Audit and Inspection Systems in UCBs

Presentation, Disclosures and Compliance

Madhav Prabhune

An audit is an independent evaluation of banks' financial statements, while inspection is a review of banks' operations with applicable laws and regulations.

Urban Cooperative Banks (UCBs) are governed by Maharashtra State Cooperative Societies Act 1960 (MCS Act) and Rules 1961 framed thereunder functioning within the State of Maharashtra, Multi-State Cooperative Societies Act 2002 (MSCS Act) functioning in more than one state, Banking Regulation Act 1949 (BR Act) equally apply to both of them and RBI's Master Directions issued from time to time. After the debacle of Punjab and Maharashtra Cooperative Bank in September 2019, which warranted giving more powers to RBI to regulate UCBs in terms of management, capital, audit, and liquidation, and therefore, the Banking Regulation Act 1949 was amended on September 16, 2020.

This article deals with various aspects of presentation, disclosures and accounting standards in financial statements by UCBs as brought out by RBI vide Circular No. 45 dated August 30, 2021, harmonising across the banking sector in India.

Format of balance sheet and profit and loss statements

Sections 29 and 56, Schedule III of the BR Act prescribed formats for the preparation of balance sheets and profit and loss accounts by UCBs.

Periodicity of preparation of financial statements

UCBs are required to prepare a balance sheet, and P & L in respect of all business transacted for the year ending 31st March. In addition, they are required to ensure strict compliance with accounting standards and disclosures specified in Annexure II (A & B) and Annexure III of the Master Direction of RBI. UCBs are also required to be guided as per the instructions issued by The Institute of Chartered Accountants of India (ICAI).

Publication and submission of financial statements

UCBs are required to get their financial statements audited, approved by RBI from the Statutory Auditors and publish the same in the local newspapers by 30th June. Subsequently, such financial statements are required to be placed before the General body, at the latest, by 30th September every year for adoption.

Inspection by RBI officials

Generally, RBI carries out inspections on the basis of audited financial statements. Table 1 explains different types of audits. RBI insist on certification of Statutory Auditors for IRAC and priority sector lending. In case of huge data, they resort to sample checking and also through external experts for software. In addition to the types of audits in Table 1, the following extra audits are required to be done by the IT-qualified experts:

- IT and system audit,
- Cyber security audit,
- Data migration audit when new software is purchased, and
- Legal audit and forensic audit.

Table 1. Types of audit

Particulars	Internal Audit	Concurrent Audit	Statutory Audit	RBI Inspection
Who does Audit	Audit Dept. of the bank	CA appointed by BOD	CAs approved by RBI	RBI itself
Periodicity	Annually	Ongoing monthly	Once a year	Once in a year / alternate year
Scope	As per the bank's policy, Internal circulars, Bye-laws	As per the policy of RBI	As per the policy of RBI as well as provisions of the MCS Act, Long Form Audit(LFAR)	As per the BR Act, Master Directions, capital - augmentation Deposit, Investment, Loans and Advances, NPAs, Provisions and other Regulatory compliances
Timeline for submission	As per the policy of the bank	In the following month	30th June	Within reasonable time
Compliance	At the earliest	In the following month	Within 3 months of the date of the audit report submitted	Within 6 weeks from the date of receipt of a report
Penal Provisions	------	------	As per MCS Act	Nominal for violations
Fees	NA	As decided by the board.	As per MCS Act	Nil. However, as per Sections 30 and 35 of the BR Act, recoverable from the bank.
Closure of Report	As per policy, but as early as possible.	On compliance, immediately. Non-complied queries to be carried forward.	On full Compliance	On full compliance

Some important and useful guidelines

1. Disclosure of events happening subsequent to 31st March

For example, a borrower whose account was standard as of 31st March, and the account slipped into NPA due to the demise of the borrower after March. The information is not relevant, but the bank may like to disclose it. In another example, the account was NPA as of 31st March. The recovery was received in full in April, and the account was closed. The auditor may not consider the same as on 31st March.

