

*Seminar on Bank Branch Audit  
Borivali(Central) CPE Study Circle*

*Audit of Loans & Advances in Bank Branch  
(Fund & Non Fund Based)*

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## Today's Agenda:

- ❑ Important Circulars/Notifications issued by Reserve Bank of India
- ❑ Importance and objectives of Audit of Advances
- ❑ Classification & Types of Advances
- ❑ Verification/Audit of Advances
  - Pre-Sanction
  - Sanction & Disbursement
  - Post Sanction - Documentation
  - Review , Monitoring & Renewal
- ❑ Audit Approach & Reporting Responsibility
- ❑ Case Studies

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# Important Circulars issued by RBI

## **Relevant Circulars applicable for FY 2016-17:**

### **❑ Master Circular/Master Directions:**

- Master Circular- Loans and Advances – Statutory and Other Restrictions dated July 1,2015
- Master Circular – Exposure Norms dated July 1,2015
- Master Circular - Guarantees and Co-acceptances dated July 1,2015
- Master Direction - Lending to Micro, Small & Medium Enterprises (MSME) Sector dated July 1,2016
- Master Direction- Priority Sector Lending- Target & Classification dated July 7,2016

### **❑ Other Circular/Notifications:**

- Review of Prudential Guidelines - Revitalising Stressed Assets in the Economy dated February 25,2016
- Framework for Revival and Rehabilitation of Micro, Small and Medium Enterprises (MSMEs) dated March 17,2016
- Sanction of Additional Working Capital Limits to Micro and Small Enterprises (MSEs) dated December 29,2016

# Classification & Types of Advances

## **Importance of Audit of Advances:**

- Lending constitutes major activity of the bank
- Advances generally constitute the largest item of the assets in the Bank Branch Balance Sheet (60% to 90% of Balance Sheet)
- Interest income and Fee income on advances (Retail as well as Corporate Loans)
- Close Monitoring of Lending Activity of the Bank by the Reserve Bank of India
- Important area of reporting in Long Form Audit Report in Bank Branch Audit
- Probable Area of Fraud, Income Leakages etc.

## Classification of Advances:

Based on	Description	Example of Facility
Funds	Funded and Non-Funded	Term loans, CC/OD, BG LC etc.
Geography	Inland and Export	Domestic TL, Packing/Pre-shipment Credit, Post-shipment Credit
Security	Secured and Unsecured	Mortgage, Hypothecation, pledge, clean, credit card
Sector	Priority sector and Non-Priority Sector	Agricultural, Home loans, Educational, small & medium enterprises



## Types of Fund Based Facility:

Type	Description
<b>Demand Loan</b>	Repayable on demand in a single or pre-determined instalments generally up to 3 years (36 months)
<b>Term Loan</b>	If demand loan's repayment exceeds 36 months, it is called Term Loan
<b>Cash Credit (CC)</b>	Credit Facility is generally granted against security of stock/book debts- Renewal every year
<b>Overdraft (OD)</b>	Credit Facility similar to cash Credit but <b><u>No Security</u></b> or other security like FD's, NSC receipts, Lien on LIC policies
<b>Bill Purchased /Discounted</b>	Advance against a sale bill after the buyer has received the goods

## Types of Non-Fund Based Facility:

Type	Description
<b>Letter of credit</b>	Undertaking by the bank to the payee (supplier of goods & services), on behalf of the buyer as per the terms of the LC
<b>Bank Guarantee (Financial / performance)</b>	To guarantee the performance of contractual obligations
<b>Letter of comfort</b>	Financial guarantee issued by bank to the beneficiary on behalf of borrower

# Types of Security for Advances:

## ❑ **Primary Security**

- Refers to security acquired by the borrower with bank finance or the one against which credit facility has been sanctioned by the bank

## ❑ **Collateral security**

- Collateral security is an additional security provided to bank in case of need. For eg, Insurance policy, FD's etc

## ❑ **Personal Guarantee**

- It is a guarantee by a third party for payment of outstanding in the event of default by the borrower

