Commercial Intelligence and Statistics

DI	Direct Investment
DICGC	Deposit Insurance and Credit Guarantee Corporation of India
DID	Discharge of Internal Debt
DLIC	District Level Implementation and Monitoring Committee
DMA	Direct Marketing Agent
DNSS	Deferred Net Settlement System
DP	Drawing Power
DPSS	Department of Payment and Settlement Systems
DRI	Differential Rate of Interest
DRT	Debt Recovery Tribunal
DSA	Direct Sales Agent
DSBB	Dissemination Standards Bulletin Board
DTL	Demand and Time Liability
DvP	Delivery *versus* Payment
EBR	Export Bills Rediscounted
ECB	External Commercial Borrowing
ECB	European Central Bank
ECGC	Export Credit and Guarantee Corporation
ECS	Electronic Clearing Service
EDMU	External Debt Management Unit
EEA	Exchange Equalization Account
EEC	European Economic Community
EEFC	Exchange Earners Foreign Currency
EFR	Exchange Fluctuation Reserve
EFT	Electronic Funds Transfer
EME	Emerging Market Economy
EPF	Employees Provident Fund
ESOP	Employee Stock Option Plans
ETF	Empowered Task Force
EUR	Euro
EWS	Early Warning System
EXIM Bank	Export Import Bank of India
FAQs	Frequently Asked Questions
FCA	Foreign Currency Assets

FCAC	Fuller Capital Account Convertibility
FCCB	Foreign Currency Convertible Bond
FCNR (B)	Foreign Currency Non-Resident (Banks)
FCNR	Foreign Currency Non-Resident
FCNRA	Foreign Currency Non-resident Account
FCNRD	Foreign Currency Non-Repatriable Deposit
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation
FEDAI	Foreign Exchange Dealers Association of India
FEMA	Foreign Exchange Management Act
FFI	Foreign Financial Institution
FFMC	Full Fledge Money Changer
FI	Financial Institution
FICCI	Federation of Indian Chambers of Commerce and Industry
FII	Foreign Institutional Investor
FIPB	Foreign Investment Promotion Board
FISIM	Financial Intermediation Services Indirectly Measured
FITL	Funded Interest Term Loan
FIU-IND	Financial Intelligence Unit – India
FLAS	Foreign Liabilities and Assets Survey
FMC	Forward Market Commission
FMD	Financial Markets Department
FOF	Flow Of Funds
FPI	Foreign Portfolio Investment
FRA	Forward Rate Agreement
FRB	Floating Rate Bond
FRBM Act	Fiscal Responsibility and Budget Management Act
FRMS	Fraud Reporting and Monitoring System
FRN	Floating Rate Note
FSAP	Financial Sector Assessment Programme
FSR	Financial Stability Report
FSS	Farmers' Service Societies
FST	Financial Sector Technology
FWG	First Working Group on Money supply
GBP	Great Britain Pound

GCC	General Credit Card
GCS	Gold Card Scheme
GDCF	Gross Domestic Capital Formation
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GFD	Gross Fiscal Deficit
GFS	Government Finance Statistics
GIC	General Insurance Corporation
GLS	Generalized Least Squares
GNIE	Government Not Included Elsewhere
GoI	Government of India
GPD	Gross Primary Deficit
G-Sec	Government Securities
HDFC	Housing Development Finance Corporation
HFT	Held For Trading
HICP	Harmonised Index of Consumer Prices
HO	Head Office
HTM	Held to maturity
HUDCO	Housing & Urban Development Corporation
IBRD	International Bank for Reconstruction and Development
IBS	International Banking Statistics
ICA	Inter creditor Agreement
ICAR	Indian Council of Agricultural Research
ICMR	Indian Council of Medical Research
IDB	India Development Bonds
IDD	Industrial Development Department
IEC	Independent Evaluation Committee
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFC(W)	International Finance Corporation (Washington)
IFCI	Industrial Finance Corporation of India
IFR	Investment Fluctuation Reserve Account
IFS	International Financial Statistics
IGC	India Gold Coins
IGLS	Iterative Generalized Least Squares

IIBI	Industrial Investment Bank of India
IIP	Index of Industrial Production
IIP/InIP	International Investment Position
IMD	India Millennium Deposits
IMF	International Monetary Fund
IN	India
INR	Indian Rupee
IOTT	Input-Output Transaction Table
IP	Interest Payment
IRAC (Norms)	Income Recognition, Asset Classification and Provisioning pertaining to Advances
IRBI	Industrial Reconstruction Bank of India
ISDA	International Swaps and Derivative Association
ISIC	International Standard Industrial Classification
ISO	International Standards Organization
IT	Information Technology
ITGGSM	Internal Technical Group on Government Securities Market
ITGI	IT Governance Institute
ITIL	IT Infrastructure Library
ITRS	International Transaction Reporting System
IWGEDS	International Working Group on External Debt Statistics
JLF	Joint Lenders' Forum
JLG	Joint Liability Groups
JPC	Joint Parliamentary Committee
KCC	Kisan Credit Card
KVIB	Khadi and Village Industries Board
KVIC	Khadi & Village Industries Corporation
KYC	Know your Customer
LAB	Local Area Bank
LAF	Liquidity Adjustment Facility
LAMPS	Large-sized Adivasi Multipurpose Societies
LAS	Loan & Advances by States
LBD	Land Development Bank
LBS	Locational Banking Statistics
LC	Letter of credit

LERMS	Liberalised Exchange Rate Management System
LIBOR	London Inter-Bank Offer Rate
LIC	Life Insurance Corporation of India
LME	London Metal Exchange
LoC	Letters of comfort
LOLR	Lender of Last Resort
LS	Level Shift
LT	Long Term
LTCCS	Long-Term Co-operative Credit Structure
LTO	Long Term Operation
M1	Narrow Money
M3	Broad Money
MA	Moving Average
MAP	Monitorable Action Plan
MCA	Ministry of Corporate Affairs
MCAs	Model Concession Agreements
MEDP	Micro Enterprise Development Programme
MFDEF	Micro Finance Development and Equity Fund
MFI	Micro Finance Institution
MIBOR	Mumbai Inter-Bank Offer Rate
MICR	Magnetic Ink Character Recognition
MIGA	Multilateral Investment Guarantee Agency
MIS	Management Information System
MLRO	Money Laundering Reporting Office
MLTGD	Medium and Long Term Government Deposit
MMBCS	Magnetic Media Based Clearing System
MMSE	Minimum Mean Squared Errors
MNBC	Miscellaneous Non-Banking Companies
MNSB	Multilateral Net Settlement Batch
MOF	Master Office File
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MPLS	Multi-Protocol Layer Switching
MRM	Monitoring and Review Mechanism
MRR	Minimum Retention Requirement

MSS	Market Stabilisation Scheme
MT	Mail Transfer
MTM	Mark-To-Market
NABARD	National Bank for Agriculture and Rural Development
NAC(LTO)	National Agricultural Credit (Long Term Operation)
NAFCUB	National Federation of Co-operative Urban Banks
NAIO	Non Administratively Independent Office
NAS	National Account Statistics
NASSCOM	National Association of Software and Services Companies
NAV	Net Asset Value
NBC	Net Bank Credit
NBC	Non-Banking Companies
NBFC	Non-Banking Financial Company
NBFI	Non-Banking Financial Institutions
NBV	Net Book Value
NDS	Negotiated Dealing System
NDS-OM	NDS Order Matching
NDTL	Net Demand and Time Liability
NEC	Not Elsewhere Classified
NEDFi	North Eastern Development Finance Corporation Ltd.
NEER	Nominal Effective Exchange Rate
NEFT	National Electronic Fund Transfer
NFA	Non-Foreign Exchange Assets
NFCC	National Foundation for Credit Counselling
NFD	Net Fiscal Deficit
NFGBC	Non-food Gross Bank Credit
NFS	National Financial Switch
NGO	Non-Government Organisation
NHB	National Housing Bank
NHC	National Housing Credit
NIA	New India Assurance Company Limited
NIC	National Industrial Credit
NIC	National Industrial Classification
NIF	Note Issuance Facility

NIMC	National Implementation Monitoring Committee
NNML	Net Non-Monetary Liabilities
NOC	No Objection Certificate
NOF	Net Owned Fund
NPA	Non-Performing Asset
NPD	Net Primary Deficit
NPFA	Non-Performing Financial Assets
NPL	Non-Performing Loan
NPRB	Net Primary Revenue Balance
NPV	Net Present Value
NR(E)RA	Non-Resident (External) Rupee Account
NR(NR)RA	Non-Resident (Non-Repatriable) Rupee Account
NRE	Non-Resident External
NRG	Non-Resident Government
NRI	Non-Resident Indian
NRNR	Non Resident Non Repatriable (Account)
NRSR	Non Resident Special Rupee (Account)
NSC	National Statistical Commission
NSE	National Stock Exchange
NSSF	National Small Savings Fund
OBS	Off-balance Sheet
OBU	Off-Shore Banking Unit
OD	Over Draft
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OECO	Organisaton for Economic Co-operation
OFI	Other Financial Institutions
OLRR	On-line Reject Repair
OLTAS	On-line Tax Accounting System
OMO	Open Market Operations
ORFS	On-line Returns Filing System
OSCB	Other Indian Scheduled Commercial Bank
OSMOS	Off-Site Monitoring and Surveillance System
OSS	Off-site Surveillance System
OTC	Over the Counter

OTS	One Time Settlement
PACF	Partial Auto-Correlation Function
PACS	Primary Agricultural Credit Society
PAN	Permanent Account Number
PAIS	Personal Accident Insurance Scheme
PCARDB	Primary Co-operative Agriculture and Rural Development Bank
PCR	Provisioning Coverage Ratio
PD	Primary Dealer
PD	Primary Deficit
PDAI	Primary Dealers Association of India
PDO	Public Debt Office
PDO-NDS	Public Debt Office-cum-Negotiated Dealing System
PES	Public Enterprises Survey
PF	Provident Fund
PIO	Persons of Indian Origin
PIO	Principal Inspection Officer
PKI	Public Key Infrastructure
PLR	Prime Lending Rate
PMLA	Prevention of Money Laundering Act
PMRY	Prime Minister Rojgar Yojna
PO	Principal Office
POS	Point of Sale
PPP	Public-Private Partnership
PRB	Primary Revenue Balance
PSB	Public Sector Bank
PSE	Public Sector Enterprise
PTC	Pass-through certificates
PUC	Paid Up Capital
QIS	Quantitative Impact Study
QRR	Quick Review Report
RBI	Reserve Bank of India
RBIA	Risk-Based Internal Audit
RBS	Risk-Based Supervision
RC	Reconstruction Company

RCS	Registrar of Co-operative Societies
RD	Revenue Deficit
RDBMS	Relational Database Management System
RE	Revenue Expenditure
REC	Rural Electrification Corporation
REER	Real Effective Exchange Rate
RERFA	Reserve for Exchange Rate Fluctuations Account
R-GDS	Revamped Gold Deposit Scheme
R-GML	Revamped Gold Metal Loan Scheme
RFC	Residents Foreign Currency
RIB	Resurgent India Bonds
RIDF	Rural Infrastructural Development Fund
RLA	Recoveries of Loans & Advances
RLC	Repayment of Loans to Centre
RMB	Renminbi (Chinese)
RNBC	Residuary Non-Banking Company
RO	Regional Office
ROC	Registrar of Companies
RPA	Rupee Payment Area
RPCD	Rural Planning and Credit Department, RBI
RR	Revenue Receipts
RRB	Regional Rural Bank
RTGS	Real Time Gross Settlement System
RTP	Reserve Tranche Position
RUF	Revolving Underwriting Facility
RWA	Risk Weighted Asset
SAA	Service Area Approach
SACP	Special Agricultural Credit Plan
SAM	Social Accounting Matrix
SAO	Seasonal Agricultural Operations
SAR	Self-Assessment Report
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SARS	Severe Acute Respiratory Syndrome
SAS	Statistical Analysis System

