CHAPTER - I
INTRODUCTION

1.1 GENERAL: - In the course of audit of a bank or of a branch of a bank, the auditor may come across matters which though not directly relevant or material for the purpose of his main audit report, would never the less be considered important enough to be communicated to the bank management. For this purpose, the auditor may in addition to his main report, submit a separate report to the management. Such compulsory and procedural report is termed as 'Long Form Audit Report' (L.F.A.R.) which was introduced w.e.f. the accounting year 1985 for the branches. Considering the utility of L.F.A.R.s from the point of view of bank management, the Reserve Bank of India has recently directed all Public Sector Commercial Banks to get L.F.A.Rs from their auditors. For this purpose, two separate questionnaires have been designed, one of which is applicable in case of auditors of Central / Regional offices of the banks. These questionnaires contain specific questions which the auditors are required to deal with in their L.F.A.Rs. Here, the advance segment of the questionnaire applicable to the bank branches has been critically analysed.

1.2 TYPES OF AUDITS IN THE BRANCHES OF PUBLIC SECTOR BANKS

Usually the following types of audit are carried out by the outside agencies: -

1.2.[1] STATUTORY AUDIT: - Authority of appointment rests with the Reserve Bank of India being the controlling authority of all banks. It forms the basis of compilation of the final report of the Bank.

1.2.[2] LONG FORM AUDIT: - In practice, this audit is performed by the Statutory Auditor after analysing the prescribed questionnaire. The issues disclosed in this report do not have any relevance to the Main Report unless and until they would not have been disclosed in the Main Report. This is due to the reason that the Main Report is the final outcome of the Statutory Audit, being mandatory one, whereas Long Form Audit Report is meant for the top management of the bank and its governing body i.e. Reserve Bank of India.

1.2.[3] TAX AUDIT: - In practice, it is too performed by the Statutory Auditors. This special type of audit is required to comply requirements of Section-44 AB of the Income-tax Act, 1961. It becomes mandatory when the total turnover of the branch exceeds Rs. 40 Lacs in the financial year.

1.2.[4] REVENUE/VERIFICATION/INCOME AND EXPENDITURE AUDIT: - The authority of appointment rests with the management and its main object is to check leakage of income and unauthorised bogus expenses.
1.2. [5] INTERNAL AUDIT/INSPECTION :-

Further, the authority of appointment rests with the management and its main object is to deeply scrutinize the routine as well as extraordinary transactions of the branch / bank and further to report all deviations to the management. Its reporting decides grades of the branches. This audit may be performed by the Internal Inspection Department of the bank as well.

1.2. [6] MANAGEMENT AUDIT :- This audit is given by the management in special circumstances when the management wants to update policies, to plan manpower, to determine the extent of delegation of power and to avoid superfluous paper work for improving organisational efficiency.

1.3. MAIN DISTINCTIONS AMONGST VARIOUS AUDITS :-

The main distinctions amongst various audits have been appraised as under :-

<table>
<thead>
<tr>
<th>S.L.</th>
<th>Nature of Audit</th>
<th>Governing Act</th>
<th>Authority</th>
<th>Object</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Statutory Audit</td>
<td>The Banking Regulation Act, 1949 &amp; The Companies Act, 1956</td>
<td>Mandatory</td>
<td>To give report with such material qualifications vitiating true &amp; fair view mainly.</td>
</tr>
<tr>
<td>2</td>
<td>Long Form Audit Reports Reports</td>
<td>-- do --</td>
<td>As per R.B.I Directions</td>
<td>To answer specified sets of questions highlighting deficiencies in those segments.</td>
</tr>
<tr>
<td>3</td>
<td>Tax Audit</td>
<td>Section 44AB of the Income-Tax Act, 1961</td>
<td>Mandatory for branches having turn-over exceeding Rs. 40 Lacs</td>
<td>To furnish report in the prescribed format of Form No. 3-CA on correctness of prescribed particulars of Form 3-CD of the Income-Tax Act, 1961</td>
</tr>
<tr>
<td>4</td>
<td>Revenue / Verification Income and Expenditure Audit</td>
<td>-- do --</td>
<td>Management</td>
<td>To report leakage of income and unauthorised/bogus expenses mainly.</td>
</tr>
<tr>
<td>5</td>
<td>Internal Audit/Inspection</td>
<td>-- do --</td>
<td>-- do --</td>
<td>To report all deviations of the routings as well as extra ordinary transactions.</td>
</tr>
<tr>
<td>6</td>
<td>Management Audit</td>
<td>-- do --</td>
<td>Management under special circumstance</td>
<td>To analyse and report on various matters meant for improving overall organisational efficiency.</td>
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</table>
1.4 IMPORTANCE OF LONG FORM AUDIT REPORTS (L.F.A.Rs) :