## ❑ **Fixed & Floating charge**

- Fixed charge is a charge on some specific and ascertained assets. Floating charge is an equitable charge on the assets, present as well as future

## **Sector wise Advances:**

### **□ Priority Sector:**

- 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 includes the following categories
  - ✓ Agriculture
  - ✓ Micro & Small Enterprise (as per limit)
  - ✓ Housing (as per Limit)
  - ✓ Export Credit

### **□ Non-Priority Sector:**

- Lending to other than priority sector is Non priority sector

# Verification of Advances- Fund & Non-Fund based

## **Important Standard on Auditing: Bank Branch Audit**

**SA 230 – Audit Documentation**

**SA 320 - Materiality**

**SA 500 – Evidence**

**SA 520 – Analytical Procedures**

**SA 530 – Audit Sampling**

**SQC 1 – Quality Control**

## **List of Requirement @ commencement of Audit:**

- ❑ RBI Master Circulars/Directions
- ❑ ICAI Material – Guidance Note 2017
- ❑ Bank's Internal Policies (HO circulars etc.)
- ❑ Annual Closing circular
- ❑ RBI inspection Report
- ❑ Internal Inspection and Concurrent audit Reports
- ❑ Previous year's AR & LFAR
- ❑ Significant accounting policies of the bank with respect to interest and Fee Income
- ❑ Sanction Power and Other limits with the Branch Manager
- ❑ Other information about branch ( Major Advances, NPA etc)

## **Audit Approach for Advances:**

- ❑ Verification of the Internal Control System in the branch
- ❑ Inspection, Observation and Inquiry- Basics of Audit
- ❑ Identify the risk areas- Large Advances, Smaller Advances
- ❑ More of Analytical procedures – On New & Old Advances
- ❑ Materiality - Sample Checking to be done
- ❑ Full verification of certain advances- Reported in IA, CA Report
- ❑ Review of internal, concurrent, RBI inspections reports etc.



## **Evaluation of Internal Control System:**

- Discussion with management & any operating manuals
- Level of implementation of the IC system
- Sanctioning process in the Bank
  - Sanctioning Authority and Powers
  - Extent of computerization & Documentation
  - Internal Communication with RO/HO
  - Quality and trained Staff
- External Inspection done by expert
- Existence of IT systems and its effectiveness
- Reports on Potential/Automatic NPAs and whether any parameters can be changed by manual intervention
- Actual Verification of Controls