SBI	State Bank of India
SBNs	Specified Bank Notes
SC	Securitisation Company
SCARDB	State Co-operative Agriculture and Rural Development Bank
SCB	Scheduled Commercial Bank
SCB	State Cooperative Bank
SCS	Size Class Strata
SDDS	Special Data Dissemination Standards
SDR	Special Drawing Right
SDS	Special Deposit Scheme
SEB	State Electricity Board
SEBI	Securities and Exchange Board of India
SEEUY	Self Employment for Educated Unemployed Youths
SEFCs	Small Enterprises Financial Centres
SEFT	Special Electronic Funds Transfer
SEZ	Special Economic Zones
SFAC	Small Farmers Agri-Business Consortium
SFC	State Financial Corporation
SFMS	Structured Financial Messaging System
SGL	Subsidiary General Ledger
SGSY	Swarn Jayanti Gram Swarojgar Yojna
SHG	Self-Help Group
SHPI	Self-Help Promoting Institutions
SIDBI	Small Industries Development Bank of India
SIDC	State Industrial Development Corporation
SIPS	Systemically Important Payment System
SI-SPA	Systems Improvement Scheme under Special Project Agriculture
SJSRY	Swarna Jayanti Shahari Rojgar Yojna
SLA	Service Level Agreement
SLAF	Second Liquidity Adjustment Facility
SLBCs	State Level Bankers' Committees
SLEPCS	State Level Export Promotion Committees
SLR	Statutory Liquidity Ratio

SLRS	Scheme for Liberalisation and Rehabilitation of Scavengers
SMA	Special Mention Account
SME	Small and Medium Enterprise
SMG	Standing Monitoring Group
SNA	System of National Accounts
SPV	Special Purpose Vehicle
SRWTO	Small Road & Water Transport Operators
SSC	Special Sub-Committees
SSI	Small Scale Industry
SSSBEs	Small Scale Service & Business Enterprises
ST	Scheduled Tribe
STBD	Short Term Bank Deposit
StCB	State Co-operative Bank
STCCS	Short-Term Co-operative Credit Structure
STP	Straight Through Processing
STR	Suspicious Transaction Report
STRIPS	Separate Trading of Registered Interest and Principal of Securities
SWG	Second Working Group on Money Supply
SWIFT	Society for Worldwide Financial Telecommunication
TAFCUB	Task Force for Urban Co-operative Banks
TBs	Treasury Bills
TC	Temporary Change
TEV	Techno-Economic Viability
TFCI	Tourism Finance Corporation of India
TLI	Term Lending Institutions
TT	Telegraphic Transfer
UBB	Uniform Balance Book
UBD	Urban Banks Department
UCB	Urban Co-operative Bank
UCN	Uniform Code Number
UIA	United India Assurance Company Ltd.
UIDAI	Unique Identification Authority of India
US	United States
USD	US Dollars

UTI	Unit Trust of India
UTLBC	Union Territory Level Bankers' Committee
VaR	Value at Risk
VC	Venture Capital
VCF	Venture Capital Fund
VKC	Village Knowledge Centre
VPN	Virtual Private Networks
VRS	Voluntary Retirement Scheme
VSAT	Very Small Aperture Terminal
WADR	Weighted Average Discount Rate
WCTL	Working capital term loan
WEO	World Economic Outlook
WGMS	Working Group on Money Supply: Analytics and Methodology of Compilation
WGRFIS	Working Group on Future Role of Financial Institutions
WPI	Wholesale Price Index
WSS	Weekly Statistical Supplement
YTM	Yield to Maturity
ZO	Zonal Office
XBRL	Extensible Business Reporting Language

IV

Illustrative list for Basis of Selection of Advance Accounts in case of Bank Branch Audit

The list given for Bank Branch Auditors is only illustrative in nature. Members are expected to exercise their professional judgment while using this list depending upon facts and circumstances of each case.

	Basis of selection of Advances accounts to be examined by Branch Auditor	**No. of Accounts**
1.	All Large accounts *(as defined- Rs. 2.00 crores or 5% of the Portfolio, whichever is less)*	
2.	Cases under consideration of Joint Lenders Forum (JLF).	
3.	NPA accounts upgraded to Standard during the year	
4.	Advances where Restructuring Proposals/ requests are pending approval/disposal at year end.	
5.	Accounts Restructured in the earlier years to determine their year-end status, if in default or not classified as per RBI norms	
6.	Accounts Restructured during the year to determine their year-end classification.	
7.	Restructured advances with moratorium of Interest where interest is accrued contrary to RBI applicable norms	
8.	FITL cases arising out of Restructuring where corresponding provisions are held in “Sundry Liabilities Account (Interest Capitalization)”.	

9. Advances accounts where there is an initiation of proceedings involving Investigation, vigilance, enquiry and those where fraud is reported.	
10. Staff Advances – where the persons have ceased to be employees of the Bank; and accounts in default.	
11. BIFR cases classified as Standard.	
12. SSI/SME cases under rehabilitation as at the year end	
13. Standard advances in litigation	
14. Central Government guaranteed cases which are Standard non-performing.	
15. Standard accounts where there is Interest Suspense/ Unapplied Interest.	
16. Advances in the list of willful defaulters of the RBI.	
17. Cases where one time settlement (OTS) has been sought; and those in which OTS was accepted but there is default in compliance.	
18. Advances subject to re-financing.	
19. Cases of Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries – Loans sanctioned after July 15, 2015.	
20. Cases of Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries - Loans sanctioned before July 15, 2015.	
21. Fresh NPAs identified by the Branch.	
22. NPA cases where the assessed realizable value of the securities has a significant shortfall – 50% or more.	
23. NPA cases where the realizable value of the security as assessed by the Bank/approved valuers /RBI is less than 10% of the outstanding.	
24. Standard Accounts with temporary deficiencies as per	

	Para 4.2.4 of Master Circular on Advances	
25.	Quick Mortality Cases	
26.	Advances comprising frauds detected (Para 4.2.9.(ii) of the IRAC Master Circular dated 1.7.2015)	
27.	Other Accounts, not covered above, with adverse comments in the existing/latest Reports (as per Para 1 of Annexure I to the initial letter to Branch)	

V

Illustrative Bank Branch Audit Programme for the Year ended March 31, 2018

Introduction

In present scenario of audit of branches of banks, the most important aspect is proper planning. Planning means advance thinking and that should be done based on knowledge of branch business. It is important to have knowledge about Composition of Business of a particular branch which is under audit. Because of variety of products and diversified bank business, auditor cannot apply the same yardstick for the branches under audit. Today, the whole process of banking is computerized however; the Audit Report is required to be signed manually after physical checking of records, documents and accounts maintained under CBS.

Many of the Banks implemented a web application for posting & online submission of Branch Audit Report, Long Form Audit Report, Tax Audit Report and various certificates, therefore review the closing instruction of the Bank prior to commencement of the audit is utmost need to understand the manner and structure in which reporting is required to be made on online web base application. The report in these cases signed digitally.

In absence of clear understanding and the pre-requisite information like borrower account No/ Customer ID's details of the facility, security, sector etc. it would not be even possible to report any change in classification and any adverse finding in the main report as well as in Long Form Audit Report.

In view of this it is important to understand the reporting structure and auditor should prepare their comments / Memorandum of changes in the similar format and manner for reporting, by getting system format as circulated by the respective Banks with the closing instructions.

The branch audit generally may be bifurcated into following Components:

Type of Report	Coverage
Branch Statutory Audit	1. Audit of Advances and reporting on divergence in assets classification and income recognition, which is generally reported through Memorandum of Changes which form part of Main Audit Report; 2. Audit of all other items of Assets and liabilities and Income and expenditure appearing in the financial statement;
Tax Audit Reports and Long Form Audit Report	These reports are separate from Branch Audit Report: 1. As per Section 44AB of Income Tax Act, 1961, the Bank is under statutory obligation to get the Tax Audit conducted by Chartered Accountant and 2. Long Form Audit Report covers reporting on the operational aspects of the Branch working as per RBI requirements,
Certificates	Required to be verified as per respective Banks Closing Instruction keeping in view RBI Guidelines, Guidelines of the respective schemes notified by the Central / State Government.

Following are the generally followed steps for conducting of Branch audit;

1. Appointment / engagement letter for Branch Statutory audit, with closing circulars.
2. NOC from the previous auditor.
3. Pre-Audit discussion with branch.
4. Audit planning, to include Understanding of the Branch software and commands for view of borrower accounts and generation of various MIS / Critical / exceptional reports.
5. Execution of the audit as given in the **Annexure I.**
6. Discussion of the draft branch audit report with bank.

7. Preparation of Memorandum of Changes and effect of the same in books of account of bank.
8. Review of the Post Memorandum (Post MOC) trail balance and reconciliation with the pre memorandum (Pre MOC) trial balance to ensure the correct accounting effect of memorandum of changes.
9. Submission of audit report to branch and copy to central statutory auditors.

Following are the area wise documents to be collected and reviewed for conducting branch audit;

1. Trial Balance as on 31st March.
2. Closing circular issued by Bank's head office for conducting branch audit – Every bank issued the closing circular which contain the concern areas and list of certificates required to be certified by the branch auditor.
3. Review of previous years auditor report / LFAR.
4. Latest RBI master circular for "Income recognition and assets classification" & other relevant circulars.
5. List of comments of RBI inspection report towards the branch.
6. Latest branch concurrent audit report /Internal inspection report/ Credit Audit Report with their compliances.
7. Copy of vigilance enquiry or any special investigation reports.
8. Comparative analysis of the trial balance with the last year's audited trail balance.
9. Review of Ghosh and Jilani committee Recommendations.
10. Documents related to verification of advances –
    - List of stress advances (SMA-2) as on 15th March. (stress advances / SMA-2 report indicate the list of advances which are overdue for more than 60 days and if the same is not regularized before year end i.e. 31st march than the advance will become NPA)
    - List of new sanction made during the year.
    - List of account referred for Restructuring. (bi-lateral, CDR, SDR, S4A or 5/25)
    - List of Bank guarantee and Letter of credit.
11. Documents related to NPA's
    - List of NPA accounts as on 31st March.

- List of accounts upgraded during the financial year.
- List of accounts downgraded during the year.
- List of early mortality cases for the year under audit.
- Details of the NPA classification with secured /unsecured details and NPA provision amount.
- Review of the valuation report of loan account. Valuation report older than 3 years cannot be consider as security (1 year in case of stock) and 100% provision need to provide on the expired secured portion.

12. Fixed Assets
    - Fixed Assets register as on 31st March.
    - List of new assets purchased during the year.
    - List of fixed assets sold during the year.
    - Physical verification report of branch fixed assets if conducted during the year.
    - Depreciation working as on 31st March.
13. Bank reconciliation
    - List of bank account which branch maintained with other banks.
    - Reconciliation statement of all banks account as on 31st march.
14. Inter branch reconciliation
    - Inter branch reconciliation statement.
    - Provision for net outstanding debit balance for more than 6 month. (refer RBI circular DBOD No. BP.BC. 73 /21.04.018/2002-03)
15. Cash
    - Physical cash balance verification during branch audit period.
    - Report of the physical cash verification conducted by branch on 31st March.

Audit of Advances

Audit of advances is discussed elsewhere in the ICAI's Journal under appropriate article. However from the angle of planning following aspects must be kept in mind:

1. **Obtain top exposure accounts:** It may be advisable for a branch auditor to ask the list accounts/ exposures along with all the details such as status, overdue amount and security etc. before starting of the audit.

2. **Obtain the list of stressed accounts:** The banks monitors stressed accounts on daily basis. The account that generally has overdue beyond 60 days or likely to slip to NPA at the quarter end is termed as stressed account (some banks may use different terminology). It is advisable to obtain such list of stressed accounts at least 15 days ahead of the closing date i.e. say stressed account list as on 15th March. This will provide the auditor a ready list of such accounts. The auditor then can scrutinise each to know whether the account has slipped or if not whether has been kept standard by unusual transaction that cannot be termed as business transaction. Like deposit and withdrawal of cash, just to show the credit turnover during the quarter in cash credit account.

3. **Obtain the list of restructured accounts:** Restructured account portfolio requires separate additional provisioning. It is necessary to obtain the list of such accounts and ensure whether the restructure is as per the RBI directives. As per latest RBI guidelines, all new restructure / CDR account will be classified as NPA.

4. **Obtain the list of CDR (bi-lateral, CDR, SDR, S4A or 5/25) accounts:** Generally CDR is not applicable to Cooperative banks. However in case the account is in consortium with any PSB/ Private bank, CDR may be applicable. In case such an account is found, ensure the compliance with the RBI guidelines in respect of CDR accounts. As per latest RBI guidelines, all new restructure / CDR account will be classified as NPA.

5. **Obtain the list of unsecured exposures above Rs. 25 Lacs.**: Unsecured exposure has significant impact on the bank, if slips to NPA. Many times such accounts are reviewed in the traditional manner. These require close monitoring not only from the perspective of financial parameters of the prudential guidelines but also non-financial parameters that give signals of the possible ill health. The banking industry has faced severe damages on account of non-identification of such non-financial parameters.

