

OVERVIEW OF BANK AUDIT AND ANALYSIS OF SELECT CIRCULARS OF RBI

March 24, 2018

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UNPRECEDENTED CRISIS IN PUBLIC SECTOR BANKS

- Galloping increase in non performing advances (NPAs)
- Reported large divergences between NPAs identified by bank management and accepted as such by auditors and that assessed by Reserve Bank of India (RBI) with telling impact on bank's income/provisions/profits
- Huge reported frauds perpetrated by borrowers in collusion with bank officials ostensibly not reported upon by the bank's statutory auditors.
- Questioning of certain senior bank management/statutory auditors by CBI/SIFO

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UNPRECEDENTED CRISIS IN PUBLIC SECTOR BANKS (contd.)

- Crisis of confidence in the audit profession and the efficacy of regulatory oversight of ICAI over its members
- Government proposes to remove disciplinary oversight of auditors of listed and large unlisted entities from ICAI and vest the same in NFRA
- Doubts on ability of banks to meet depositors' dues in spite of large recapitalization of banks out of tax payers' monies
- Sluggish credit growth. Reluctance by banks to extend credit
- Is the banking sector on the verge of collapse??

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HUGE DENT IN CREDIBILITY OF THE AUDIT PROFESSION

- What has led to sharp divergences in quantum of NPAs, income and provisioning??
- Could these frauds been pointed out by statutory auditors?
- Causes- lax auditing procedures, audit restricted to review of assets/liabilities as at year end, no tests of control/substantive procedures carried out, audit reports not taken seriously by management, slam bam audits carried out in a matter of few days?????

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HUGE DENT IN CREDIBILITY OF THE AUDIT PROFESSION

- Wake up call for the profession
- What needs to be done to remedy situation?
- Can the profession emerge stronger out of the present crisis or will it sink in importance by its inability to read situation/respond satisfactorily to this crisis of confidence??
- Responsibility lies on each one of us

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PREPARATORY STEPS BEFORE COMMENCING AUDIT

- Appointment formalities
 - Obtaining no objection from previous auditor
 - Issue of engagement letter in accordance with SA 210. (Scope of audit, fact that due to inherent limitations of an audit, together with inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though audit is properly planned/performed in accordance with SAs, need for management's written representations, fact that audit may be subject to peer review etc.) refer appendix VII of guidance note on audit of banks 2017

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PREPARATORY STEPS BEFORE COMMENCING AUDIT (contd.)

- Study bank's closing instructions/significant accounting policies
- Study reports of RBI inspection, previous statutory and long form audit, concurrent audit, credit audit reports etc. Summarize deficiencies in internal control, documentation, monitoring, observations needing follow up
- Understand/have a walk through of CBS - setup, data fields, validations, reports particularly for identification /application of IRAC norms, controls for application of interest/fees, charging of service tax/GST, system generated entries, security environment, activities outside

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PREPARATORY STEPS BEFORE COMMENCING VERIFICATION (contd.)

- Obtain branch head's financial powers
- Fresh credits/enhancements (fund/non based) sanctioned during the year
- List of large advances (fund/non fund) (Credit facilities to borrowers beyond a monetary threshold) (retail and wholesale)
- Credit facilities restructured during the year
- Credit facilities upgraded during the year- NPA to PA
- Credit facilities denominated in foreign currency (PCFCs, FBD, FTL, FLC, FBG etc.)

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Base interest rates prevailing during the year

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PREPARATORY STEPS BEFORE COMMENCING VERIFICATION (contd.)

- Select sample of accounts to be audited
 - End to end
 - for asset classification only
 - to ascertain current status of accounts commented in various audit reports
- Large non based exposure, facilities granted in excess of sanctioned limits, devolved BGs, LCS, LUTs, fee charged
- Large deposits accepted/repaid, debits to inoperative accounts, death settlements, DDs issued/paid, cash deposits accepted/repaid etc.

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PREPARATORY STEPS BEFORE COMMENCING VERIFICATION (contd.)

- Preparation of audit planning document including assessing and identifying risk factors and exercising professional judgment to determine whether such factors, separately or in combination, are significant enough to require a special response
- Understanding all circulars of RBI having a bearing on the audit

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ADVANCES – AUDIT STEPS TO BE CARRIED

- For select sample, review accounts through entire gamut of life cycle of credit facility. Review all credit facilities to select borrower (s) together.

Appraisal, sanction, acceptance of sanction terms by borrower, documentation, compliance with sanction terms by borrower, creation of charge, disbursement, post disbursement monitoring, recovery, rescheduling, modification of terms, classification, interest calculations, rebate on bills discounted, recognition of income, reversal of income on NPAs, provisioning, sacrifices etc.

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ADVANCES – AUDIT STEPS TO BE CARRIED (Contd.)