2. Outstanding entries in inter-branch A/c

All debit and credit entries outstanding more than 6 months but less than 5 years be netted off, and if the net balance is credit, the same shall be shown as liabilities. Similarly, if the net balance is debited, the same shall have to be provided with a 100 percent debiting profit and loss account. All credit entries outstanding for more than 5 years are to be transferred to 'Blocked Account', and the same shall be reckoned for DTL, CRR and SLR purposes.

3. Above the Line and Below the Line concepts

All provisions, write-off mandatory and / or prudential, shall be reflected in the P & L statement before arriving at net profit are said to be 'Above the Line'. Draw down from net profit by way of appropriation shall be effected after arriving at net profit / loss is said to be 'Below the Line'.

4. Utilisation of reserves appropriated Below the Line

Due to insufficiency of net profit, banks may need to use some part of other reserves to meet, say, the requirement for BDDR. In such cases, banks are required to obtain prior permission from RBI. This is, however, not applicable when excess provision is made above the line. For example, excess provision of investment depreciation made above the line can be utilised to meet other contingencies.

5. Frauds detected

This needs to be provided at once 100 percent debiting to P & L A/c. If no sufficient profit is available, make proportionate provision drawing from other reserves other than the statutory reserve, and the same be restored in the next financial year in four quarters.

6. Segment reporting

AS 17, banks are to decide segment reporting for wholesale and retail banking for INR 5 crore and above at their own discretion.

7. Loans and advances to directors, their relatives and firms and companies in which they are interested.

This is required to be disclosed, but no such disclosure is required with respect to key persons such as CEO / MD.

8. Discontinuing operations - Closure of certain services

As per AS 24, when any services are discontinued, for example, franking of stamp papers or insurance business, the same be disclosed.

9. Intangible asset (AS26)

The details of such assets, say, new software purchased, be shown with the useable life of such assets.

10. Impairment of fixed assets

AS 28 provides to report fixed assets such as lockers and vehicles not in use be shown under this head.

11. Asset-liability statement

The mismatches in assets and liabilities from 1 day to more than 5 years are to be prepared and given to the auditors.

12. Excess provision for NPA

This is charged to P & L above the line and not appropriated from net profit, which is said to be prudential, unlike BDDR, whose minimum is mandatory as stipulated by RBI. As such, use of such excess provision does not require permission from RBI.

13. Concentration of deposits, advances, exposures and NPAs

The details of the top 25 depositors and borrowers, along with the amount to be given here for previous and current years, with details of percentages.

14. Disclosure of Complaints from customers

The 'Top grounds' complaints of customers received from the office of the Banking Ombudsman for the last 2 years are required to be reported here.

15. Disclosure of penalty imposed by RBI

UCBs are required to mention details of penalties imposed by RBI in the financial year. In case such penalties are contributed by the employees and paid, the details thereof are required to be furnished, and entries passed in P & L both for debit and credit.

16. Shifting of Investment

RBI permitted UCBs to shift to and fro investments classified under the head 'Held to Maturity' (HTM) at the beginning of the year, i.e. by 30th April. As such, shifting cannot be at any time during the year. Shifting shall be in one go and not in a piecemeal. If such shifting exceeds 5 percent of the book value of HTM, the same shall have to be disclosed here.

17. IRAC (Income Recognition and Asset Classification)

RBI insist on UCBs to generate NPA daily through the system. It is a fact that the system has certain limitations, and as such, manual intervention is felt needed.

For example, updating values of the asset (say, vehicles every year and immovable every 3 years) has to be done manually as the same cannot automatically be done through the system. RBI never permits UCBs to make any changes from the back end.

All the provisions of IRAC cannot captured by the system. For example, nonrenewal of cash credit / overdraft facility within 90 days. In other words, all regulatory provisions cannot be customised. Advances shall be reported net of provisions other than provision for standard assets but inclusive of floating provisions of NPA.

18. Stock statements

UCBs stipulate charging of penal interest for late submission of stock statements for cash credit and overdraft accounts. When such statements are received late, the same can be posted with a back date in the system, which option is always open, and thus, the same is subject to manipulation.

