Presentation on Bank Audit

Audit Procedures, LFAR, Tax Audit, Certification, Demonetization etc.

VIP Chartered Accountants’ Study Circle

By Rishi Khator

FCA, CPA(US), CIFRS

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The banking sector has moved from:

- Traditional banking to high level financial advisory
- Traditional products of deposits and lending to boutique of financial services/Para-banking activities.
- Branches to Service outlets.
- Customer of branches to customer of bank.

Then why do we still need Branch Audits
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KEY TERMINOLOGIES

• CBS
• Evergreening
• Early Mortality
• SMA
• Restructuring
• Upgrading
• Moratorium
• IRAC
• SBN
PART - A

APPROACH TO BANK AUDIT

1. KNOW THE BRANCH AND ITS BANKING
2. UNDERSTAND BANKING SOFTWARE
3. COMPONENTS OF FINANCIAL STATEMENTS
4. AUDIT PROCEDURES
5. CONCLUSIONS
1. KNOW THE BRANCH

• Obtain the following reports to assess the branch performance

  ➢ Level of Automation (Risks, Complexity in working)
  ➢ Previous Year’s Auditor’s Report/ LFAR ;
  ➢ Concurrent Audit Reports for the audit period ;
  ➢ Risk Based Internal Audit Report ;
  ➢ Zonal Inspection Reports, if any ;
  ➢ Exception Report ;
  ➢ Latest Revenue Audit Report ;
  ➢ IT System Audit Report ;
  ➢ RBI Inspection Report.
1. KNOW THE BRANCH- Cont.

• Understand the bank portfolio

➤ Types of deposits and advances
➤ Whether branch is deposit or advance rich
➤ Types of customers and borrowers
1. KNOW THE BRANCH - Cont.

- Must go through
  - RBI Master Circulars
  - Bank’s Internal Circulars and Guidelines *(controlling authority)*
  - Relevant Closing Circulars
  - Other relevant regulations under various statutes:
1. KNOW THE BRANCH- Cont.

• Reporting Requirements

➤ List the Returns and Certificates to be signed (*elsewhere listed*)
➤ Items to be reported in LFAR (*elsewhere listed*)
➤ Management Representation Letter (*elsewhere given*)
➤ Audit Report Format (*elsewhere given*)
Illustrative Bank Branch Audit Programme for the Year ended March 31, 2017 (pg 7)
2. Understanding Banking Software

- CBS (Records day to day software)
  - Like Balance Sheet and Profit & Loss
- Financial Statements generating software
  - All other non advances related returns
- Assets classification & Provisioning software
  - All advances related Basel and Capital Adequacy Returns
- Other Returns & Certificates
2. UNDERSTAND BANKING SOFTWARE

- Level of Automation
- Exception Reports
- Level of access rights at branch level – editable and uneditable fields
- System of downgrading and upgrading of accounts
- Interest Calculations
- Generation of reports relating to advances classification and Capital Adequacy calculation etc.

*Complexity, Risk Backup, Login (separate for each, long leave, manager, DBA)*
System Generated Transactions

• Certain System generated transactions are:
  ➢ Application of Interest.
  ➢ Application of service charges.
  ➢ Updation of parameters globally.
  ➢ Balancing & Reconciliations.
  ➢ Classification of inoperative accounts etc.
  ➢ Classification of Probable NPA’s
Manual Inputs

• Master File - Check Parameters
  ➢ Repayment Schedule
  ➢ EMI’s
  ➢ Interest Rate
  ➢ Drawing Power
  ➢ Penal Interest
  ➢ Overdue Principal and Interest (LAOPI)
  ➢ Asset Classification
  ➢ Account Inquiry (ACI)
Exception Reports

These reports reveal the exceptions and anomalies encountered during the day. Vital amongst these reports are:
• Exceptional report: It generally contains the following details, though it varies from software to software:
  ➢ Debit /Credit balance change
  ➢ Maturity record deleted
  ➢ Inactive accounts reactivated
  ➢ Excess allowed over limit
  ➢ Debits to Income head accounts
  ➢ Overdue bills and bills returned
Exception Reports

- Withdrawal against clearings
- Deposits accounts debit balance
- Temporary O/D beyond sanction limit
- Standing instruction failed in day
- Change in master: Auditor should check mainly for 29-30 sep, 30-31 mar, 1-2 apr.
COMPONENTS OF FINANCIAL STATEMENTS

Components of Financial Statements to be verified at Branch Level

- **Balance Sheet**
  - Advances, Deposits, Fixed Assets, Accrued Interest, FITL, Provisions etc.