Every institution, specially large one, requires effective Internal Control System and every type of audit is a part of it, specially Internal Audit, giving detailed report. L.F.A.R. gives an effective and detailed report strengthening the Internal Control System. Further, it gives various material adverse features of other reports of previous Auditors / Inspectors including non-compliances thereof, if any. It not only analyses the material adverse features, but also those adverse features which are ignored by the management without undergoing compliances. Thus, it makes post-mortem of various previous reports as well. Detailed importance of L.F.A.Rs. is given herebelow :

1.4.[1] Branch returns are thoroughly scrutinized to find out inadequacy either by way of any Statutory information gap or any misleading information or giving information capable of misinterpretation and to suggest modifications accordingly.

1.4.[2] The L.F.A.R. gives details of pending reconciliation between Control Account and Savings Accounts & Ledgers, Control Account and Current Accounts, Ledgers, Control account and Advances, Ledgers etc. This information reveals the fields where there may be chances of deviations from normal procedures resulting even frauds as well.

1.4.[3] While framing L.F.A.Rs, previous latest reports issued by various agencies are scrutinized to find out major adverse features. Further persisting adverse features should also be reported. This information helps to take over proper remedial action by the top management as it consolidates major adverse features of reports issued by various agencies.

1.4.[4] The L.F.A.R. gives observations on proper maintenance of books of accounts e.g. overwriting, cutting or rubbing without proper authentication.

1.4.[5] Reporting on Cash balances far in excess of normal requirements serves the purpose of saving the risk from being lost and risk from being defrauded, as the management will take proper steps to keep level of cash normal.

1.4.[6] Further reporting on non-implementation of physical verification of cash balances at periodical intervals gives a signal of risk of expected leakages/frauds.

1.4.[7] Reconciliation Statement of the accounts with the Reserve Bank of India/State Bank of India may disclose unrecorded cash transactions, unexplained/unadjustable old outstanding balances and revenue items requiring adjustments. While going through this reconciliation statement some transactions may be material enough due to having implications on profitability or otherwise.
1.4.[8] The branches usually have balances in current accounts with other banks without having any return on it. However, the large bank balances are detrimental to the bank's interest due to these reasons: - Firstly balances in current accounts do not bear interest and secondly scarce financial resources lie idle which, otherwise, may be utilised anywhere else.

1.4.[9] To charge interest on bad and doubtful advances is not advisable in view of over assessment of the real profits and consequential overassessment of the current assets / other assets as the case may be. Therefore, it becomes obligatory to recognise such advances and report short provisions, if any.

1.4.[10] Reporting on documentation defects like non-insurance, shortfall in security etc. gives the management an alarm to rectify these defects before any mishapening. Thus, it materialises the slogan - prevention is better than cure.

1.4.[11] In case of bad and doubtful advances, it is necessary to lodge eligible claims with Credit Guarantee Corporation as the funds may remain blocked in such advances let they not be reported for non-lodging of claims.

1.4.[12] In case of authorised legal action, it becomes the duty of the branch to take legal action at the earliest but in several cases, belated legal action or no legal action may have been taken by the branch whether intentionally or due to omission. Reporting on such belated/ no legal action prevents the advances from becoming time-barred and thus improves liquidity by shortening time-span of recoverable measures.

1.4.[13] The Reserve Bank Of India has issued guidelines vide letter No. FOL. BC 126/C. 249-85 dated 07.11.1985 to classify all advances according to the eight codes on the basis of status of the advances. This classification is known as Health Code System. This analytical approach is helpful in assessing the status of the advances. If the classification is deviated, it will give false projection of the real picture. Thus reporting on such deviations gives real status of the advances for taking appropriate action.

1.4.[14] Rehabilitation may be recommended in case of sick/sticky advances. However, all sick/sticky advances do not deserve such facility of rehabilitation. Sanctioning of this facility depends upon various factors like stages of sickness i.e., whether revival of the unit is possible on rehabilitation, status of the management i.e., whether the management is competent enough to cope with such sickness, dead-lock in the management i.e., whether there is such dead-lock, if so, then revival of the unit may not be possible etc. Reporting on status of Rehabilitation Programme will show status of revival of such sick/sticky unit and in case of non-revival the consequent reason/s for such petty revival. After such analysis the revival may be positively directed by the management.
1.4.[15] It has been directed by the Reserve Bank of India to get audit reports on specified formats from the Chartered Accountants in case of working capital limits exceeding Rs. 10 Lacs. Reporting on noncompliances of this condition in any case will alarm the management to take immediate action on such big account in order to know real financial position of the unit by getting fresh audit report.