19. Deferred Tax Liability (DTL)

This is not a current liability. This is calculated by finding the difference between taxable income and account earnings before taxes and multiplying that by the expected tax rate. DTL needs to be payable in future.

For example, the bank posted a net profit, say INR 20 cr. To save tax, the bank created a special reserve u/s 36(1) (viii) of the IT Act. Net profit thus gets reduced to, say, INR 16 cr. Now, the income tax is payable only on INR 16 cr. DTL is created for INR 4 cr. in the books and is to be shown as a future liability in the balance sheet.

Next year, when the special reserve is reversed and added to the net year's profit of, say, INR 10 + INR 4 cr., the total net profit would be INR 14 cr., and the bank shall have to pay income tax on INR 14 cr.

It is thus clarified that whenever certainty seems to be happening in future and provision is reversible, DTL is created with the intention to pay in future.

20. Deferred Tax Asset (DTA)

When a bank pays excess income tax in the year than the actual payable, the difference is said to be DTA. For example, the bank paid a tax of INR 10.60 lacs as against its liability of INR 10 lacs. The excess amount of INR 0.60 lac is the amount of DTA to be debited to DTA assets and credited to P & L.

Similarly, when a bank provides for depreciation at higher rates than what is provided in the Income Tax Act, the profit gets reduced, and less tax is paid. In future, the value of fixed assets for income tax purposes gets reduced at a lower rate of depreciation and is fully wiped out at the end of the life of such assets.

In such cases of losses, DTA is created, and tax loss can be carried forward to be set off against future profits, which is certain to happen and demonstrate to reduce taxable liability in the following year. DTA is an intangible Asset.

21. BDD reserve and BDD fund

The provision made by the bank is an allowable deduction in income tax to the extent of 7.5 percent. When such a provision is reversed in future by crediting to P&L, it is not subject to tax as the same was never offered for tax.

For example, BDDR was created for INR 20 cr., and the Income Tax Act permitted deduction, say, for INR 16 cr. In other words, a deduction of INR 4 cr. was not allowed. The bank shall have to pay tax on the same. Therefore, the bank shall have to create a DTA.

As regards bad and doubtful debt funds, when created by way of appropriation below the line (drawdown is always below the line), permission from RBI is to be obtained to take the same to the credit of the P & L account. Such funds cannot be used for writing off bad debts or making any other provisions.

22. Revaluation of fixed assets (immoveable properties)

RBI now permits UCBs to get their immovable properties revalued from the panel of Government Valuers once every 3 years. Banks shall pass the following entries in their books:

a. Fixed Asset debit ..Rs…..

Credit Revaluation Reserve ..Rs……

(at revised value)

By the end of the financial year, banks shall provide depreciation on the entire value and pass the following entry.

a. Debit P & L Depreciation A/c t..Rs…

Credit Fixed Asset..Rs……

b. Debit Revaluation Reserve A/c. Rs…..

Credit P & L Appropriation A/c Rs…..

Thus, initially, profit for the year gets reduced above the line without any effect on profit when transferred to the balance sheet after appropriation as aforesaid.

The benefit of the revaluation of the fixed asset is that 45 percent of the revalued amount can be taken to either Capital Funds Tier I or Capital Funds Tier II at the choice of UCBs, which helps increase CRAR and exposure limits for loaning to individual and group of entities to boost up profit.

23. Writing off bad and doubtful debts

With a view to the cleansing of the balance sheet, banks resort to writing off such debts when 100 percent provision is already made and certified by Statutory

Auditors for such prudential write-off. The bank's legal right to recover, however, continues unabated. Passing entry for the above is as follows:

Debit BDDR A/c… Rs

To Credit Loan A/c ……Rs

This helps the bank to reduce the percentage of gross and net NPAs and also save substantial income tax (7.5 percent on earlier provisioning and now 92.50 percent on the write-off amount) by claiming the same in the IT return. When recoveries are made in future in written-off accounts, the same shall be directly credited to P & L A/c.