6. **Early mortality cases:** Any advance slippage to NPA within 12 months of its introduction is called early mortality case. Early mortality cases invoke penalty to the sanctioning authorities. This will have to be checked to understand the reason for such happening to avoid such cases in future and also to find out whether there are any cases classified as performing on some untenable ground to push it beyond early mortality.

7. **Upgraded accounts during the Year:** Review of the upgraded accounts is one of the important area to be check during audit. As per RBI circular, the account will get upgraded when arrears of interest and principal are paid by the borrower. After recovery, the accounts will get upgraded to standard assets. There should not be any overdue in borrower accounts as on date of up-gradation. The recovery in the accounts need to be review specially in cash of cash credit accounts where the borrower rotate the fund just to keep the account as performing assets.

8. **Evergreening of accounts:** Evergreening refers to the practice of giving a fresh loan to repay an old one. Technically, evergreening refers to the practice of managing the balance sheet through means, which may not be violating banking laws in letter, but breaching them in spirit. To Illustrate and to make it more clear : say a bank disburse a loan of Rs 10000 to a borrower and the account become overdue after a year or two , the same bank sanction a loan of Rs. 20000 or Rs. 30000 which enable borrower to repay first loan. Therefore, the source of recovery needs to be review in case of stress accounts.

9. **Other routine checks:** The auditor may engage into other routine check of advances to satisfy himself such as classification of advances, new sanctions during the year, monitoring mechanism and provisioning under prudential norms. It may be pertinent to mention here two broad aspects that are heavily dependent on the branch auditor relating to advances. Also these are one of the most strong argument, amongst many, why branch audits are necessary even in CBS environment;

    - **Checking of documentation**: Documentations for newly sanctioned advances along with their enforceability, review documents and its appropriate reflection in CBS

    - **Security value for provisioning**: After classification, the most important aspect in presenting the true and fair view of the financial statements of a bank is correct provisioning amount. This highly depends on fair assessment of security value. The base documents relating to the valuation are usually available at the branches. Correct depiction thereof in the CBS is a crucial check.

Audit of other Items in Trial Balance

It may not be necessary to elaborate on this point as this has been basic skill of auditing profession. However, following aspects may require specific attention of a branch auditor:

1. **Suspense, Inter Branch reconciliation and any other pending reconciliation item in Trial Balance:** As per the RBI guidelines, any debit entry in these accounts appearing for more than 6 months require 100% provision.

2. **Provisions other than relating to advances:** Year-end accounting provision that do not get generated through CBS require specific attention at the branch level. It may be advisable to do a comparative study of last year end, half year and current year end figure comparison. This throws lot of insights into the branch operations.

Ensuring various compliances:

Generally the branch requires following various compliances in respect of audit:

1. **Concurrent Audit report:** Any comments or remarks in the concurrent audit report that the branch is required to comply with.

2. **Compliance to RBI Inspection report:** If RBI has conducted inspection in the branch, the comments in the report need compliance. Any non-compliance under the pretext that the bank has represented to RBI to reconsider the observation should not be accepted. RBI has clearly taken a stand that unless auditor is physically shown a letter of reversal from RBI comments in their report must be adhered to.

3. **Compliance to Internal audit report:** If the bank has conducted internal audit, which usually an internal exercise, obtain the report and check for the compliances thereof.

4. **Stock audit report:** Generally an account having exposure of Rs. 5 Cr. and above requires stock audit, the compliance thereof should be commented upon. Also any adverse comment in the report needs to be dealt with appropriately.

5. **Application of interest in CBS:** Generally bankers always argue that the interest is calculated by the system and requires no cross verification. While this is true, the correct calculation by the system is subject to correct input by the branch staff relating to interest. Hence input of interest rates requires test check.

Annexure I

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 2. Letter for NOC to previous auditors		
3. Meeting and discussion with the bank branch management and understanding the profile of the branch and its business and take a note on the same.		
4. Letter of requirement to the Branch		
5. Review of • previous year's audit report/ LFAR, • current period's Internal Audit Report/ Concurrent Audit Report • Revenue Audit Report • RBI Inspection Report • compliance of the branch to all of the above and • any other special review report.		
6. Physical verification of • cash, • Gold (for Gold loan) • and valuable securities. 7. Note down • Shortage of cash appearing in Trial Balance • Difference in physical verification of gold		

Audit Aspects	Covered By Whom	Extent of Check
8. Physical verification of Investments (obtain certificate from bank manager for the same). If investment is hold /done by the Branch		
9. Understand the system in CBS at Branch • verify controls • verify exceptional report • understand the editable & uneditable fields at Branch, • system of downgrading & upgrading of accounts, • interest calculations, • Generation of reports relating to advances classification and Capital Adequacy calculation, etc.		
10. Compliance of instructions issued by bank's year and closing circulars, other relevant internal instructions/circulars, Master circulars and other notifications issued by RBI, significant accounting policies of the bank Mandatory Accounting Standards/Auditing Standards and other notification.		
11. Prepare a list of various closing returns to be verified and certified, and then checking of the same during the audit.		
Checking of Balance Sheet Items		
1. Checking of the advances:		
• Take list of all advances along with facility wise limits, outstanding, Name of Lead bank, Credit Rating, Credit summations in the account, last date of submission of stock statement, date of review of account, etc. This shall help to select the accounts for		

Audit Aspects	Covered By Whom	Extent of Check
scrutiny in detail.		
• Critical review of all large advances and their reporting as per prescribed norms.		
• Classification of advances as per IRAC norms.		
• Latest valuation of security given against advances.		
• Provisions on NPA as per IRAC norms.		
• Review of all major restructured cases along with the compliance of norms as per RBI Guidelines.		
• List of all SMA 2 accounts and reporting of the same to concerned authorities.		
Loan Accounts (Performing)		
I. Review of all large advances with balance of lower of 5 % or Rs.2 crore of total advances.		
II. Review of loans sanctioned during the year.		
III. Review of other advances on test check basis.		
IV. Review of adverse comments by Concurrent auditors, RBI/internal inspectors and the reply given and corrective actions taken by the branch.		
V. Review of suit filed and decree accounts on sample basis with respect to provision thereon and progress of recovery thereof and Classification as per IRAC norms		
VI. Review of accounts upgraded during the year from NPA to standard. and ensure full recovery		

Audit Aspects	Covered By Whom	Extent of Check
of total overdues before upgradation		
VII. Review of all accounts frequently exceeding limits/DP and watch-list accounts		
VIII. Also verify all the credit card dues which are overdue & debit balances in SB A/c		
IX. Check Drawing Power calculation in detail as per the norms of the bank.		
Loan Accounts (Non Performing)		
I. Review the accounts which are classified as NPA during the year w.r.t Security Value, Interest Reversed, Date of NPA, provisioning thereon etc.		
II. Review the annual stock audit report for the NPA with balance of Rs. 5 cr. and above & latest valuation report for the immovable properties in case the valuation is older than 3 years.		
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 (ix) should be documented.		
2. Verify controls in respect of the		

Audit Aspects	Covered By Whom	Extent of Check
following important items of assets. (i) Dual custody of cash (ii) Custody and issue of /pay orders/other stationery items etc. (iii) ATM cash as per books and actual balance tallied at year end.		
3. Fixed Assets		
I. Checking of additions/deduction/ transfers of fixed assets, supported by proper bills/invoices and confirmation of date put to use. Compliance of Accounting Standard related to fixed assets		
II. Checking of Depreciation on additions, deduction during the year and on existing assets as per the policy of the bank.		
III. Verification of Fixed Assets Schedule for furniture & fixtures and other assets and reconciliation with figures appearing in the Balance Sheet and FA management software used by the bank (if any).		
4. Deposits		
a) Verification of Anti Money Laundering guidelines and Compliance with KYC norms on test check basis that overdue deposits,		
b) Check TDS compliance on the interest paid and on test check basis checking of Form 15G & 15H and confirm whether those forms are submitted with respective Income Tax Authority		
c) Movement of Deposit vis-à-vis		

Audit Aspects	Covered By Whom	Extent of Check
movement in interest expense.		
5. Inter-Office & Suspense A/c:		
1. Reconciliation of accounts with other banks, head office and inter branch adjustment accounts.		
2. Inter Office Reconciliation (IOR) Accounts: I. Verify Inter Branch Items In Transit (IBIT) account for old entries. II. Compare on test Check basis, the balance and the entries in IOR Accounts with the copies of the statements submitted to the IOR department/s. III. Old un reconciled entries are being provided/ reported to HO for provision		
3. Detailed checking of suspense accounts – credit as well as debit schedules. i.e., Nominal ledger.		
Balance Sheet Finalisation		
1. 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 for any negative balance in the trial balance (i.e. assets / expenses having credit balances and liability / income having debit balances)		
ii) check in case of advances that:		
a) interest accrued but not due on loans is not included in advances.		
b) credit balances in O/D, CC inoperative current accounts		

Audit Aspects	Covered By Whom	Extent of Check
should not be netted off with advances and the same should be shown under demand deposits.		
c) Verification of Anti Money Laundering guidelines and Compliance with KYC norms on test check basis		
2. Checking, (i) Liability under Bank Guarantee/ L/C and effects of expired BGs. (ii) Reconciliation of General Ledger and Subsidiary Ledger.		
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. Check the system is properly configured to check the interest calculation and the changes in interest rate is changed in system on respective dates		
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 income like commitment charges, processing fees, recovery of insurance/ legal fees etc.		
4. Derive various ratios of items of income with comparable and related assets (like Avg. Interest Income to Average Advances etc.) and verify		

Audit Aspects	Covered By Whom	Extent of Check
major movements or variances.		
5. Checking of interest in NOSTRO Accounts debit balances.		
6. Verification of recovery on account of locker rent, staff accommodation, etc., with details of arrears, if any.		
7. Commission income on account of Government Business, i.e., collection as well as remittance of Income tax, sales tax, excise duty, etc.,		
8. Details of Prior Period items of Income as well as expenses and complete details of provisions to be made, if any.		
9. Booking of Interest Income on account of partial recovery in NPA's.		
10 Note down the reasons for material variances, if any		
Others		
1. Checking of statement of frauds adequacy of provision, timely reporting to competent authority, recovery and movement in balances.		
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 LC issued are within the powers of the authorised person and		

Audit Aspects	Covered By Whom	Extent of Check
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 certificate (as per various RBI & Government schemes), correct accounting & whether the same are given to the eligible .borrowers.		
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 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 annexures and preparation of Tax Audit Report.		
Final Audit and Reporting		
1. Preparation of Audit Report as per format prescribed by ICAI under SA 700 and under any other regulatory authority.		
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. Preparation of Tax Audit Report.		
4. Preparation of Long Form Audit		

Audit Aspects	Covered By Whom	Extent of Check
Report (by giving annexures where ever necessary)..		
To collect the following Certificates:		
1. Physical verification of the fixed assets carried out on March 31, 2018/During the year		
2. Physical verification of Investment carried out on March 31, 2018/ During the Year. If investment are held or appearing in the Trial Balance.		
3. Physical verification of the cash & other items as on March 31, 2018.		
4. Written Representation Letter.		
To verify and issue the certificates (as applicable): Illustrative list		
1. Certificate of Ghosh and Jilani committee Recommendations.		
2. Certificate giving details of claims lodged with DICGC / ECGC however, rejected by them		
3. Risk weighted assets as per the capital adequacy report (BASEL II & III).		
4. Certificate for treating an account as bad or doubtful of recovery as per the requirement of DI and CGC.		
5. Subsidy claim under Prime Minister Rojgar Yojna Or any other scheme of the Central/State Government.		
6. Certificate for Interest Subvention		

Prepared by: Reviewed by:

VI

Illustrative Checklist for the verification of the aspects of the Treasury/Investments of the Bank in Statutory Audit

SN	Area	Description
1.	Investment Policy	Verify if the Bank has a Board Approved Investment Policy in place and the same has been reviewed on annual basis. Verify if the Investment policy has been framed in concurrence with RBI guidelines.
2.	Prudential Limits	Verify if the Bank has adhered to the prudential limits relating to investments as prescribed by RBI from time to time and Internal Policies.
3.	Income Calculation & Accounting	Verify if the Income on various Investments has been correctly calculated and recorded in the Books of Account taking into consideration RBI guidelines issued from time to time and Accounting Policies followed by Bank.
4	Verification of Investments	Verify the investments physically and/or with the available holding statements/confirmations
5.	Classification/ Valuation	**RBI Master Circular Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks** **Classification:** Check entire investment portfolio is classified under three categories viz: AFS, HFT & HTM. **Sale/Transfer/Shifting:** Verify there are no securities held in the HFT for more than 90 days.