1.4.[16] Reporting on inadequacies in the system relating to physical verification of furnitures and fixtures and major discrepancies, if any, noticed on such physical verification carried-out at the branch, notifies position of the Internal Control on these assets. On this very basis pilferage may be checked by taking appropriate action.

1.4.[17] Stationery comprising of security papers (Term Deposit Receipts, Drafts, Cash Orders, Travellers Cheques etc. is key portfolio for proper control. Leakage of these documents may give rise to frauds of any huge amount. Thus reporting on non-implementation of well-established Internal Control procedures with regard to security papers or any inadequacies therein may be informative to the management to take preventive measures in order to avoid unprecedented risks. Further suggestions, if any, for improvement of the existing procedures by an expert will give a big hand in improving the existing system.

1.4.[18] The branches in the Suspense Account may keep substantial outstanding lying pending for clearance since long. For example, advances to the staff may be outstanding without any adjustment which might have affected profitability of the branch, if it would have been adjusted during the year. To report on the system of the bank for expeditious clearance of Suspense items may give rise to improvement and further analysis on break-up of old outstanding may highlight bad intention of the branch management, if any.

1.4.[19] On scrutiny of old and outstanding balances, other than loans and advances, the auditors may come across cases of non-recoverable balances requiring provision or write-off. On writing off such balances, real picture of profit and other assets will get reflected.

1.4.[20] Under the Bills payable several old outstanding may lie unadjusted in absence of relevant advices to be received from other branches/offices e.g. The drafts of other branches are used to be paid in absence of advices which are used to be received later-on resulting outstanding under this head.

1.4.[21] Usually untraced deposits are accounted in the Sundry Deposits Account and on proper tracing/submission of relevant supportings, these outstanding are transferred to relevant accounts. For example: a petty borrower may be issued Recovery Certificate (R.C.) for his borrowings being overdue. In the meantime, he might have deposited money to clear his overdues,
but the clerk might have posted it in the Sundry Deposit Account due to issue of R.C. In spite of his deposit, the borrower may be defaulter in the eyes of the bank as well as in the eyes of the Recovery Clerk of the court with an imposition of 10% of the recoverable borrowing. Under such circumstances, the relevant borrower may be imprisoned in spite of that he has cleared his borrowings.

1.4.[22] Disclosure of Contingent Liabilities, especially of material amounts, is essential in order to know the real health of an organisation. For example:- A branch may have a few suits in hand having poor grounds and these may be lost. Though, the present financial viability of the branch may be very lucrative, but on finalisation of the suits, the branch would incur heavy losses. Therefore, such future events are necessarily to be disclosed for assessing present financial health of the branch.

1.4.[23] Interest forms major part of the branch's income. Let there be major discrepancies in it, the branch's profit would either be overstated or understated and further would affect the customers realisations by affecting bank's goodwill, especially in case of wrong over realisations.

1.4.[24] Next to the interest income, commission is one of the major source of revenue realisations for the bank. Omission in charging such commission mainly occurs at the time of renewal of guarantees and at the time of calculation of days of bills for collection on which realisation of commission is based. Such reporting helps the management to realise present dues and further to prevent such recurrence, if any.

1.4.[25] Comparison of present co-relation of the output to the source with that of the previous year gives us the trend of performance. Therefore, reporting on comparison along with the reasons, of the present co-relation of the interest and other income to the relevant aggregate of average advances, outlay of funds with that of previous year would give the management clues for taking appropriate action for improving the performance of the branch. The same importance is that of comparing the co-relation of the interest paid on deposits, borrowings etc. with the relevant figures of aggregate average deposits and borrowings.

1.4.[26] In the L.F.A.R., there are certain specified questions to be answered analytically. However, various questions which would remain unanswered though important enough, if freedom will not be given to the auditor. Therefore, a segment miscellaneous is incorporated therein in order to give such freedom e.g., the branch is secured by the ungunned guard.

1.5. FORMAT OF L.F.A.R. REGARDING THE SEGMENT OF ADVANCES

(a). LARGE ADVANCES :-
1). Have you examined all large advances. Indicate the accounts considered doubtful, the shortfall in security, and whether or not provision has been recommended/made.

11). (a). Are there any other adverse features in such advances, e.g., documentation defects, value of security and inspection thereof, frequent/unauthorised overdrawing beyond limits, insurance coverage, charge registration etc.

(b). In respect of other advances examined by you, have you come across any adverse features which need to be brought to the notice of the management, if so, please state them.

(c). Whether appropriate claims for credit guarantees/insurance have been duly lodged and recovered. If not, indicate the number of cases and the amounts involved.