24. Non-banking assets acquired in satisfaction of claims

When immovable assets cannot be sold after conducting 2-3 auctions, the same can be purchased by the bank in its own name at a reserve price and by paying stamp duty and registration charges. Such assets can be held by the banks for a period of 7 years with a further extension of 5 years from RBI as per Section 9 of the BR Act. The following entries are required to be passed by the banks.

1. Debit NBA. Rs (with outstanding ledger amount in loan A/c)

   to credit loan A/c (to close the same).

2. Banks shall continue to hold BDDR on the said account without reversal until the NBA is sold.

3. If the NBA is sold for an amount, say, higher than book value, the following entry could be passed:

a.	Debit Bank A/c	Rs 12 cr.
	To Credit NBA A/c	Rs 10 cr.
	P & L A/c Interest received	Rs 2 cr.
b.	For Reversal of BDDR, pass the following entry:	
	Debit BDDRA/c	Rs 10 cr.
	To Credit P & L BDDR A/c	Rs 10 cr. (for reversal)
c)	Reversal of the following contra entry:	
	G/L Debit Interest Reserve A/c	Rs
	To Credit Interest Receivable A/c	Rs

Note:

a) When NBA acquires a tenanted property, the bank shall not collect the rental amount but get the tenants evicted from the premises as soon as possible.

b) No depreciation is to be provided on the NBA.

c) If NBA cannot be sold for a maximum period of 12 years, refer the matter to RBI for further instructions.

d) When NBA is sold for a higher amount, and the bank recovers the entire amount with interest, the excess amount, if any, left with the bank is to be returned to the borrower as per the provisions of Section 100, Rule 85 of the MCS Act. However, as per the SARFAESI Act, the same could be retained by the bank and credited to its own P & L A/c. profit on the sale of NBA.

25. Non-Performing Investments

Such investments first be depreciated at Mark-to-Market rates and thereafter provide 100 percent provision on the balance amount.

26. New loans with a moratorium period.

During the period of moratorium, as per sanction, no interest becomes due, and as such, the same is to be capitalised. A question of reversal of the same would not arise if the said accounts slip into NPA. In the above case, if interest is not paid, the same is converted into FITL, and the due instalments are to be recovered. However, if the same remains overdue beyond 90 days, such an account is to be treated as NPA with necessary provisioning. Changes in the rate of interest, replacement of security and conversion of CC / OD into T / L would not amount to restructuring, reschedulement, etc.

27. Date of commencement of commercial operational (DCCO)

When the due amount is not serviced during the moratorium period beyond 90 days, such account shall be marked as NPA, and the period can be extended for a further period of up to 2 years. However, due to reasons beyond the control of the borrower, such as a matter pending in the court, etc., the same need not be treated as NPA.

Other assets

All staff loans, cash margin deposits with CCIL, and deposits placed with NABARD, SIDBI, and NHB for a shortfall in priority sector targets are to be shown here.

Contingent liabilities

Unclaimed deposits transferred to DEAF A/c and undrawn partial credit facilities shall be mentioned here.

Conclusion

UCBs are required to meticulously follow all the provisions of the Banking Act 1949, the MCS Act and rules framed thereunder, and the Master Directions of RBI issued from time to time to avoid violations and qualifying remarks from the auditors and RBI inspecting officials.

Presentation of financial statements with full disclosures and showing a true and fair picture would definitely create value in honesty and help strengthen the confidence of all the stakeholders and the public at large who are interested in making use of the same.

About the Author

Madhav Prabhune is presently on the boards of a couple of co-operative banks as expert director, advisor or member.

He has 25 years of experience in Central Bank of India which includes 3 years as a Faculty Member, at Sir Sorabji Pochkanwalla Bankers' Training College, Mumbai. He was also selected as an Assistant Personal Advisor, Indian Banks' Association in 1988. He also has additional 22 Years experience in various co-operative banks as a CEO.

His academic and professional qualifications include B.A. (Hons.), B.com, LLB, CAIIB, DIR, DPM, and GDC&A. He has been a visiting guest faculty- to more than 50 banks, IIBF, RBI Training Centre and various co-operative sociieties and boards. He has authored three books on banking and has published articles in various newspapers and magazines.

He can be reached at Madhav_prabhune@rediffmail.com