		Verify there has been no shifting of securities to/from HTM Portfolio without the approval of the Board beyond the allowed percentage as per the RBI i.e. 5% of the HTM Portfolio is allowed only in the beginning of the year. Shifting in excess of 5% of the HTM Portfolio, the Bank should disclose in the Notes to Accounts the Market Value of Investments held in HTM and also indicate the Book Value in excess of Market Value to the extent not provided for. Profit & Loss from the HFT & AFS Category of Investments is taken to P&L Account. **Valuation:** Check the Valuation of various securities has been performed in line with the RBI Master Circular – Prudential Norms for Classification, Valuation & Operation of Investment Portfolio of Banks. • HTM Portfolio is carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to . • AFS has to be marked to market on quarterly or frequent intervals. To arrive at Net Appreciation or Net Depreciation in the portfolio, The securities under same classification can be aggregated to arrive at the Net Appreciation or Net Depreciation No set off can be done for the Depreciation of one classification against the other. • Net Depreciation to be provided for and Net Appreciation to be ignored. • HFT also has to be marked to market or monthly or more frequent intervals.
6	Verification of Non-Performing Investments (NPI)	Verify that the investments are classified as NPI as per the extant guidelines issued by RBI from time to time.

7.	Regulatory Returns	Verify the accuracy of all the Regulatory Returns submitted to the RBI and also verify whether the same have been submitted within the deadlines.
8.	Computation of SLR & CRR	Verify the mechanism and accuracy of the Computation of SLR & CRR.
9.	Disclosure Requirements	Verify the following disclosures required to be made to the Notes to Accounts have been made and made accurately. 1. Details regarding Securities sold under Repo and Purchased against Reverse Repo. 2. Details of the issuer composition of non-SLR investments and the non-performing non-SLR investments. 3. Details of Transfer of Securities from HTM portfolio to AFS in excess of 5%, Banks should disclose the market value of the Investments and Book Value in excess of Market value for which provision is not been made. 4. Details of corporate debt securities lent or acquired under repo or reverse repo transactions. 5. In respect of the Non SLR Securities portfolio, the issuer details in the format prescribed vide RBI Master Circular on_Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks. 6. Penalty paid to Reserve Bank of India during the financial year

VII

Illustrative Flow Charts for Use of Core Banking Solution Software in case of Bank Branch Audit

The advances are categorized in different Schemes and each them is codified. The Branch auditor is required to get the understanding of the Scheme code and can generate the report for all account under the Scheme by giving account Number.

The Branch auditor on start of the audit obtain the Balance Report of the advances Facility Wise / Scheme wise to identify the Scheme code of facility. The illustrative Scheme codes are CCAGR – Cash Credit Agriculture, CCOTH – Cash Credit Other and TLEDU – Term loan Education etc.

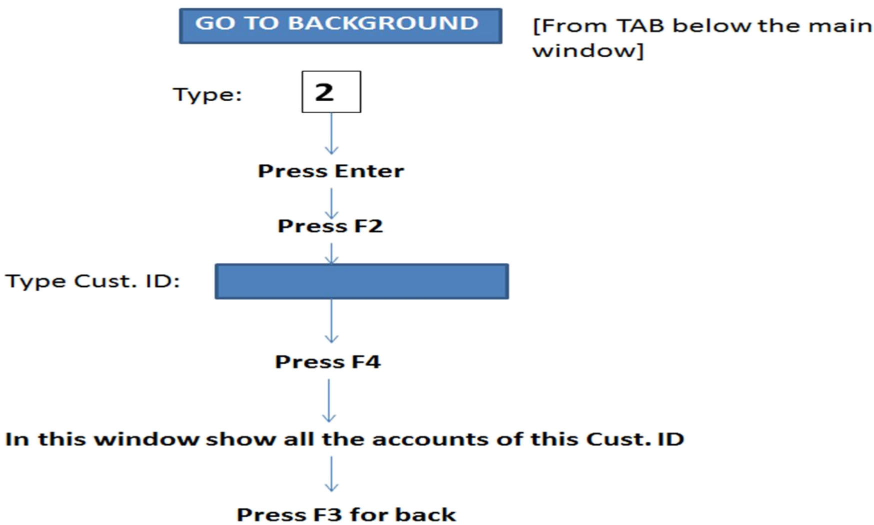
Generally, in Branch audit if the Branch auditor can get the dump of the borrower account for the given period in soft copy, the work of review of the advances can be completed smoothly, the flow chart for Process of Generate A Pass Sheet will be quite helpful to generate Scheme wise borrower account of the branch for a given period (It can be for Four Years – if required in case of Agriculture Advances).

The review of the advances account can be made by generating the report for each of the Scheme account. The report is generated in Text file (with .rpt extension) and can be easily opened in note pad / word pad and easily portable to excel. It's advisable to retain the main copy safe for documentation and conversion to excel may be made coping the file with another name.

Illustrative important process Flow Chart of widely used banking software like Finacle are given hereunder for:

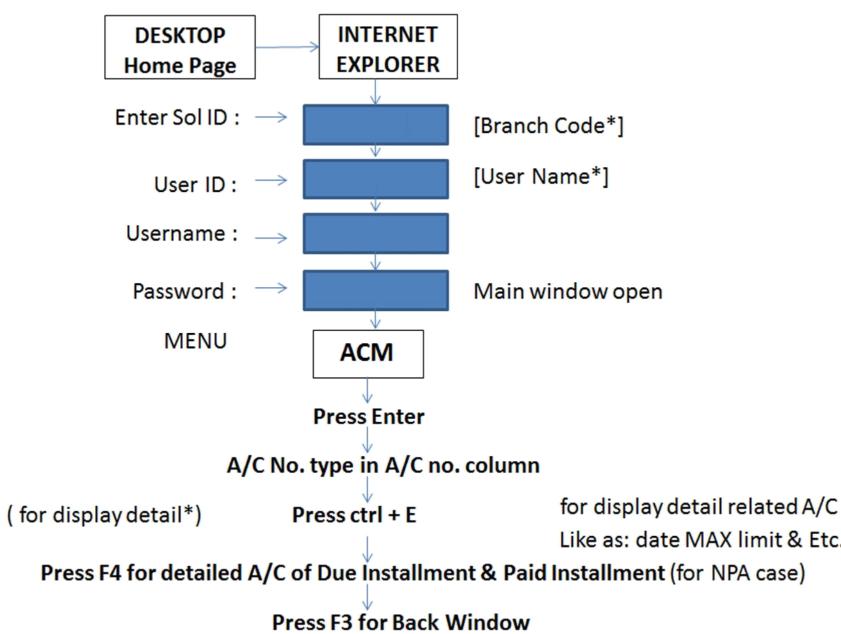
1. How to know account number from Customer ID
2. Flow Chart for review of the Loan account
3. Flow chart to generate Text file for of Borrowers Accounts product wise / Individual Account
4. Flow Chart to Review Fixed Deposit Account – Interest / TDS inquiry etc.

FLOW CHART TO FIND A/C No. FROM CUST. ID



FLOW CHART FOR REVIEW OF THE LOAN ACCOUNT

Checking loan/CC/OD & other A/c in the Finacle, steps are given below.



FLOW CHART - PROCESS OF GENERATE A PASS SHEET (ACCOUNT STATEMENT)

[A/C wise, Scheme wise etc.]

↓

Click on Internet Explorer

↓

Central MIS Server

↓

Enter your SOL ID (Branch Code, like as : 00001)

↓

I Agree

↓

Username: →

Password: →

↓

Main Menu of MIS server

↓

Menu **PSP** (Left side below)

PSP: Pass Sheet Print

↓

Press F4

↓

Press tab continue till A/C No. / Scheme No.

(type Scheme code, A/C No.)

↓

Press tab, come next column period (after press F4)

↓ (A short Dialogue box opens above)

In first column **F** **& Press F4**

↓

In Second Column **N** **& Press F10** (for print)

↓

PASS Sheet generate in the system

↓

Press F3 & come back on main menu

↓

MENU **PR** (PR- code for show report in Finacle)

↓

Press Ctrl + E (on selected first report)

↓ Dialogue box open

A TAB given below the dialogue box name is <u>TEXTDUMP</u> CLICK ON

↓ A small dialogue box open

In this dialogue box copy the file extension (like…TLT 89abkt.RPT) copy text till (RPT)

↓

Press F3 & come main menu

↓

MENU | **PTW** | (PTW: code for report download in system)

↓

Type 'T' given below [many options are given but 'T' is denote for ' transfer file to PC']

↓

Press F4

↓

Paste the file copied in (text dump: TLT 89abkt.RPT)

↓

Press F4

↓

Type the destination folder where file should be saved in drive C

↓ [C:\ AUDITOR]

Press F4

↓ Report downloading in auditor folder in C drive

Check report

<u>STEPS FOR CHECK FIXED DEPOSIT DETAILS</u>

(Like Interest, TDS on Interest, TDS 15H/15G)

<u>MAIN MENU OF FINACLE</u>

↓

MENU Option | **CUMM**

↓

Press Enter

↓ New window open

Type: **I**

↓ in the first column

Type: Cust. ID

↓

Press F4

↓ Window Open — In this window general information of customer are given

Press F6

↓

Then Press F6 for TDS Details like 15H,15G, selection criteria & etc.

↓

Press F3 for Back

VIII
List of Relevant Master Directions issued by RBI

S. No.	Direction No.	Subject
1.	RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17	Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs
2.	RBI/DBR/2015-16/26 Master Direction DBR.FID.No.108/01.02.000/2015-16	Master Direction - Reserve Bank of India (Financial Statements of All India Financial Institutions - Presentation, Disclosure and Reporting) Directions, 2016
3.	RBI/DBR/2015-16/25 Master Direction/DBR.FSD.No.101/24.01.041/2015-16	Master Direction- Reserve Bank of India (Financial Services provided by Banks) Directions, 2016
4.	RBI/DBR/2015-16/24 Master Direction DBR.PSBD.No. 97/16.13.100/2015-16	Master Direction – Ownership in Private Sector Banks, Directions, 2016
5.	RBI/DBR/2015-16/22 Master Direction DBR.PSBD.No. 96/16.13.100/2015-16	Master Direction – Amalgamation of Private Sector Banks, Directions, 2016
6.	RBI/DBR/2015-16/21 Master Direction DBR.PSBD.No.95/16.13.100/2015-16	Master Direction - Issue and Pricing of shares by Private Sector Banks, Directions, 2016
7.	RBI/DBR/2015-16/20 Master Direction DBR.Dir.No.85/13.03.00/2015-16	Master Direction - Reserve Bank of India (Interest Rate on Advances) Directions, 2016

8.	RBI/DBR/2015-16/19 Master Direction DBR. Dir. No.84/13.03.00/2015-16	Master Direction - Reserve Bank of India (Interest Rate on Deposits) Directions, 2016
9.	RBI/DBR/2015-16/18 Master Direction DBR.AML.BC.No.81/14.01.001/2015-16	Master Direction - Know Your Customer (KYC) Direction, 2016
10.	RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17	Master Direction on Money Market Instruments: Call/Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)
11.	RBI/FED/ 2015-16/16 FED Master Direction No.2 /2015-16	Master Direction – Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses
12.	RBI/FIDD/2017-2018/55 Master Direction FIDD Co.FSD.BC. 8/05.10.001/2017-18	Master Direction - Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2017
13.	RBI/FIDD/2017-18/56 Master Direction FIDD.MSME & NFS.12/06.02.31/2017-18	Master Direction - Lending to Micro, Small & Medium Enterprises (MSME) Sector
14.	RBI/FIDD/2016-17/33 Master Direction FIDD.CO.Plan.1/04.09.01/2016-17	Master Direction-Priority Sector Lending-Targets and Classification
15.	RBI/FMRD/2016-17/31 FMRD Master Direction No. 1/2016-17	Master Direction - on Risk Management and Inter-Bank Dealings
16.	RBI/DCM/2017-18/59 Master Direction DCM(CC) No.G - 2/03.35.01/2017-18	Master Direction 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

17.	RBI/IDMD/2016-17/29 Master Direction IDMD.PDRD.01/03.64.00/2016-17	Master Direction – Operational Guidelines for Primary Dealers