- **Statement of Profit & Loss**
  - Interest earned, Interest paid, Commission, Other income and expenses

- **Off Balance Sheets Items**
  - Letter of Credit, Bank Guarantees, Bills for Collection etc.
4. 1.1 ADVANCES - OVERVIEW

ADVANCES

Fund Based

1. Term Loan
2. Cash Credit
3. Overdraft
4. Bills Purchased/Discounted
5. LC Devolved
6. BG Invoked

Non Fund Based

1. Letter of Credit (LC)
2. Bank Guarantees (BG)
3. Bills for Collection
4.1.2 ADVANCES - AUDIT PROCEDURES

(I) ANALYTICAL PROCEDURES

• Trend Analysis for the outstanding balances:
  ➢ Year on Year Basis
  ➢ Half Year
  ➢ 15th March and 31st March
4.1. ADVANCES - AUDIT PROCEDURES

(I) ANALYTICAL PROCEDURES- Cont.

➢ Calculate the interest percentage by applying the following formula:

\[
\text{Interest Income as per P&L account} \div \text{Average Balance of Loan Outstanding}
\]

➢ The above calculation to be performed for the period mentioned above and analyze the interest rate for the period.
• Comparative Analysis:

Perform comparative analysis on Year on Year basis for the following parameters

➤ Customer wise
➤ Exposure wise

• Percentage:

Calculate category-wise percentage of total loans and advances outstanding to know the coverage of each type.
• Ratio Analysis :

➢ Credit to Deposit Ratio : Advances given / Deposits

➢ NPA Ratio : Net NPAs / Advances given

➢ Provision Coverage Ratio : Provisions / Gross NPAs

➢ Return on Assets : Net Profits / Avg. Total Assets
(II) SAMPLING TECHNIQUES

- Obtain the following and consider for selecting sample
  - Trial Balance (or similar report) and list down the GLs and Sub GLs code of advances;
  - List of accounts (category wise) along with borrower name and outstanding amount;
  - List of accounts
    - opened,
    - closed and
    - opened & closed during the period under review;
  - Statement of potential Non-Performing Assets (NPA) i.e., Special Mention Accounts (SMA);
• Obtain the following and consider for selecting sample - Cont.

- List of NPAs as on reporting date;
- List of Restructured accounts;
- List of Upgraded during the period;
- List of accounts continuously appearing in exception report;
- List of critical accounts highlighted in Concurrent Audit Report, RBIA Report, Zonal Inspection Report, Branch Monitoring Reports etc.;
(III) AUDIT STEPS – (A) TERM LOANS

- Sanction is as per the discretionary lending powers of bank.
- Ensure disbursement is only after compliances with pre-disbursement conditions
- Check for security is created like equitable mortgage deed and pari-passu rights are clearly mentioned in the sanction letter and mortgage deed
- Ensure the latest security is correctly fed in the Asset Classification and Provision software.
- Repayment schedule is correctly fed in CBS & Asset Classification and Provision software. *(ACI Option E)* Also check for moratorium option, rephase, For year end credits enquire source
- Verify the Interest Parameters (Regular & Penal Interest)
- Ensure that critical amount due has reported in SMA Report has been received by the bank.
- Asset Classification correctly set up *(ACI : Asset Classification Inquiry)*
(III) AUDIT STEPS – (B) CASH CREDIT/OVERDRAFTS:

- Customer wise **Limit Lookup**
- Stock / Debtors Statements Tracking and calculation of DP
- Changes in SL/DP *ACLHM: Account limit History Maintenance*
- Turnover of CC Account based on Borrower’s Business profile
- Verify the Interest Parameters (Regular & Penal Interest)
- Review the Overdrawn Report for the outstanding amount exceeding sanction limits, if any. *ACLI: Option O, to check TOD*
- Verify the movements in the account to ensure that credits are routed through to suggest healthy movements. *For year end credits enquire source*
- Check interest is correctly applied on the day-end balances.
(III) AUDIT STEPS – (C) BILLS PURCHASED/DISCOUNTED:

- Scrutinize the bills register to ensure there are no overdue/matured bills for more than 90 days.
- Check whether bill wise break up is available in Asset Classification and Provision software.
- In Foreign Bills Register, ensure that exposure in foreign currency and equivalent Indian currency is correctly reported.
- Check interest collected is correctly classified under current and pre paid income.
- Devolved Bills under LC to be debited to limit A/C and not parked in some other account.
- BI & FBI – With Bill Status as “K” using Status Date Filter
(III) AUDIT STEPS – (D) RESTRUCTURE ACCOUNTS: PROVISIONING NORMS:

- Total provision required would be normal provision plus provision in lieu of diminution in fair value of advances.
- Diminution in fair value would be required to be recomputed on each balance sheet date.
- Banks have option of notionally computing the diminution in fair value and providing at 5% in case of all restructured accounts where the total dues to bank is less than one crore.
- Verify the restructuring proposal to ensure the accuracy of the sacrifice value:
  - Interest rate pre and post restructuring
  - Credit rating
  - Discounting factor (BR + Premium based on credit rating)
  - Period of loan reimbursement (pre and post restructuring)
  - Segment to which loan belongs to (Large corporate, Mid corporate etc)
(III) AUDIT STEPS – (D) RESTRUCTURE ACCOUNTS : PROVISIONING NORMS : - Cont.

- In fresh Restructure account, ensure that interest charged in the account is reversed and FITL, Interest Capitalization account is created for the same.
(III) AUDIT STEPS – (E) NON PERFORMING ASSETS : AUDIT STEPS

- Review the accounts which are classified as NPA with respect to
  - Security Value
  - Interest Reversal
  - Date of NPA
  - Provisioning thereon

- Review the annual stock audit report for the NPA with balance of Rs. 5 crores and above and latest valuation report for the immovable properties in case the valuation is older than 3 years.

- Review the accounts to ensure no interest is charged on such accounts.
4.2.1 DEPOSITS - OVERVIEW

DEPOSITS

Time Deposits

1. Current Account Deposits
2. Savings Account Deposits
3. Overdue Deposits

Term Deposits

1. Fixed Deposits
2. Recurring Deposits
3. Margin Money
4.2.2 DEPOSITS - AUDIT PROCEDURES

(I) SAMPLING TECHNIQUES

- Obtain the following and consider for selecting sample:
  - Trial Balance (or similar report) and list down the GLs and Sub GLs code of deposits;
  - List of accounts (scheme-wise) along with customer name and outstanding amount;
  - List of accounts
    - opened,
    - closed and
    - opened & closed during the period under review.
(II) AUDIT PROCEDURES

- Verification of KYC norms on test check basis.
- Obtain the interest report and verify interest calculation is accurate.
- Ensure that overdue deposits, matured time deposits, cash certificates and certificates of deposits are shown in Demand Deposits.
- Check Interest accrued but not due is not be included in deposits but, shown under other liability
- Check TDS compliance on the interest paid and on test check basis checking of Form 15G & 15H to confirm whether those forms are submitted with respective Income Tax Authority.
- Review the exceptional report for deposits without PAN, etc.
4.3 STATEMENT OF PROFIT & LOSS

- Major Expenses should be verified with supportings
- Provisions (e.g. Disputed municipal tax on premises, rentals) and Prepaid Exp to be computed.
- For NPA accounts income should be recognized on realization basis. When an account becomes non-performing, unrealized interest of the previous periods should be reversed or provided.
4.4 OFF BALANCE SHEET ITEMS

Off Balance Sheet Comprises of
a) Letter of Credit (LC)
b) Bank Guarantees (BG)
c) Bills for Collections

• Care in case of devolved LC’s/invoked BG’s:
  Devolved amounts adjusted by allowing excess drawings or adhoc or TOD’s, should be verified.
• Repayments made by the customer for devolved LC’s/invoked BG’s should also be verified.
• Non-reversal of Expired Guarantees to be looked into carefully – impact on capital adequacy.
For Balance Sheet and P&L account audit

- Age wise and nature(head) wise classification of all office accounts.
- Advances disbursed by transferring to deposit A/c.
- Abnormal transactions in term deposit A/c.
- GL error report
- Accounts having minimum interest rate pegged.
- Interest applied/failed report for deposits.
- Interest applied/failed report for advances.
- Loan account with Zero interest rate.
5. CONCLUSIONS

- Conclusions drawn based on the above audit procedures to be discussed with Branch head
- Based on the above discussions same shall be report in MoC and LFAR.
Illustrative Format of Report of the Branch Auditor of a Nationalised Bank – (Pg 28)
Illustrative Format of Written Representation Letter to be obtained from Branch Management- (Pg.60)
PART B - LFAR