(d). Does an overall review of the advances portfolio of the branch indicate generally proportionate change in bad and doubtful debts as compared to those of the earlier year? The following information may be given in this regard:-

<table>
<thead>
<tr>
<th>PARTICULARS</th>
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<tbody>
<tr>
<td>THIS YEAR</td>
</tr>
<tr>
<td>NO. OF A/cs.</td>
</tr>
<tr>
<td>a. Total Advances</td>
</tr>
<tr>
<td>b.i. Bad &amp; Doubtful advances</td>
</tr>
<tr>
<td>ii. Suit-filed &amp; decreed debts (other than those at (b)i) above</td>
</tr>
<tr>
<td>iii. Sick/recalled advances other than those under (b)(i) and (ii) above</td>
</tr>
<tr>
<td>Total (b)</td>
</tr>
<tr>
<td>(c). Percentage of (b) to (a)</td>
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</table>

Particulars/details may be furnished as regards provision for doubtful debts recommended beyond that made by the branch as at the year end.

(e). Have you come across cases where the Board/Local Board has authorised legal action for recovery of advances and no such action was taken by the branch management for an unduly long period.
(f). Whether the branch has identified and classified the advances in accordance with guidelines issued by the Reserve Bank Of India for classifying advances as per the Health Code System. Have sticky/sick large advances been reported to the controlling Authority? Also state whether any Rehabilitation Programme in respect of such advances has been undertaken, and if so, the status of such programme may be described.

(g). Have you come across cases of advances to non-corporate entities with limits beyond Rs. 10 Lakhs where Reserve Bank Of India guidelines with regard to compulsory audit have not been complied with?

1.6 GENERAL DISCUSSION :-

1.6.[1] The L.F.A.Rs. pertaining to the bank branches would be required to be furnished by the branch auditors to the chairman of the concerned bank with a copy to the Statutory Auditors who will consider the L.F.A.Rs received from various branches and consolidate them before submitting their L.F.A.Rs. of the whole bank to the Reserve Bank of India.

1.6.[2] No time limit for submission of L.F.A.R. is prescribed, However, it is advisable to submit it alongwith the main statutory report or within one week after submission of the main report.

1.6.[3] Detailed procedural analysis of various segments at a glance:--

(a) LARGE ADVANCES :- The advances in respect of which the outstanding are in excess of 1% of the advances portfolio of the branch or Rs. 1 crore, whichever is less.

i). The following ingredients are to be reported exhaustively:-

(A). To examine all large advances,

(B). To recommend shortfall in provisions required for amounts considered doubtful of recovery,

(C). To report shortfall in security,

ii). To report other adverse features e.g., documentation defects such as guarantee missing etc., value of security such as taken on higher side, physical inspection not periodically done, frequent/ unauthorised overdrawing beyond limits, inadequate insurance coverage, charge not registered etc. Also quote illustrations, wherever required.

(b) To report adverse features noticed by the auditors which are significant enough in case of large advances.

(c). (i) To ascertain the procedure for identifying doubtful accounts eligible for credit guarantee claims,

(ii) To ascertain initiation of appropriate steps for recovery,
(iii) To ascertain lodging of claims,
(iv) To furnish year-wise break-up
(vi) To furnish number and amount of claims ought to have been lodged but not yet lodged.

d. To review advances at year-end by scrutinizing the branch return is required for the comparison with that of the previous year as specified in the prescribed format of the questionnaires. Further, the auditors are required to furnish particulars as regards provision for doubtful debts recommended beyond that made by the branch as at the year end.

e. The auditor should report on delayed legal action/ no legal action in cases it was authorised by the management.

f. (i). The auditors should generally examine whether, the advances have been properly classified in accordance with the guide lines.

(ii). The auditors should examine and report whether the branch has been submitting the information regarding stick/sick large advances to the controlling Authority as per procedures laid down in this behalf.

(iii). Status of the nursing programmes should be reported for such stick/sick large advances in case of initiation of such programmes.

g. The Reserve Bank of India has advised to all Scheduled banks for Compulsory Audit by the Chartered Accountants in case of non-corporate borrowers enjoying aggregate working capital limits of Rs. 10 lacs or more. This requirement is to be complied with even in case of renewal of the limit.

1.6.[4] MISCELLANEOUS :-

As noticed above, the auditors would have to report on certain specified questions. However, there may be other important issues which would be fruitful to the management to be highlighted e.g., the guard of the branch renders his services without arming with gun, though, he would have been required to be armed during discharge of his duty.

1.6.[5] OTHERS :-

It must be recognised that the L.F.A.R. can not in any way be substitute for the main report. It, therefore, follows that in all cases, matters covering statutory responsibility of the auditors would have too be dealt within the main report. In fact, L.F.A.R. is one of the means to communicate to the top management on any matter requiring to its proper disposal at the branch level.