IX

List of Relevant Master Circulars Issued by RBI

S. N.	Circular No.	Subject
1.	RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16	Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances
2.	RBI/2015-16/97 DBR No BP.BC.6 /21.04.141/2015-16	Prudential norms for classification, valuation and operation of investment portfolio by banks
3.	RBI/2015-16 /95 DBR.No.Dir.BC.10/13.03.00/2015-16	Loans and Advances – Statutory and Other Restrictions
4.	RBI/2015 -16/36 DBR.BP.BC.No.5/21.04.172/2015-16	Bank Finance to Non-Banking Financial Companies (NBFCs)
5.	RBI /2015-16/70 DBR.No.Dir.BC.12 /13.03.00/2015-16	Exposure Norms
6.	RBI/2015-16/99 DBR.BP.BC No.23 /21.04.018/2015-16	Disclosure in Financial Statements - Notes to Accounts
7.	RBI / 2015-16/76 DBR. No. Dir. BC.11 /13.03.00/2015-16	Guarantees and Co-acceptances
8.	RBI/2015-16/98 DBR.No.Ret.BC.24/12.01.001/2015-16	Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)
9.	RBI/2015-16/31 DBR.No.FSD.BC.18/24.01.009/2015-16	Credit Card, Debit Card and Rupee Denominated Co-branded Prepaid Card operations of banks and Credit Card issuing NBFCs

10.	RBI/2015-16/30 DBR.No.FSD.BC.19/24.01.001/2015-16	Para-banking Activities
11.	RBI/2015-16/86 DBR.No.BP.BC. 3/21.01.002/2015-16	Prudential Norms on Capital Adequacy-Basel I Framework
12.	RBI/2015-16/85 DBR.No.BP.BC.4./21.06.001/2015-16	Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)
13.	RBI/2015-16/46 DBR.No.DIR.BC.13/08.12.001/2015-16	Housing Finance
14.	RBI /2015-16/39 DBR.No.Dir.BC. 7/13.03.00/2015-16	Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts
15.	RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16	Willful Defaulters
16.	RBI/ /2015-16/47 DBR No.DIR.BC.14/ 04.02.002/ 2015-16	Rupee / Foreign Currency Export Credit & Customer Service to Exporters
17.	RBI/2015-16/29 FIDD.FID.BC.No.02/12.01.033/ 2017-18	SHG – Bank Linkage Programme
18.	RBI/2015-16/ 35 DBR.AML.BC.No.16/14.08.001/ 2015-16	Guidelines issued under Section 36(1)(a) of the Banking Regulation Act, 1949 - Implementation of the provisions of Foreign Contribution (Regulation) Act, 2010
19.	RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/2015-16	Basel III Capital Regulations
20.	RBI/2015-16/59 DBR No.Leg.BC. 21/09.07.006/2015-16	Customer Service in Banks

21.	RBI/2015-16/52 DCM (FNVD) G- 4/16.01.05/2015-16	Detection and Impounding of Counterfeit Notes
22.	RBI/2015-16/38 DCM (NE) No. G - 2/08.07.18/2015-16	Facility for Exchange of Notes and Coins
23	RBI/2016-17/17 DPSS.CO.PD.MobileBanking.No./2/02.23.001/2016-2017	Mobile Banking transactions in India – Operative Guidelines for Banks
24	RBI/2016-2017/16 DPSS.CO.PD.PPI.No.01/02.14.006/2016-17	Policy Guidelines on Issuance and Operation of Pre-paid Payment Instruments in India
25	RBI/2017-18/4 FIDD.CO.FSD.BC.No.7/05.05.010/2017-18	Kisan Credit Card (KCC) Scheme

X
List of Relevant General Circulars

S. No.	Date	Title of the Circular	Circular No.
1.	February 12, 2018	Resolution of Stressed Assets – Revised Framework	RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18
2.	February 07, 2018	Relief for MSME Borrowers registered under Goods and Services Tax (GST)	RBI/2017-18/129 DBR.No.BP.BC.100/21.04.048/2017-18
3.	August 16, 2017	Interest Subvention Scheme for Short Term Crop Loans during the year 2017-18	RBI/2017-2018/48 FIDD.CO.FSD.BC.No.14/05.02.001/2017-18
4.	August 3, 2017	Natural Calamities Portal – Monthly Reporting System	RBI/2017-2018/38 FIDD.CO.FSD.BC.No.13/05.10.006/2017-18
5.	August 3, 2017	Exclusion of the name of State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala, State Bank of Travancore and Bharatiya Mahila Bank from the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2017-2018/37 DBR.No.Ret.BC.80/12.06.004/2017-18
6.	August 2, 2017	Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR	RBI/2017-2018/36 DBR.BP.BC.No. 81/21.04.098/2017-18

		Disclosure Standard	
7.	August 2, 2017	Change in Bank Rate	RBI/2017-2018/34 DBR.No.Ret.BC.82/12.01.001/2017-18
8.	August 2, 2017	Liquidity Adjustment Facility – Repo and Reverse Repo Rates	RBI/2017-2018/32 FMOD.MAOG.No.121/01.01.001/2017-18
9.	July 27, 2017	Appointment of Statutory Central Auditors (SCAs) – modification of rest period	RBI/2017-2018/29 DBS.ARS.BC.04/08.91.001/2017-18
10.	July 13, 2017	Interest rates for Small Savings Schemes	RBI/2017-2018/22 DGBA.GBD.69/15.02.005/2017-18
11.	July 13, 2017	Investment in plant and machinery for the purpose of classification as Micro, Small and Medium Enterprises – documents to be relied upon	RBI/2017-2018/21 FIDD.MSME & NFS.BC.No.10/06.02.31/2017-18
12.	July 6, 2017	Point of Presence (PoP) Services under Pension Fund Regulatory and Development Authority (PFRDA) for National Pension System (NPS)	RBI/2017-2018/16 DNBR(PD)CC.No.087/03.10.001/2017-18
13.	July 3, 2017	Master Circular – Deendayal Antyodaya Yojana - National Rural Livelihoods Mission (DAY-NRLM)	RBI/2017-2018/10 FIDD.GSSD.CO.BC.No.04/09.01.01/2017-18
14.	July 3, 2017	Master Circular - Credit facilities to Scheduled Castes (SCs) & Scheduled Tribes (STs)	RBI/2017-2018/7 FIDD.CO.GSSD.BC.No.06/09.09.001/2017-18
15.	July 3, 2017	Master Circular – Deendayal Antyodaya Yojana – National Urban Livelihoods Mission (DAY-NULM)	RBI/2017-2018/5 FIDD.GSSD.CO.BC.No.03/09.16.03/2017-18
16.	July 3, 2017	Master Circular - Kisan Credit Card (KCC) Scheme	RBI/2017-2018/4 FIDD.CO.FSD.BC.No.7/05.0

			5.010/2017-18
17.	June 22, 2017	Exclusion of “The Royal Bank of Scotland N.V.” from the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/325 DBR.No.Ret.BC.75/12.07.150/2016-17
18.	June 13, 2017	, Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF) - Eligible Credit Rating Agencies – INFOMERICS Valuation and Rating Pvt Ltd. (INFOMERICS)	RBI/2016-2017/321 DBR.No.BP.BC.74/21.06.009/2016-17
19.	June 7, 2017	Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR)	RBI/2016-2017/318 DBR.No.Ret.BC.71/12.02.001/2016-17
20.	June 7, 2017	Individual Housing Loans: Rationalisation of Risk-Weights and Loan to Value (LTV) Ratios	RBI/2016-2017/317 DBR.BP.BC.No.72/08.12.015/2016-17
21.	May 30, 2017	Submission of Annual Information Return relating to issue of Bonds for 5 lakh or more under Section 285 BA of Income Tax Act, 1961 - Change thereof	RBI/2016-2017/313 IDMD.CDD.No.3058/13.01.299/2016-17
22.	May 25, 2017	Submission of Annual Information Return relating to issue of Bonds for 5 lakh or more under Section 285 BA of Income Tax Act, 1961-Change thereof	RBI/2016-2017/309 IDMD.CDD.No.3031/13.01.299/2016-17
23.	May 25, 2017	Continuation of Interest Subvention Scheme for short-term crop loans on interim basis during the year 2017-18- regarding	RBI/2016-2017/308 FIDD.CO.FSD.BC.No.29/05.02.001/2016-17

24.	May 8, 2017	National Electronic Funds Transfer (NEFT) system – Settlement at half-hourly intervals	RBI/2016-2017/300 DPSS (CO) EPPD No.2612/04.03.01/2016-17
25.	May 5, 2017	Timelines for Stressed Assets Resolution	RBI/2016-2017/299 DBR.BP.BC.No.67/21.04.048/2016-17
26.	April 27, 2017	Risk Management Systems – Role of the Chief Risk Officer (CRO)	RBI/2016-2017/294 DBR.BP.BC.No.65/21.04.103/2016-17
27.	April 20, 2017	Exclusion of KBC Bank N.V. – from the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/288 DBR.No.Ret.BC.24/12.07.118A/2016-17
28.	April 20, 2017	Alteration in the name of "Coöperatieve Centrale Raiffeisen - Boerenleenbank B.A." to "Coöperatieve Rabobank U.A." in the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/287 Ref.DBR.No.Ret.BC/21/12.07.131A/2016-17
29.	April 20, 2017	Cessation of KBC Bank N.V. as a banking company within the meaning of sub-section (2) of Section 36(A) of the Banking Regulation Act, 1949	RBI/2016-2017/286 DBR.No.Ret.BC.23/12.07.118A/2016-17
30.	April 20, 2017	Alteration in the name of "Abu Dhabi Commercial Bank Limited" to "Abu Dhabi Commercial Bank PJSC" in the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/285 DBR.No.Ret.BC/22/12.07.053A/2016-17
31.	April 20, 2017	Compliance with Ghosh Committee Recommendations	RBI/2016-2017/284 Ref. DBS.CO.PPD.BC.No.9/11.01.005/2016-17
32.	April 18,	Disclosure in the “Notes to	RBI/2016-2017/283

	2017	Accounts" to the Financial Statements- Divergence in the asset classification and provisioning	DBR.BP.BC.No.63/21.04.018/2016-17
33.	April 18, 2017	Additional Provisions For Standard Advances At Higher Than The Prescribed Rates	RBI/2016-2017/282 DBR.No.BP.BC.64/21.04.048/2016-17
34.	April 18, 2017	Guidelines on compliance with Accounting Standard (AS) 11 [The Effects of Changes in Foreign Exchange Rates] by banks - Clarification	RBI/2016-2017/281 DBR.BP.BC.No.61/21.04.018/2016-17
35.	April 18, 2017	Prudential Guidelines – Banks' investment in units of REITs and InvITs	RBI/2016-2017/280 DBR.No.FSD.BC.62/24.01.040/2016-17
36.	April 13, 2017	Grant of 'Certificate of Registration' – For carrying on the business of credit information – Transunion CIBIL Limited	RBI/2016-2017/277 DBR.CID.BC. 60/20.16.040/2016-17
37.	April 13, 2017	Revised Prompt Corrective Action (PCA) Framework for Banks	RBI/2016-2017/276 DBS.CO.PPD.BC.No.8/11.01.005/2016-17
38.	April 10, 2017	Setting up of IFSC Banking Units (IBUs) – Permissible activities	RBI/2016-2017/273 DBR.IBD.BC.59/23.13.004/2016-17
39.	April 6, 2017	Change in Bank Rate	RBI/2016-2017/270 DBR.No.Ret.BC.58/12.01.001/2016-17
40.	April 6, 2017	Marginal Standing Facility	RBI/2016-2017/269 FMOD.MAOG.No.119/01.18.001/2016-17
41.	April 6, 2017	Liquidity Adjustment Facility – Repo and Reverse Repo Rates	RBI/2016-2017/268 FMOD.MAOG. No. 118 /01.01.001/2016-17
42.	April 6, 2017	Interest rates for Small Savings Schemes	RBI/2016-2017/267 DGBA.GAD.2618/15.02.005/2016-17
43.	March 29,	All payment systems to	RBI/2016-2017/260