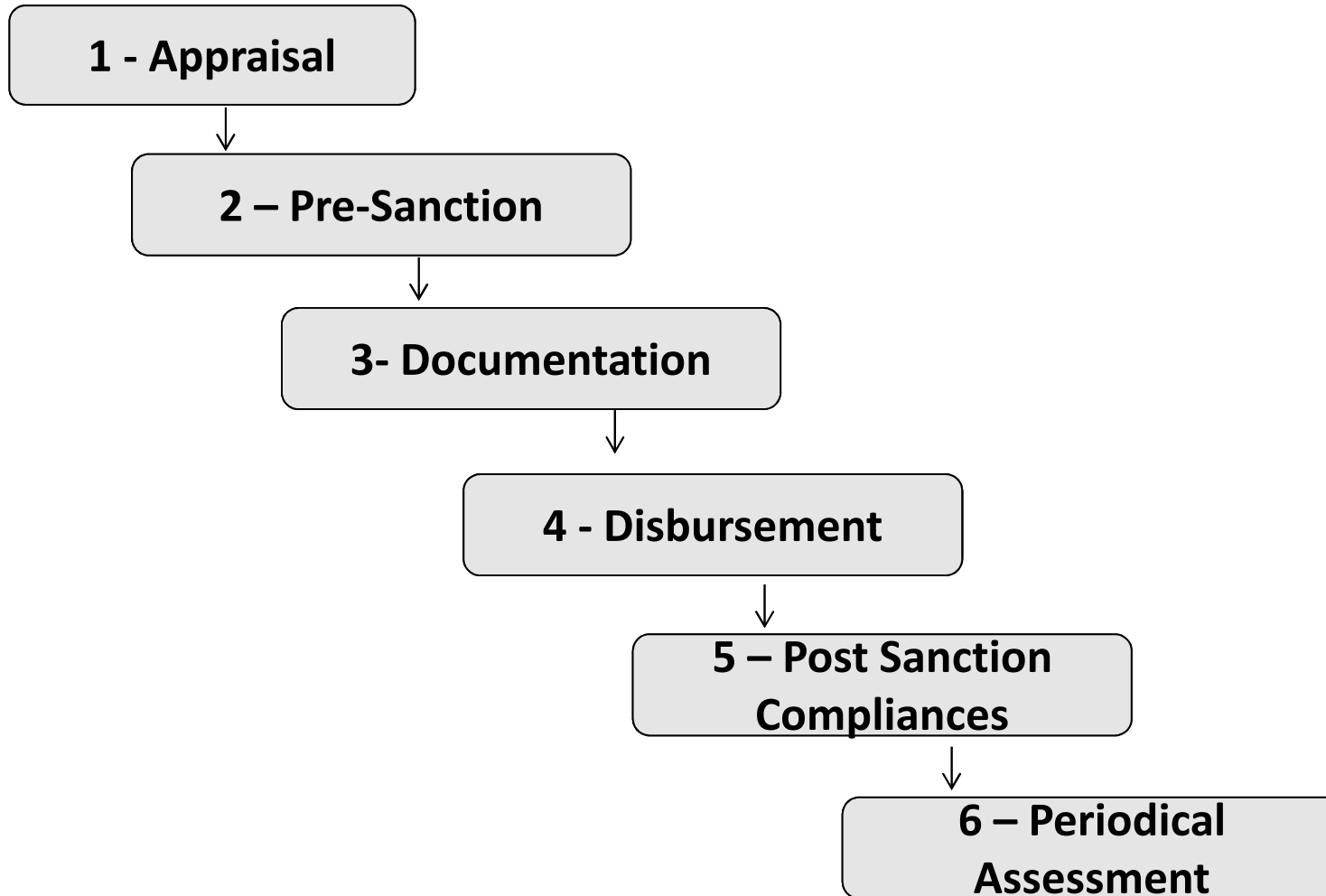
## **Extent of Checking & Materiality Level:**

- New Sanctions during Financial Year
- All Large Advances (Lower of 5% of Advances or 2crs )
- Adverse Remarks in
  - Concurrent Audit/IA Report
  - PY LFAR & Audit report
  - RBI Inspection
  - Internal Inspection
  - Special Audit
- Major movements (upgrades & down grades) in NPA / Restructured advances
- Type of Branch (Advances, Deposits)

## **Stages of Verification of Advances:**

- Credit Appraisal and Sanction of Advances
  
- Disbursement of Advances
  
- Review of Operations in Accounts
  
- Renewal/Enhancement/Re-schedulement/Balance Confirmations
  
- Physical Inspection of Securities & Valuations

# Stages of Verification of Advances: Flow Chart



# Credit Appraisal and Sanction of Advances

- ❑ Application / renewal in prescribed form/KYC Compliance
- ❑ Other documentations like project report, audited FS, cash flows etc
- ❑ Loan Application Scrutiny – Competent authority
- ❑ Review of credit appraisal system- Credit Checks
- ❑ Purpose of the loan- either business or personal
- ❑ Eligibility criteria & Repayment capacity of Borrower
- ❑ Verify that sanction is within the power of authority-(Branch or HO)
- ❑ Report any discrepancy noted during verification

## **Credit Appraisal and Sanction of Advances:**

- In this stage, the branch has the following functions:
  - ✓ Adequacy of Security & credit rating of borrower
  - ✓ Standing of promoters/ guarantors
  - ✓ Preliminary inspection of the business unit or residence of the borrower.
  - ✓ Inspecting the nature of the securities offered particularly Immovable properties.
  - ✓ Preparing report after such inspection stating specific reasons for either sanctioning/rejecting the loan.