• LFAR is an internal control evaluation questionnaire.
• It should therefore be clearly understood that LFAR by no means is an extension of the statutory audit report but is a supplementary report to bring awareness to the management and/or regulators.
• It should therefore be clearly understood that any point requiring qualification in the audit report must be qualified there itself, with such details as would be required and mere reference that the particular point has been reported in the LFAR is not enough.
• LFAR should be sufficiently detailed and quantified so that they can be expeditiously consolidated by SCA.
Major Clauses in LFAR:

• **Assets:**
  - Cash
  - Balances with RBI, SBI and Other Banks.
  - Money at Call and Short Notice.
  - Investments
  - Advances
  - Other Assets

• **Liabilities:**
  - Deposits
  - Other Liabilities
  - Contingent Liabilities
Major Clauses in LFAR:

- **Profit and Loss Account.**
- **General:**
  - Books & Records
  - Reconciliation of Control & Subsidiary Records.
  - Inter Branch Accounts
  - Audits/ Inspections
  - Frauds
  - Other Miscellaneous Matters
- **Annexure attached to the LFAR** – For Large Advances having exposure with more than 5% of Total Advances or Rs.2.00 Crores whichever is less.
Major Clauses in LFAR:

• Questionnaires applicable to Specialized Branches like –
  ➢ Branches dealing in Foreign Exchange Transactions.
  ➢ Branches dealing in Very Large Advances in excess of Rs.100 Crores.
  ➢ Branches dealing in NPA Recovery (Asset Recovery Management Branch)
  ➢ Branches dealing in Clearing House Operations (Service Branches)
An illustrative list of data which is to be collected by the Auditor from the Branch for the purpose of compiling LFAR (Pg 535)
For LFAR Procedures

- Overdue reviews/renewals of credit limits.
- Expired insurance/under insurances of securities.
- Overdue inspection of securities.
- Overdue renewal of loan documents.
- Overdue valuations of fixed asset charges in NPA.
- TDRs where lien has been lifted.
- Loans against TDR where lien not marked.
- Cash balance above the cash retention limit.
- Accounts having sanction limit exceeding rupees five crore.
For IRAC compliance Audit

• Accounts where moratorium period expired and interest flag “N”.
• Sub standard A/c restructured during the year
• Standard A/c rescheduled during the year
• Transaction turnover in CC accounts
• Report on overdue instalments and interest in loan A/c.
• Accounts where value of securities is less than drawing power.
• Accounts out of order for more than 90 days.
• Sub standard NPA upgraded during the year.
Long Form Audit Report of Bank Branches (Pg 538)
Securities Master Maintenance

Generally, the credit limits are administered through security register maintenance. Value of various securities i.e. stocks, book-debts, plant and machineries and Land & Buildings etc. are updated at the branch and drawing powers are administered accordingly.

Required:
• To check whether values of various securities are updated promptly and drawing powers are allowed on current value of such securities, based on the report of valuation officer.
• To check whether periodical reports on securities master are taken and scrutinized for verification of various fields i.e. value of securities, date of inspection, insurance, date of valuation, etc.,
ATM

• To check whether ATM Cash has been verified periodically cash should come in branch balance sheet or not.
• To check whether ATM transactions are reconciled periodically.
• Replenishment of Cash in ATM
Compliance with Implementation of Ghosh & Jilani Committee Recommendations-(Pg 641)
Illustrative Format of Certificate w.r.t. Compliance/Implementation Status of the Recommendations of the Ghosh and Jilani Committees- (Pg 648)
Tax Audit u/s 44 AB of I.Tax Act:

- Audit Report in Form No.3CA.
- Statement of Particulars in Form No.3CD.
- Generally, most of the clauses – filled in by the Bank in printed form – Some of the Items applicable only at the HO Level.
- Only few clauses to be answered by the Branch Auditor.
Tax Audit – Relevant Clauses:

- Books of Accounts Maintained and Examined – Generally printed list.
- Particulars of Depreciation allowable –
  Details of Purchase, Sale, Transfer and Disposal/ Write-off of Fixed Assets to be verified by Branch Auditor. - Depreciation calculation – generally at HO.
- Any amount of Capital Expenditure debited to Profit and Loss A/c.
- Expenditure by way of Penalty or Fine for violation of any law debited to Profit and Loss A/c.
Any amount inadmissible u/s 40(a):

- **Amount inadmissible u/s 40(a)(i):**
  - Any interest paid to a Non-Resident person or to a Foreign Company without TDS.