	2017	remain closed on April 1, 2017	DPSS.CO.CHD.No./2720/03.01.03/2016-17
44.	March 25, 2017	Payment systems to remain open on all days from March 25, 2017 to April 1, 2017	RBI/2016-2017/257 DPSS.CO.CHD.No./2695/03.01.03/2016-17
45.	March 16, 2017	Pradhan Mantri Garib Kalyan Deposit Scheme (PMGKDS), 2016 - Clarification	RBI/2016-2017/251 IDMD.CDD.No.2347/14.04.051/2016-17
46.	March 9, 2017	Inclusion of "The Royal Bank of Scotland plc" in the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/244 DBR.No.Ret.BC.54/12.07.150/2016-17
47.	March 2, 2017	Financial Literacy by FLCs (Financial Literacy Centres) and rural branches - Policy Review	RBI/2016-2017/236 FIDD.FLC.BC.No.22/12.01.018/2016-17
48.	February 16, 2017	Forward Rate Agreement (FRA) and Interest Rate Swap (IRS) - Withdrawal of Fortnightly return	RBI/2016-2017/232 FMRD.DIRD.13/14.01.019/2016-17
49.	February 16, 2017	Inclusion of "Capital Small Finance Bank Limited" in the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/231 DBR.No.Ret.BC.51/12.07.145A/2016-17
50.	February 16, 2017	Inclusion of "Equitas Small Finance Bank Limited" in the Second Schedule to the Reserve Bank of India Act, 1934	RBI/2016-2017/230 DBR.No.Ret.BC.52/12.07.143A/2016-17
51.	February 9, 2017	Interest rates for Small Savings Schemes	RBI/2016-2017/225 DGBA.GAD.2012/15.02.005/2016-17
52.	February 2, 2017	Basel III Capital Regulations- Additional Tier 1 Capital	RBI/2016-2017/222 DBR.BP.BC.No.50/21.06.201/2016-17
53.	December 31, 2016	Facility for exchange of Specified Bank Notes	RBI/2016-17/205 DCM (Plg) No.2170 /10.27.00/2016-17

		(SBNs) during Grace Period – Verification of KYC and Account details	
54.	December 30, 2016	Cash withdrawal from ATMs – Enhancement of daily limits	RBI/2016-17/204 DCM (Plg) No. 2142/10.27.00/2016-17
55.	December 30, 2016	Closure of the scheme of exchange of Specified Bank Notes (SBNs) at banks on December 30th 2016- Accounting	RBI/2016-17/201 DCM (Plg) No.2103/10.27.00/2016-17
56.	December 29, 2016	Sanction of Additional Working Capital Limits to Micro and Small Enterprises (MSEs)	RBI/2016-17/200 FIDD.MSME & NFS.BC.No.20/06.02.31/2016-17
57.	December 28, 2016	Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances	RBI/2016-17/198 DBR.No.BP.BC.49/21.04.048/2016-17
58.	December 27, 2016	Master Circular on Issuance and Operations of Prepaid Payment Instruments – Amendments to paragraph 7.9	RBI/2016-17/196 DPSS.CO.PD.No.1610/02.14.006/2016-17
59.	December 21, 2016	Withdrawal of Legal Tender Character of existing ₹ 500/- and ₹ 1000/- Bank Notes (Specified Bank Notes) - Deposit of Specified Bank Notes (SBNs) into bank accounts-Modification	RBI/2016-17/191 DCM (Plg) No. 1911/10.27.00/2016-17
60.	December 19, 2016	Withdrawal of Legal Tender Character of existing ₹ 500/- and ₹ 1000/- Bank Notes (Specified Bank Notes) - Deposit of Specified Bank Notes (SBNs) into bank accounts	RBI/2016-17/189 DCM (Plg) No. 1859/10.27.00/2016-17

61.	December 16, 2016	Pradhan Mantri Garib Kalyan Deposit Scheme (PMGKDS), 2016 - Operational Guidelines	RBI/2016-17/188 IDMD.CDD.No.1454/14.04.050/2016-17
62.	December 16, 2016	Pradhan Mantri Garib Kalyan Deposit Scheme (PMGKDS), 2016	RBI/2016-17/187 IDMD.CDD.No.1453/14.04.050/2016-17
63.	December 15, 2016	Compliance to provisions of Master Direction on Know Your Customer (KYC)	RBI/2016-17/183 DBR.AML.BC.48/14.01.01/2016-17
64.	December 12, 2016	Detection of counterfeit notes in Specified Bank Notes (SBNs) - Reporting	RBI/2016-17/179 DCM (Plg) No. 1679/10.27.00/2016-17
65.	December 09, 2016	Security and Risk Mitigation measure - Technical Audit of Prepaid Payment Instrument issuers	DPSS.CO.OSD.No.1485/06.08.005/2016-17
66.	December 01, 2016	Financing of Infrastructure – 'Definition of 'Infrastructure Lending'	DBR.BP.BC.No.42/08.12.014/2016-17
67.	December 01, 2016	Information from Unauthenticated Sources – Advisory to banks	RBI/2016-17/166 DCM (Plg) No.1500/10.27.00/2016-17
68.	November 29, 2016	Deposit of Specified Bank Notes (SBNs) – Chest Balance Limit / Cash Holding Limit	RBI/2016-17/164DCM (Plg) No. 1459/10.27.00/2016-17
69.	November 29, 2016	Accounts under PMJDY - Precautions	RBI/2016-17/165 DCM (Plg) No. 1450/10.27.00/2016-17
70.	November 28, 2016	Chest Guarantee Scheme for Specified Bank Notes (SBNs) – CGSS	RBI/2016-17/162 DCM (Plg) No.1438/10.27.00/2016-17
71.	November 28, 2016	Withdrawal of cash from bank deposit accounts - Relaxation	RBI/2016-17/163 DCM No.1437/10.27.00/2016-17
72.	November 27, 2016	Chest Guarantee Scheme for Specified Bank Notes (SBNs) - CGSS	RBI/2016-17/160 DCM (Plg) No. 1430/10.27.00/2016-17

73.	November 26, 2016	Reserve Bank of India Act, 1934 – Section 42(1A) Requirement for maintaining additional CRR	RBI/2016-17/159 DBR.No.Ret.BC.41/12.01.001/2016-1
74.	November 25, 2016	Withdrawal of cash – Weekly limit	RBI/2016-17/158 DCM (Plg) No. 1424/10.27.00/2016-17
75.	November 24, 2016	Specified Bank Notes (SBNs) - Deposit under Guarantee Scheme to decongest the storage facilities at banks	RBI/2016-17/153 DCM (Plg) No.1383/10.27.00/2016-17
76.	November 24, 2016	Special knowledge or practical experience useful to banking companies	DBR.Appt.BC.No.39/29.39.001/2016-17
77.	November 21, 2016	Withdrawal of Legal Tender Character of existing □ 500/- and □ 1000/- Bank Notes –Revisions	RBI/2016-17/146 DCM (Plg) No.1323/10.27.00/2016-17
78.	November 21, 2016	Withdrawal of Legal Tender Character of Specified Bank Notes – Cash Withdrawal Limit	RBI/2016-17/142 DCM (Plg) No.1317/10.27.00/2016-17
79.	November 21, 2016	Withdrawal of Legal Tender Character of existing ₹ 500/- and ₹ 1000/- Specified Bank Notes (SBNs) – Cash withdrawal for purpose of celebration of wedding	RBI/2016-2017/145 DCM (Plg) No.1320/10.27.00/2016-17
80.	November 21, 2016	Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances	RBI/2016-17/143 DBR.No.BP.BC.37/21.04.048/2016-17
81.	November 17, 2016	Withdrawal of Legal Tender Character of existing 500/- and 1000/- Bank Notes – Exchange over the counters	RBI/2016-17/139 DCM (Plg) No.1302/10.27.00/2016-17
82.	November 15, 2016	Standard Operating Procedure (SOP) for	RBI/2016-17/133 DCM (Plg)

		putting indelible ink on the finger of the customers coming to a bank branch for SBNs	No.1280/10.27.00/2016-17
83.	November 14, 2016	Withdrawal of Legal Tender Character of existing 500/- and 1000/- Bank Notes – Applicability of the Scheme to DCCBs	RBI/2016-17/130 DCM (Plg) No.1273/10.27.00/2016-17
84.	November 13, 2016	Withdrawal of Legal Tender Character of existing 500/- and 1000/- Bank Notes – Revision in limits	RBI/2016-17/129 DCM (Plg) No.1272 /10.27.00/2016-17
85.	November 10, 2016	Repo / Reverse Repo Transactions with RBI	FMOD.MAOG.No.116/01.01.001/2016-17
86.	November 10, 2016	Schemes for Stressed Assets - Revisions	DBR.No.BP.BC.34/21.04.132/2016-17
87.	November 10, 2016	Scheme for Sustainable Structuring of Stressed Assets - Revisions	DBR.No.BP.BC.33/21.04.132/2016-17
88.	November 08, 2016	Withdrawal of Legal Tender Character of existing ` 500/- and ` 1000/- Bank Notes	RBI/2016-17/112 DCM (Plg) No.1226/10.27.00/2016-17
89.	October 13, 2016	Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR)	DBR.No.Ret.BC.15/12.02.001/2016-17
90.	October 4, 2016	Liquidity Adjustment Facility – Repo and Reverse Repo Rates	FMOD.MAOG.No.114/01.01.001/2016-17
91.	September 1, 2016	Priority Sector Lending - Targets and Classification: Lending to non-corporate farmers – System wide average of last three years	FIDD.CO.Plan.BC.14/ 04.09.01/2016-17
92.	August 25, 2016	Risk- based Internal Audit	DBS.CO.PPD.05/11.01.005/ 2016-17

93.	August 25, 2016	Review of Prudential Norms –Risk Weights for Exposures to Corporates, AFCs and NBFC-IFCs	DBR.No.BP.BC.6/21.06.001/ 2016-17
94.	August 4, 2016	Dishonour of cheques – Modification in procedure	DBR.No.Leg.BC.3/09.07.005 /2016-17
95.	July 28, 2016	Priority Sector Lending – Targets and Classification- Bank loans to MFIs for onlending - Qualifying asset - Revised loan limit	FIDD.CO.Plan.BC.No.8/04.0 9.001/2016-17
96.	July 21, 2016	Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards	DBR. BP.BC.No.2/21.04.098/2016 -17
97.	June 30, 2016	Performance Audit of Crop Insurance Schemes	FIDD.No.FSD.BC.28/05.10.0 07/2015-16
98.	June 23, 2016	Implementation of Indian Accounting Standards (Ind AS)	DBR.BP.BC.No.106/21.07.0 01/2015-16
99.	June 23, 2016	Reporting Requirements under Basel III Capital Regulations- Review	DBR.BP.BC.No.105/21.06.0 01/2015-16
100.	June 2, 2016	Cyber Security Framework in Banks	RBI/2015-16/418 DBS.CO/CSITE/BC.11/33.0 1.001/2015-16
101.	May 19, 2016	Repo / Reverse Repo Transactions with RBI	FMRD.DIRD. 10 /14.03.002/2015-16
102.	May 5, 2016	Discontinuation of Statements on Special Agriculture Credit Plan (SACP)	FIDD. No. FSD. BC.24/05.05.014/2015-16
103.	April 28, 2016	Compliance with Jilani Committee Recommendations	Ref.DBS.CO.PPD.BC.No.10 /11.01.005/2015-16
104.	April 28, 2016	F-TRAC – Counterparty Confirmation	FMRD.FMID.8/14.01.02/201 5-16

105.	April 21, 2016	Guidelines on Investment Advisory Services offered by Banks	DBR.No.FSD.BC.94/24.01.026/2015-16
106.	April 18, 2016	Provisioning pertaining to Fraud Accounts	DBR.No.BP.BC.92/21.04.048/2015-16
107.	April 7, 2016	Revision of interest rates for Small Savings Schemes	DGBA.GAD.3175/15.02.005/2015-16
108.	April 7, 2016	Priority Sector Lending Certificates	FIDD.CO.Plan.BC.23/04.09.01/2015-16
109.	April 5, 2016	Liquidity Adjustment Facility – Repo and Reverse Repo Rates	FMOD.MAOG. No. 112 /01.01.001/2015-16
110.	April 5, 2016	Marginal Standing Facility	FMOD.MAOG. No.113 /01.18.001/2015-16
111.	March 31, 2016	Risk Based Supervision – Follow up of Risk Management Systems in Banks	DBS.CO.PPD.10887/11.01.005/2015-16
112.	March 31, 2016	Gold Monetisation Scheme, 2015	DBR.IBD.BC.89/23.67.001/2015-16
113.	March 23, 2016	Liquidity Risk Management & Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards	DBR.BP.BC.No.86/21.04.098/2015-16
114.	March 17, 2016	Framework for Revival and Rehabilitation of Micro, Small and Medium Enterprises (MSMEs)	FIDD.MSME & NFS.BC.No.21/06.02.31/2015-16
115.	March 17, 2016	Pradhan Mantri Fasal Bima Yojana	FIDD. No. FSD. BC.20/05.10.007/2015-16
116.	March 01, 2016	Master Circular – Basel III Capital Regulations - Revision	DBR.No.BP.BC.83/21.06.201/2015-16
117.	February 11, 2016	Basel III Framework on Liquidity Standards –	DBR. BP. BC. No. 77/21.04.098/2015-16

		Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards	
118.	February 11, 2016	Implementation of Indian Accounting Standards (Ind AS)	DBR.BP.BC.No.76/21.07.001/2015-16
119.	January 21, 2016	Fraud Reporting and Monitoring	DBS.CO.CFMC.BC.No.007/23.04.001/2015-16
120.	January 14, 2016	Credit information reporting in respect of Self Help Group (SHG) members	DBR.CID.BC.No.73/20.16.56/2015-16
121.	January 14, 2016	Master Circular – Basel III Capital Regulations - Clarification	DBR.No.BP.BC.71/21.06.201/2015-16
122.	January 07, 2016	Non-Fund Based Facility to Non-constituent Borrowers of Bank	DBR.Dir.BC.No.70/13.03.00/2015-16
123.	December 31, 2015	Extension of Credit Facilities to Overseas Step-down Subsidiaries of Indian Corporates	DBR.IBD.BC.No.68/23.37.001/2015-16
124.	December 10, 2015	Fourth Bi-monthly Monetary Policy Statement, 2015-16 – SLR Holdings under Held to Maturity Category	DBR.No.BP.BC.65 /21.04.141/2015-16
125.	December 4, 2015	Interest Equalisation Scheme on Pre and Post Shipment Rupee Export Credit	DBR.Dir.BC.No.62/04.02.001/2015-16
126.	November 26, 2015	Central KYC Records Registry (CKYCR) - template for Know Your Customer (KYC) and reporting requirements under Foreign Account Tax Compliance Act (FATCA)/ Common Reporting Standards (CRS)	DBR.AML.BC.No.60/14.01.001/2015-16

127.	November 26, 2015	Bank Finance to Factoring Companies	DBR.BP.BC.No.55/21.04.172/2015-16
128.	November 19, 2015	Non-Operative Financial Holding Company (NOFHC) – Application of Capital Adequacy Norms	DBR.No.BP.BC.57/21.06.201/2015-16
129.	November 19, 2015	Provision of Factoring Services by Banks – Review	DBR.No.FSD.BC. 58/24.01.007/2015-16
130.	November 18, 2015	Priority Sector Lending – Targets and Classification	FIDD.CO.Plan.BC.13/ 04.09.01/2015-16
131.	November 4, 2015	Sovereign Gold Bonds, 2015-16 - Operational Guidelines	IDMD.CDD.No. 968/14.04.050/2015-16
132.	November 3, 2015	Gold Monetisation Scheme, 2015- Amendment	DBR.IBD.BC.52/23.67.003/2015-16
133.	November 3, 2015	Gold Monetisation Scheme, 2015- Interest Rate	DBR.IBD.BC.53/23.67.003/2015-16
134.	October 22, 2015	Gold Monetisation Scheme, 2015	DBR.IBD.No.45/23.67.003/2015-16
135.	October 15, 2015	Financial Inclusion Fund (FIF)- Revised Guidelines	DCBR.RCBD.BPD.No.4/19. 51.010/2015-16
136.	October 8, 2015	Individual Housing Loans: Rationalisation of Risk-Weights and LTV Ratios	DBR.BP.BC.No. 44 /08.12.015/ 2015-16
137.	October 8, 2015	Risk Weights for Claims on Foreign Central Banks	DBR.BP.BC.No.43/21.06.001/2015-16
138.	September 24, 2015	Prudential Norms on Change in Ownership of Borrowing Entities (Outside Strategic Debt Restructuring Scheme)	DBR.BP.BC.No.41/21.04.048/2015-16
139.	September	Constitution of the Audit	DBS.ARS.BC 4 /

	24, 2015	Committee of the Board	08.91.020/2015-16
140.	September 24, 2015	Framework for Revitalising Distressed Assets in the Economy – Review of the Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)	DBR.BP.BC.No.39/21.04.132/2015-16
141.	September 23, 2015	Half yearly/Quarterly Review of Accounts of Public Sector Banks	DBS. ARS.No. BC. 5/08.91.001/2015-16
142.	September 16, 2015	Guidelines on Compensation of Chief Executive Officer/ Whole Time Directors – Restrictions under Section 20 of the Banking Regulation Act, 1949 – Loans to Directors	DBR.Dir.BC.No.38/13.03.00/ 2015-16
143.	September 16, 2015	Equity Investment by Banks – Review	DBR.No.FSD.BC.37/24.01.001/2015-16
144.	August 28, 2015	Reporting requirement under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)	DBR.AML.BC.No.36/14.01.001/2015-16
145.	August 27, 2015	Security and Risk Mitigation Measures for Card Present and Electronic Payment Transactions – Issuance of EMV Chip and PIN Cards	DPSS.CO.PD.No.448/02.14.003/2015-16
146.	August 21, 2015	Guidelines for relief measures by banks in areas affected by natural calamities	FIDD No. FSD.BC.12/05.10.001/2015-16
147.	August 13, 2015	Union Budget - 2015-16 Interest Subvention Scheme	FIDD.No.FSD.BC. 59/05.04.02/2015-16

148.	July 16, 2015	Concurrent Audit System in Commercial Banks - Revision of RBI's Guidelines	DBS.CO.ARS.No. BC. 2/08.91.021/2015-16
149.	July 16, 2015	Priority Sector Lending – Targets and Classification	FIDD.CO.Plan.BC.08/04.09. 01/2015-16
150.	June 8, 2015	Strategic Debt Restructuring Scheme	DBR.BP.BC.No.101/21.04.1 32/2014-15
151.	June 4, 2015	Submission of Long Form Audit Report (LFAR) by Concurrent Auditors	DBS.CO.ARS.BC.8/08.91.00 1/2014-15
152.	May 7, 2015	Framework for dealing with loan frauds	DBS.CO.CFMC.BC.No.007/ 23.04.001/2014-15
153.	March 11, 2015	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks	RBI/2014-15/497 DBR.No.BP.BC.76/21.04.15 8/2014-15
154.	February 03, 2015	Ready Forward Contracts in Corporate Debt Securities	FMRD.DIRD.04/14.03.002/2 014-15
155.	December 15, 2014	Flexible Structuring of Existing Long Term Project Loans to Infrastructure and Core Industries	DBR.No.BP.BC.53/21.04.13 2/2014-15
156.	December 04, 2014	Mobile Banking Transactions in India - Operative Guidelines for Banks	DPSS.CO.PD.No.1017 / 02.23.001 / 2014-2015
157.	October 21, 2014	Framework for Revitalising Distressed Assets in the Economy – Review of the Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)	DBOD.BP.BC.No.45/21.04.1 32/2014-15
158.	October 16, 2014	Revisions to Basel II-Advanced Approaches of Operational Risk-TSA and	DBOD.No.BP.BC.43/21.06.0 17/2014-15

		AMA	
159.	October 7, 2014	Fourth Bi-monthly Monetary Policy Statement, 2014-15 –SLR Holdings under Held to Maturity Category	DBOD.No.BP.BC.42/21.04.141/2014-15
160.	September 29, 2014	Calculation of Drawing power in consortium accounts including CDR/bilaterally restructured Account	C&I/Circular/2014-15/689 issued by Indian Bank Association
161.	August 14, 2014	Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances – Project under Implementation	DBOD.No.BP.BC.33/21.04.048/2014-15
162.	July 22, 2014	Loans against Gold Ornaments and Jewellery for Non-Agricultural End-uses	DBOD.No.BP.BC.27/21.04.048 /2014-15
163.	July 15, 2014	Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries	DBOD.No.BP.BC.24/21.04.132/2014-15
164.	June 9, 2014	Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards	DBOD.BP.BC.No.120 / 21.04.098/2013-14
165.	June 3, 2014	Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure-Clarifications	DBOD.No.BP.BC.116/21.06.200/2013-14

166.	March 21, 2014	The Depositor Education and Awareness Fund Scheme, 2014 - Section 26A of Banking Regulation Act, 1949	DBOD. No. DEAF Cell. BC. No. 101/ 30.01.002/2013-14
167.	February 26, 2014	Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)	DBOD.BP.BC.No.97/ 21.04.132 / 2013-14
168.	February 11, 2014	Guidelines on Management of Intra-Group Transactions and Exposures	DBOD.No.BP.BC.96/21.06.102/2013-14
169.	February 7, 2014	Utilisation of Floating Provisions/Counter Cyclical Provisioning Buffer	DBOD.No.BP.95/21.04.048/ 2013-14
170.	January 20, 2014	Lending against Gold Jewellery	DBOD.BP.BC.No.86 /21.01.023 /2013-14
171.	January 15, 2014	Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure	DBOD.No.BP.BC. 85 /21.06.200/2013-14
172.	December 30, 2013	Non-Agriculture Loans against Gold Ornaments and Jewellery	DBOD.No.BP.79/21.04.048/ 2013-14
173.	December 20, 2013	Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961	DBOD. No.BP.BC.77/21.04.018/2013-14
174.	December 9, 2013	Novation of OTC Derivative Contracts	DBOD.No.BP.BC.76/21.04.157/2013-14
175.	November 25, 2013	Financing of Infrastructure - Definition of 'Infrastructure Lending'	DBOD.BP.BC.No.66 / 08.12.014 / 2013-14
176.	October	Amendments to Banking	DBOD.NO.PSBD.BC.62/16.

	23, 2013	Regulation Act 1949 -- Banking Laws (Amendment) Act 2012 - Applicability to private sector banks	13.100/ 2013-14
177.	September 25, 2013	Export Credit in Foreign Currency	DBOD.Dir.BC.No. 57 /04.02.001/2013-14
178.	September 20, 2013	Section 42(1) of the Reserve Bank of India Act, 1934 - Change in Daily Minimum Cash Reserve Maintenance Requirement	DBOD.No.Ret.BC.55 /12.01.001/2013-14
179.	September 3, 2013	Housing Sector: Innovative Housing Loan Products – Upfront disbursal of housing loans	DBOD.BP.BC.No. 51 /08.12.015/2013-14
180.	September 2 , 2013	Base Rate – Revised Guidelines	DBOD. No. Dir. BC. 47/13.03.00/ 2013-14
181.	August 26, 2013	Rupee Export Credit - Interest Subvention	DBOD.Dir.BC.No.43 /04.02.001/2013-14
182.	August 23, 2013	Investment portfolio of banks – Classification, Valuation and Provisioning	DBOD.BP.BC.No. 41 / 21.04.141 /2013-14
183.	February 28, 2013	Security and Risk Mitigation Measures for Electronic Payment Tractions	DPSS (CO) PD No.1462/02.14.003 / 2012-13
184.	January 31, 2013	Disclosure Requirements on Advances Restructured by Banks and Financial Institutions	DBOD.BP.BC.No.80/21.04.132/2012-13
185.	November 26, 2012	Review of the Prudential Guidelines on Restructuring of Advances by Banks/Financial Institutions	DBOD.No.BP.BC.63/21.04.048/2012-13
186.	October 12, 2012	Reporting Platform for OTC Foreign Exchange and	FMD.MSRG.No.72/02.05.002/2012-13

		Interest Rate Derivatives	
187.	September 18, 2012	The Scheme of 1% Interest Subvention on Housing Loans up to Rs. 15.00 lakh	RPCD.MSME&NFS.BC.No. 30 /06.11.01/2012-13
188.	July 23, 2012	Prudential Norms for Off-balance Sheet Exposures of Banks	DBOD.No.BP.BC.31 /21.04.157/2012-13
189.	May 07, 2012	Revisions to the Guidelines on Securitisation Transactions	DBOD.No.BP.BC-103/21.04.177/2011-12
190.	May 2, 2012	Guidelines on Implementation of Basel III Capital Regulations in India	DBOD.No.BP.BC.98 /21.06.201/2011-12
191.	March 9, 2012	Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives	FMD.MSRG.No.67/02.05.002/2011-12
192.	January 25, 2012	Deregulation of Savings Bank Deposit Interest Rate – Guidelines	DBOD.Dir.BC. 75/13.03.00/2011-12
193.	December 16, 2011	Deregulation of Interest Rates on Non-Resident (External) Rupee (NRE) Deposits and Ordinary Non-Resident (NRO) Accounts	DBOD.Dir.BC. 64 /13.03.00/2011-12
194.	November 30, 2011	Prudential Guidelines on Credit Default Swaps (CDS)	DBOD.BP.BC.No.61/21.06.203/2011-12
195.	November 2, 2011	Comprehensive Guidelines on Derivatives: Modifications	DBOD.No.BP.BC. 44 /21.04.157/2011-12
196.	October 25, 2011	Deregulation of Savings Bank Deposit Interest Rate - Guidelines	DBOD.Dir.BC. 42 /13.03.00/2011-12
197.	August 11, 2011	Prudential Norms for Off-balance Sheet Exposures of Banks	DBOD.No.BP.BC. 28 / 21.04.157 / 2011-12