- Special importance to be given to trade finance – discounting of bills (domestic and foreign), bills for collection, LCs, guarantees, LUTs, acceptances etc.
- Any possibility of accommodation bills discounting not backed by genuine sales and delivery of goods??
- Payments for imports not backed by physical receipt of imports. Reports to be filed with RBI.
- Charging of service tax/GST on fee income

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ADVANCES – AUDIT STEPS TO BE CARRIED (Contd.)

- Interest rate to be charged to take into account penal interest for delays in payment of principal /interest, additional rate to be charged for delay in commencement of commercial production, delays in execution of charge and furnishing collaterals, delays in submission of stock statements etc
- Fees recognized on non fund based facilities, margin provided, devolved LCs, LUTs, guarantees, recovery etc
- To enquire whether provisions are required for invoked LCs, LUTs and BGs but not paid

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ADVANCES – AUDIT STEPS TO BE CARRIED (Contd.)

- Compliance with accounting standards on foreign currency monetary assets
- To check whether credits in account are out of fresh credits either to borrower or a related party
- Analytical review of divergent trends in income received, yield on advances, movement of NPAs and provisions thereon.

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CIRCULAR OF RBI- MSME BORROWERS

- Circular dated Feb 7, 2018- Relief for MSME Borrowers registered under GST with aggregate exposure of banks/NBFCs not exceeding Rs 25 crores & classified as standard as on Aug 31, 2017 (incl. non based facilities) - extending T+90 days to T +180 days for dues between Sept1, 2017 and Jan 31, 2018.
- Extended period not applicable to income recognition and additional time is for the purpose of asset classification only
- Banks to make a provision of 5% in respect of the exposure not so classified as NPA.

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CIRCULAR OF RBI-RESTRUCTURING

- Circular dt. Feb 12, 2018- revised framework for resolution of stressed assets. Earlier circulars re stressed assets resolution, strategic debt restructuring, norms in change of ownership of borrowers, joint lenders forum, corrective action plan, CDR, restructuring of dues of SMEs etc. as detailed in annexure 3 to circular repealed.
- Lenders to identify incipient stress in loan accounts, immediately on default, by classifying them as special mention accounts (SMA) 0 (overdue < 31 days), 1 (overdue < 61 days and 2 (overdue < 91 days)
- Detailed guidelines for implementation of resolution plan, time lines.

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CIRCULAR OF RBI- RESTRUCTURING

- Restructuring is an act where bank, due to borrower's financial difficulty, grants concessions- change in terms / securities, change in repayment period/amount/ instalments /rate of interest/roll over/additional facilities/ enhancement of credit limits / compromise where time for payment of settlement amount > 3 months.
- Restructuring of projects under implementation involving deferment of DCCO shall continue to be covered under master circular dated July 1, 2015.
- On restructuring, standard accounts to be downgraded as NPA. NPAs, on restructuring, to continue as such. Asset classification will be governed by extant ageing criteria/

norms,
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CIRCULAR OF RBI- RESTRUCTURING

- Standard accounts classified as NPA & NPAs retained in same category on restructuring to be upgraded only when there is 'satisfactory performance' (payments not in default **at any point of time**) during 'specified period' (as defined)
- To upgrade large accounts (exposure > Rs 100 crores), in addition, facilities to be rated as investment grade (BBB- or better) at the end of specified period. Accounts with exposure > Rs 500 crores to have 2 ratings
- In case there is no satisfactory performance during specified period, account shall on such default, be reclassified as per pre restructuring repayment schedule. Future upgrade contingent on implementation of a fresh RP & satisfactory

performance
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CIRCULAR OF RBI- RESTRUCTURING

- Additional finance given under RP to be treated as standard during specified period if there is satisfactory performance. If not or account does not qualify for upgrading at end of specified period, additional finance to be placed in same AC category as restructured debt.
- Interest income from restructured accounts- standard to be recognized on accrual basis and NPAs on cash basis. Additional finance where pre-restructuring facilities were classified as NPA - interest income to be recognised on cash basis except where there is change in ownership.

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Forward contracts

- To test verify select settled as well as outstanding forward contracts with reference to sanction terms, advice from treasury, export/import contracts of customer, rates at which settled, cancellation/premature termination of contracts etc.
- To ensure that all outstanding forex contracts are disclosed as a contingent liability

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REGULATORY ISSUES

- Bank cannot grant loans/advances against security of its shares.
- restrictions on loans/advances to directors/entities in which they hold interest.
- Except with prior approval of RBI, remit debt due by its directors/specified related parties
- not hold shares in any company (including as pledgee) exceeding lower of 30 % of latter's paid-up capital or 30% of its paid-up capital & reserves.

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REGULATORY ISSUES

- Banks not to grant loans/advances without approval of its Board of Rs. 25 lakhs and above to directors of other banks/their specified related parties
- RBI's directives re credit against specified sensitive commodities.
- No loans to be granted against partly paid shares.
- No advances exceeding specified limit for purchase of securities through IPOs.
- RBI's directions-loans to corporates against security of shares held to meet promoters' contribution to equity of new companies.