## **Documentation before Disbursement:**

Adequate documentation – as per sanction note/bank's policy

Regularly updated

Enforceable by law

Any short comings observed

Maintenance and safe custody

## **Documentation before Disbursement:**

- Auditor should examine the loan documents obtained & compare with the list specified in the documentation manual.
- Auditor should verify whether:
  - ✓ All the particulars in the documents have been filled in.
  - ✓ All the particulars filled in are correct.
  - ✓ Signature and acceptance from the borrower has been obtained including the sanction letter.
  - ✓ Branch official concerned have verified & authorized that all the documents have been duly obtained.
  - ✓ Creation of charge – ROC site
  - ✓ Board resolutions – authorizing signatory
  - ✓ Borrower and Guarantors papers



## **Disbursement of Loans:**

- Verification of security – (title and valuation)
- NOC from previous banker – Take Over Advances
- Title clearance – search report – legal clearance
- All the terms of sanction are complied (quotations / proforma invoices )
- Direct disbursements to vendor/third party
- Verification of own contribution
- Pre disbursement inspection
- In case of draw down facility – stage of completion to be verified
- Follow up with original documents, registration etc.

## Post Disbursement Compliance:

❑ After the disbursement of the loan, the branch should monitor and comply all the term and conditions specified in Loan sanction letter.

❑ This compliance includes the following:

➤ Verification of end-use of the funds- *Whether they are utilized for intended purpose with a certificate from a CA.*

➤ In case of Immovable property offered as security:

✓ *Mortgage has created & registered.*

✓ *Valuation report, Legal opinion report, Latest encumbrance certificate has been obtained.*

✓ *Creation of charge & lien*

✓ *Insurance*

## **Review of Operation in Accounts:**

- ❑ Important stage in verification of advances- Regular Health Check-up
  
- ❑ Intelligent Scrutiny of Operations in accounts
  - transfer from/transfer to other accounts
  - Frequent cheque returns, excessive withdrawal
  - Turnover in account is disproportionate to sale in business
  - Transfer of funds to group concern
  
- ❑ Comparison of sales and purchase with the month wise stock statement submitted by the borrower
  
- ❑ Computation & Recomputation of DP limits on the basis of Stock statement by the borrower
  
- ❑ Reconciliation of balance of Advances with the General Ledger- unreconciled items needs attention

## **Renewal of Advances:**

- ❑ Renewal only at the end of one year- unless ad-hoc advances or otherwise prescribed in sanction letter- Non Renewal-NPA
- ❑ Limit realigned/enhanced- necessary documents are executed for such enhancement
- ❑ Reschedulement/Restructuring as per IRAC Norms
- ❑ Obtain "Letter of Acknowledgement of Debt" from borrower – to avoid documents becoming time barred
- ❑ Factors considered at time of renewal- History of Accounts, Future Projects etc.

## **Physical Inspection of Security & Valuations:**

- ❑ Examine stock audit report for any adverse comments with special attention to non moving/obsolete stock.
- ❑ Demat papers, physical shares, TDR, NSC usually in custody of bank and should be physically verified.
- ❑ Loan against shares- Periodic statement of valuation of shares pledged to ensure margin is maintained.
- ❑ NPA A/cs- Valuation report for all immovable properties mortgaged to the bank at least once in 3 years.
- ❑ Factory/ Property visit by the Branch Manager on regular basis
- ❑ Assesement of Impact of Change in Government Rules & Regulations (Cancellation of Coal mines by SC)

## **Reporting/ Rectification:**

- ❑ Auditors to report discrepancies noted in advances in - Statutory Audit Major/Critical discrepancies report & Long Form Audit Report (LFAR)
- ❑ If the discrepancy has to be rectified, it has to be through Memorandum of Changes (MOC)
- ❑ Adequate documentation for the discrepancies observed and rectified through MOC
- ❑ Documentation of Issues reported in LFAR to avoid any dispute in future

*Thank You*

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