198.	August 2, 2011	Comprehensive Guidelines on Derivatives: Modifications	DBOD.No.BP.BC. 27 / 21.04.157 / 2011-12
199.	May 31, 2011	Findings of Forensic Scrutiny- Guidelines for prevention of frauds _	DBS. CO.FrMC.BC.No.10/23.04.001/2010-11
200.	May 9, 2011	Section 24 of the Banking Regulation Act, 1949- Maintenance of Statutory Liquidity Ratio (SLR)	Ref. DBOD No. Ret. BC. 92 /12.02.001/2010-11
201.	May 4, 2011	Mobile Banking Transactions in India - Operative Guidelines for Banks	DPSS.CO.No.2502 /02.23.02/ 2010-11
202.	April 29, 2011	Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Fraud – Implementation of Recommendations	DBS.CO.ITC.BC.No.6/31.02.008/2010-11
203.	April 27, 2011	Implementation of the Advanced Measurement Approach (AMA) for Calculation of Capital Charge for Operational Risk	DBOD.No.BP.BC. 88 /21.06.014/2010-11
204.	February 21, 2011	Guidelines on Base Rate	DBOD.Dir.BC. 81 /13.03.00/2010-11
205.	February 9, 2011	Re-opening of pension option to employees of Public Sector Banks and enhancement in gratuity limits - Prudential Regulatory Treatment	DBOD.No. BP.BC.80/ 21.04.018/2010-11
206.	February 2, 2011	Classification of loans against gold jewellery	RPCD.CO.Plan.BC. 51 /04.09.01/2010-11
207.	January	Regulatory Capital	DBOD.BP.BC.No.75/21.06.0

	20, 2011	Instruments – Step up option	01/2010-11
208.	January 14, 2011	End use of funds – Monitoring	DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11
209.	January 6, 2011	Guidelines on the Base Rate	DBOD.No.Dir.BC. 73 /13.03.00/2010-11
210.	December 30, 2010	Know Your Customer (KYC) norms / Anti-Money Laundering (AML) standards/ Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002	DBOD. AML. BC. No.70/14 .01.001/2010-11
211.	December 28, 2010	Directions for opening and operation of Accounts and settlement of payment for electronic payment transactions involving intermediaries	RBI/2010-11/339 DPSS.CO.OSD. No. 1448/06.08.001/ 2010-2011
212.	December 27, 2010	Issuance and operation of Prepaid Payment Instruments in India – Auditor Certificate on the balances in Escrow account	RBI/2010-11/341 DPSS.CO.OSD. No. 1445 /06.12.001/ 2010-2011
213.	December 27, 2010	Directions for submission of system audit reports from CISA qualified Auditor	RBI/2010-11/340 DPSS.CO.OSD. No. 1444 /06.11.001/ 2010-2011
214.	December 23, 2010	Housing Loans by Commercial Banks – LTV Ratio, Risk Weight and Provisioning	DBOD.No.BP.BC. 69 /08.12.001/2010-11
215.	December 15, 2010	Swarna jayanti Gram Swarozgar Yojana (SGSY) - Group Life Insurance Scheme	RPCD.GSSD.BC.No.30 /09.01.01/2010 -11
216.	December 7, 2010	Operation of bank accounts & money mules	DBOD. AML. BC. No. 65/14 .01.001/2010-11
217.	November	Guidelines on Fair	DBOD. Leg. BC. 61

	12, 2010	Practices Code for Lenders – Disclosing all information relating to processing fees / charges	/09.07.005/2010 -11
218.	October 28, 2010	Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges	DBOD.No.BP.BC.51 / 21.06.101 / 2010-11
219.	October 7, 2010	Prudential Guidelines on Restructuring of Advances by Banks	DBOD.BP.No. 49/21.04.132/2010-11
220.	October 1, 2010	Prudential Norms for Off-Balance Sheet Exposures of Banks – Bilateral netting of counterparty credit exposures.	DBOD.No.BP.BC.48 / 21.06.001/2010-11
221.	September 30, 2010	Banks' Exposure to Capital Market - Issue of Irrevocable Payment Commitments (IPCs)	DBOD.Dir.BC.46 /13.03.00/2010-11
222.	September 27, 2010	Bank loans for financing promoters contribution	DBOD.No.BP.BC. 42 /21.04.141/2010-11
223.	September 1, 2010	Dishonour / Return of Cheques - Need to Mention the 'Date of Return' in the Cheque Return Memo	DPSS.CO.CHD.No. 485 / 03.06.01 / 2010-11
224.	July 30, 2010	Guidelines on trading of Currency Options on Recognised Stock / New Exchanges	RBI/2010-11/147 A.P. (DIR Series) Circular No. 05
225.	May 6, 2010	Working Group to Review the Credit Guarantee Scheme for Micro and Small Enterprises (MSEs) – Collateral free loans to MSEs	RPCD.SME & NFS. BC.No. 79 /06.02.31/2009-10

226.	April 23, 2010	Investment in Unlisted Non-SLR Securities	DBOD.No.BP.BC. 98/ 21.04.141/ 2009-10
227.	April 20, 2010	Conversion of term deposits, daily deposits or recurring deposits for reinvestment in term deposits	DBOD. No. Dir. BC. 91/13.03.00/2009-2010
228.	April 12, 2010	Collateral Free Loans - Educational Loan Scheme	RPCD.SME&NFS.BC.No. 69/06.12.05 /2009-10
229.	April 9, 2010	Guidelines on the Base Rate	DBOD. No. Dir. BC 88 /13.03.00/2009-10
230.	March 31, 2010	Implementation of The Standardised Approach (TSA) for Calculation of Capital Charge for Operational Risk	DBOD. No. BP.BC. 84 /21.06.001/2009-10
231.	March 30, 2010	Classification in the Balance Sheet - Capital Instruments	DBOD.BP.BC No.81/ 21.01.002/2009-10
232.	March 15, 2010	Additional Disclosures by banks in Notes to Accounts	DBOD.BP.BC.No.79 /21.04.018/2009-10
233.	January 13, 2010	Retail Issue of Subordinated Debt for Raising Tier II Capital	DBOD.BP.BC.No. 69 / 21.01.002/ 2009-10
234.	December 7, 2009	System Audit of the Payment Systems operated under the PSS Act, 2007	DPSS.AD.No./ 1206/02.27.005/2009-2010
235.	November 24, 2009	Directions for opening and operation of Accounts and settlement of payments for electronic payment transactions involving intermediaries	DPSS.CO.PD.No.1102 /02.14.08/ 2009-10
236.	September 1, 2009	Guidelines on Exchange Traded Interest Rate Derivatives	IDMD.PDRD.No. 1056/03.64.00/2009-10

237.	April 27, 2009	Policy Guidelines for issuance and operation of Prepaid Payment Instruments in India	DPSS.CO.PD.No. 1873 /02.14.06/ 2008-09
238.	April 22, 2009	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks – Compliance Certificate	Ref. DBS.CO.PPD.BC. 5 /11.01.005/2008-09
239.	February 10, 2009	Lending under Consortium Arrangement / Multiple Banking Arrangements	DBOD.No. BP.BC.110/08.12.001/2008-09
240.	December 31, 2008	Internal assignments in banks by statutory auditors	DBS.ARS. No. BC. 02/ 08.91.001/ 2008-09
241.	December 11, 2008	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks	DBOD.No.BP. 97 /21.04.158/2008-09
242.	December 08, 2008	"Lending under Consortium Arrangement/Multiple Banking Arrangements	DBOD.No.BP.BC.94 /08.12.001/2008-09
243.	December 1, 2008	"Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/ restrictions	DBOD.No.BP.BC.89 /21.04.141/2008-09
244.	October 13, 2008	Prudential Norms for Off-Balance Sheet Exposures of Banks	DBOD.No.BP.BC.57/ 21.04.157/2008-09
245.	September 19, 2008	Lending under Consortium Arrangement/Multiple Banking Arrangements	DBOD No. BP. BC.46/ 08.12.001/2008-09
246.	August 22, 2008	Unclaimed Deposits/inoperative accounts in Banks	DBOD No. Leg.BC.34/ 09.07.005/2008-09
247.	August 8,	Prudential Norms for Off-	DBOD.No.BP.BC.31/21.04.1

	2008	Balance Sheet Exposures of Banks	57/2008-09
248.	April 9, 2008	Guidelines on Asset-Liability Management (ALM) System	DBOD.No.BP.BC.68/21.04.098/2007-08
249.	October 29, 2007	Guidelines for issuing preference shares as part of regulatory capital	DBOD.No. BP. BC. 42 /21.01.002/2007-2008
250.	October 24, 2007	Guidelines on Asset-Liability Management (ALM) System – amendments	DBOD. No. BP. BC. 38 / 21.04.098/ 2007-08
251.	June 26, 2007	Guidance Note on Stress Testing	DBOD. No. BP. BC.101 / 21.04.103/ 2006-07
252.	April 20, 2007	Comprehensive Guidelines on Derivatives	DBOD.No.BP.BC. 86/21.04.157/2006-07
253.	April 20, 2007	Compliance Function in Banks	DBS.CO.PP.BC.6/11.01.005 /2006-07
254.	March 6, 2007	Prudential Limits for Inter-Bank Liabilities (IBL)	DBOD.BP.BC.66/ 21.01.002/2006-07
255.	December 26, 2006	Cheque Drop Box Facility and the facility for acknowledgement of cheques.	RPCD.CO.RF.BC.NO./40/07.40.06/2006-07
256.	November 3, 2006	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks	DBOD.NO.BP. 40/ 21.04.158/ 2006-07
257.	September 20, 2006	Section 17 (2) of Banking Regulation Act, 1949 – Appropriation from Reserve Fund	DBOD.BP.BC.31/21.04.018/ 2006-07
258.	April 5, 2006	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
259.	December	Donations by banks	DBOD. No. Dir. BC. 50/

	21, 2005		13.01.01/ 2005–06
260.	March 15, 2005	Guidelines on compliance with Accounting Standard (AS) 11(revised 2003) 'The Effects of Changes in Foreign Exchange Rates'	DBOD No.BP.BC.76 /21.04.018/2004-05
261.	June 26, 2004	Risk Based Supervision – Follow up of Risk Management Systems in Banks	DBS.CO.PP.BC. 14 /11.01.005/2003-04
262.	April 30, 2004	Guidelines on compliance with Accounting Standards (AS) by banks	DBOD No.BP.BC. 82 /21.04.018/2003-04
263.	April 30, 2004	Information System Audit - A review of Policies and Practices	DBS.CO.OSMOS.BC/ 11 /33.01.029/2003-04
264.	April 20, 2004	Appointment of statutory auditors in banks – abstention of declaration of indebtedness	DBS.ARS.No. B.C. 09 /08.91.001/2003-04
265.	June 3, 2003	Guidelines on Exchange Traded Interest Rate Derivatives	IDMC. MSRD. 4801/06.01.03/2002-03
266.	March 29, 2003	Guidelines on compliance with Accounting Standards (AS) by banks	DBOD.No.BP. BC. 89 /21.04.018/2002-03
267.	February 26, 2003	Inter-branch Accounts-Provisioning for net debit balance	DBOD.No.BP.BC.73/21.04.018/2002-03
268.	February 25, 2003	Guidelines for consolidated accounting and other quantitative methods to facilitate consolidated supervision	DBOD.No.BP.BC.72/21.04.018/2001-02
269.	October 21, 2002	Certification of Borrower's Account by Chartered Accountants	DBOD.No.BP.BC. 33/21.04.018/2002-03
270.	August 24,	Reconcilation of Nostro	DBOD.BP.BC.16/21.04.018/

	2001	Accounts- Old Outstanding Credit Entries	2001-02
271.	June 14, 2001	Internet Banking in India – Guidelines	DBOD.COMP.BC.No.130/ 07.03.23/ 2000-01
272.	July 7, 1999	Forward Rate Agreements/ Interest Rate Swaps	MPD.BC.187/07.01.279/1999-2000
273.	February 10, 1999	Asset - Liability Management (ALM) System	DBOD BP.BC. 8/21.04.098/99