- **Amount inadmissible u/s 40(a)(i)(a):**
  - Any interest, commission, brokerage, fees for Professional/Technical Services or Contract Amount paid to a Resident person without TDS.
Tax Audit – Relevant Clauses:

• Section 40A(3) read with Rule 6DD:
  ➢ Whether any amount is inadmissible u/s 40A (3) read with Rule 6DD – relating to disallowance of any expenditure paid otherwise than by A/c. Payee Cheque?
  ➢ Obtain a Certificate from the Branch Management relating to payments covered u/s 40A(3).

• Bank’s Contribution and Employees’ Contribution to Provident Fund-Annexure details to be verified.
Tax Audit – Relevant Clauses:

• Compliance of TDS provisions:
  ➢ Verify TDS compliance under all relevant sections like Salary, Interest, Interest to NRI, Contract Payments, Technical & Professional Fees etc.
  ➢ Provide Details of:
    ✓ Tax Deductible but not deducted at all.
    ✓ Shortfall on account of lesser TDS than required.
    ✓ Tax Deducted late
    ✓ Tax Deducted but not paid to Central Govt.
Exception Report For Tax Audit

• Interest paid on term deposit above the exemption limit
• TDS not remitted within seven days from the last day of previous month.
• Repayment of FD’s amounting more than Rs. 20000/- must be through account payee cheque.
Demonetization

• The auditor should require the bank management to identify and inform him about any adverse observations in the implementation of the demonetisation
  • Exchange (4K, 4.5K, 2K, requisition slip, proof)
  • Deposit (no KYC :<=50K)
  • Withdrawal (20K, 24K, 50K)
  • ATM : Cash in hand, calibration
  • Reporting by Bank – Notes held by it on, SBN exchanged by it
  • PMJDU withdrawals, NRO deposit
  • Marriage withdrawal – Rs2.5 lakh
  • Risk of fake
  • Not to include in cash retention limit
Other Certificates:

• Certificate for **Compliance** of MOC-1 and MOC-2 as suggested by previous auditors.
• Certificate for **Cash and Bank Balances on reporting Fridays** (One Friday in each month).
• Certificate for **Investments** held by the Branch on behalf of Central Office.
• Certificate for **subsidy** claim under PMRY Scheme.
• Certificate for remittance of recovery in claim paid accounts to DICGC.
• Certificate for Advances granted to Corporate/Wholesale Banking Segment (Verification of Quarterly Returns on Segment Reporting)
Report on Implementation of Ghosh Committee Recommendations:

- Banking Sector always faces the threat of Frauds.
- Committee under Chairmanship of Mr.A. Ghosh, Dy. Governor, RBI.
- Ghosh Committee inquired into various aspects of Frauds and mal-practices in Banks and gave recommendations to minimize the occurrence of frauds in Banks.
- The Branch Management is required to prepare this report on implementation of Ghosh Committee Recommendations (in “YES” or “NO” Format) and The Auditor is supposed to verify the answers given by the Branch.
The main objective of this report is to ensure

- Existence of Proper Systems in Banks to ensure –
  - Safety of assets,
  - Compliance of laid down procedures,
  - Accuracy and completeness of accounting and other records.
  - Proper segregation and rotation of duties and responsibilities of staff and,
  - Measures for the prevention of frauds.
  - Timely detection of frauds and malpractices and taking corrective actions.
Report on Implementation of Jilani Committee Recommendations:

• Effective Internal Check and Control System is key to the success of Banking Sector.

• Committee under Chairmanship of Mr. Rashid Jilani, former CMD of PNB was asked to review the effectiveness of Internal Control, Inspection and Audit System in Banks.

• Jilani Committee made various recommendations for strengthening Internal Control, Inspection and Audit System in Banks under three broad categories based on areas of operations in Banks:
  
  ➢ EDP Environment in Banks.
  
  ➢ Inspection/ Internal Audit in Banks.
  
  ➢ Other Miscellaneous matters.

- The Branch Management is required to prepare this report on implementation of Jilani Committee Recommendations (25 Questions to be answered in Implemented/Not implemented Format) and The Auditor is supposed to verify the answers given by the Branch.

- Some of the Recommendations of Jilani Committee are to be implemented at Branch Level and some of them at RO/ZO Level.

- Central Statutory Auditors have reported in past that the reports received from branches on Ghosh and Jilani Committee are not properly verified by the auditors and they are replica of previous reports. - The Auditor is supposed to verify the correctness of the reports prepared by the Branch – In case of negligence, the auditor may be held accountable.
Thank You

Growing Stronger, Together