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REGULATORY ISSUES

- RBI's directives-lending to infrastructure projects
- Prudential exposures-single/group borrower limits

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ACCOUNTING STANDARDS

- Accounting of BG/LC fees on cash basis and not recognizing fees for unexpired period as a liability is in accordance with AS ?
- To test outstanding LCs and BGs extended to borrowers whose accounts have been classified as NPA with reference to AS 29.

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DEPOSITS/OTHER BORROWINGS

- Understanding various products and its nuances
- To carry out end to end procedures:-
 - New accounts opened/KYC procedures
 - Fresh deposits accepted/renewed
 - Deposits repaid incl. death claims/transmission
 - Application of interest/withholding tax admn.
 - Marking of lien- loans against deposits
 - Repayment of old/inoperative accounts
 - Large cash deposits and with draws (Possible instances of money laundering??)

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DEPOSITS/OTHER BORROWINGS

- Inward and outward clearing procedures
- RBI norms re NRO/NRE/FCNR/RIFC/EEFC accounts
- Withholding tax at higher rates on interest paid to non residents
- Compliance with accounting standards on foreign currency monetary liabilities
- Analytical review of divergent trends in interest expense, cost of funds, movement of deposits etc.
- Any possibility of window dressing? Deposits out of book entries??

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SUNDRY ASSETS AND LIABILITIES

- Controls over issue of drafts, pay orders, gift cheques and other items of bills payable
- Controls over payments of drafts, pay orders, gift cheques and other items of bills payable issued by other branches
- Old/unclaimed bills payable settled during the year
- Old/ unclaimed bills payable and still outstanding
- Old items in sundries, suspense, clearing differences
- Controls - travellers cheques, prepaid/gift cards

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CONTROLS OVER CASH AND BANK

- Controls over custody of cash
- Passing of cheques for withdrawals
- Validation of cheque numbers of withdrawals with reference to cheque books issued
- Physical verification of cash daily by a person independent of cashier
- Cash sent to ATMs, amounts dispensed therefrom and reconciliation of balance with books
- Reconciliation of balances with RBI/other banks
- Controls over specimen signature records.

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REMITTANCES

- Controls over remittance systems- RTGS, Swift etc. Are they interfaced with CBS?
- Repatriation of funds belonging to non residents (deposits, asset sale proceeds etc.)
- Remittances to non residents for imports, royalty, fees for services, capital in subsidiaries and JVs, purchase of shares etc.
- Withholding tax compliance, LRS
- Funds received from exports and issue of FIRC's
- Funds received from non residents- capital, consideration for purchase of business etc.

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REMITTANCES (contd.)

- Fee income for government business- payment of pensions, collection of taxes
- Reconciliation of receipts from Govt. and payments made therefrom
- Reconciliation of taxes collected and payments to Govt.
- Reconciliation of funds received from corporates and payment of interest, salaries, dividends therefrom and fees earned thereon
- Reconciliation- funds from IPOs, controls over ASBA, remittances and fees earned thereon

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REMITTANCES (contd.)

- Income from distribution of third party products- mutual funds, insurance etc., reconciliation of funds collected and remitted

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COMPLIANCE

- Remittance of provident fund, professional tax etc.
- Withholding tax compliance- interest on deposits, payment of rent, professional fees, payments to advocates, chartered accountants, valuers, appraisers, brokerage, payments to contractors, payments to non residents.
- GST Compliance- collection & payment of GST on output services, inter branch transactions, input credit eligibility and availment, returns etc.

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MISCELLANEOUS MATTERS

- To review transactions in accounts of select employees for large/unusual flow of funds
- Operation and maintenance of safe deposit lockers
- Breaking open of lockers
- Frauds detected and reported during the year
- Interest subvention claims - eligibility, compliance with schemes
- Loan waiver claims- eligibility, compliance with schemes
- Analytical reviews of operating expenses

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MISCELLANEOUS MATTERS (contd.)

- Payment and administration of salaries to employees, leave records, leave encashment, increments, promotions, final settlements, payment of gratuity, pension and deductions (social security, taxes)
- Test checking of capital and operating expenditure, depreciation
- Controls over security papers (cheques, drafts, gift cards, ASBA etc.)
- Rotation of staff in terms of RBI/bank's extant rules

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Audit reports & meetings with statutory auditors

- Audit reports to be drafted keeping in mind relevant standards on auditing.
- Auditor to clearly set out observations with impact thereof. Not to make general comments.
- Branch auditor to summarize in his report comments in LFAR which have a bearing on true and fairness of FS
- Branch auditors to meet CSAs - major issues & disagreements with bank officials
- To maintain minutes of meetings/correspondence with statutory auditors
- To obtain management representations

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THANK YOU

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