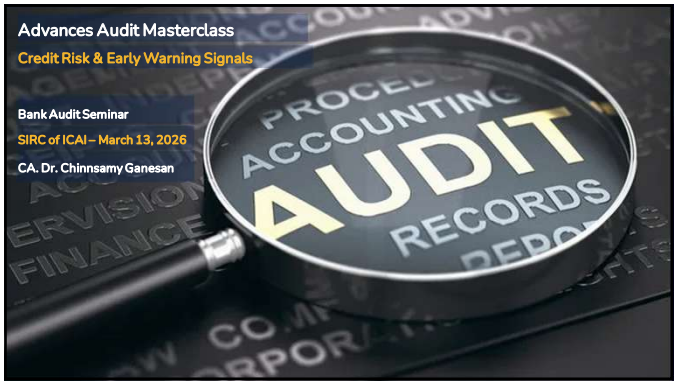


1

Session Roadmap

What We Will Cover Today

This masterclass is structured to move from foundational regulatory context through to live case studies — equipping you with actionable audit tools you can deploy at your branch assignment immediately after this session.

01
Regulatory & RBI Framework
IRAC norms, RBI Master Circulars, and ICAI GN 2026 — what changed and what matters at branch level

02
Credit Risk Architecture
Types of credit risk, classification of advances, and the anatomy of a bad loan

03
Early Warning Signals (EWS)
RBI's EWS framework — financial, operational, behavioural and external red flags

04
Audit Procedures & Live Case Studies
Step-by-step audit checks, documentation, and real-world cases of EWS ignored and EWS actioned

2

Setting the Stage

Regulatory Framework for Advances Audit

Key Regulatory Pillars

- **RBI Master Circular on IRAC Norms** (updated July 2024) — the primary classification guide
- **RBI Circular on Wilful Defaulters & Large Defaulters** — mandatory reporting thresholds
- **RBI Framework for Early Warning Signals** (June 2019 Circular) — applicable to all scheduled commercial banks
- **ICAI Guidance Note on Audit of Banks, 2026 Edition** — Chapter 6 covers advances in detail

Branch Auditor's Specific Mandate

Branch auditors sign the Branch Audit Report, certify the Long Form Audit Report (LFAR) and critically — comment on asset quality, NPA identification, and adequacy of provisions.

The ICAI GN 2026 explicitly states that branch auditors must apply professional scepticism when reviewing watch-list accounts, restructured loans, and accounts where EWS are present.

3

Core Concepts

Anatomy of Credit Risk in a PSB Branch

Credit risk – the risk that a borrower will default on contractual obligations – manifests at the branch level through loan sanction, disbursement, monitoring, and recovery. Understanding each dimension is essential before identifying warning signals.

Appraisal Risk
Inadequate project appraisal, inflated projections, and weak due diligence at sanction stage – the original sin of most NPAs

Diversion of Funds
Loan proceeds used for purposes other than sanctioned – a leading cause of wilful default and fraud classification

Concentration Risk
Over-exposure to a single borrower, group, sector, or geography amplifies systemic vulnerability at branch level

Operational Deterioration
Falling sales, shrinking margins, rising creditor days — business performance signals that precede default by 6–18 months

4

IRAC Classification

NPA Classification — The Branch Auditor's Primary Lens

Standard → NPA Trigger Points

Under RBI IRAC norms, an asset becomes an NPA when interest or principal remains overdue for **more than 90 days** in respect of a term loan. For working capital, it is when the account remains out of order continuously for 90 days. The ICAI GN 2026 reminds auditors to verify this independently — not to rely solely on the bank's CBS-generated NPA list.

Critical Audit Step: Pull the DPD (Days Past Due) report from CBS independently and cross-check against the NPA list provided by branch management. Discrepancies are red flags.

NPA Sub-Classification

Sub-Standard	NPA for up to 12 months — 15% provision on secured, 25% on unsecured
Doubtful – D1	NPA for 12–24 months — 25% secured + 100% unsecured
Doubtful – D2	NPA for 24–36 months — 40% secured + 100% unsecured
Doubtful – D3	NPA beyond 36 months — 100% provision
Loss Asset	Identified by auditor/bank/RBI — full provision, write-off recommended

5

The Core of Today's Session

Early Warning Signals — The RBI Framework

RBI's June 2019 circular (RBI/2019-20/38) mandated all scheduled commercial banks to put in place a robust EWS framework. For the branch auditor, familiarity with this framework is not optional — it is a professional obligation under the ICAI GN 2026, which dedicates specific paragraphs to the auditor's responsibility in evaluating whether EWS were acted upon.

Financial EWS
Declining turnover, falling DSCR, rising leverage, delays in financials submission, frequent requests for ad hoc limits

Operational EWS
Drop in machine utilisation, layoffs, management changes, disputes among promoters, delays in project completion

Banking Behaviour EWS
Frequent return of cheques, low average balance, multiple loan applications to other banks, overdrawal requests

External / Market EWS
Adverse news reports, regulatory actions against borrower, sector headwinds, key customer/ supplier loss

6

CASE STUDY 01

Punjab National Bank — The Nirav Modi Fraud (₹14,356 Cr)

What Went Wrong

PNB's Brady House branch issued fraudulent Letters of Undertaking (LoUs) and Foreign Letters of Credit (FLCs) over nearly **eight years (2011–2018)** to entities linked to Nirav Modi and Mehul Choksi. The critical failure: SWIFT messaging was **deliberately decoupled from the Core Banking Solution (CBS)**. Authorised SWIFT messages were raised without any corresponding entries in CBS, leaving no audit trail within the bank's internal systems. Two mid-level officials — Deputy Manager Gokulnath Shetty and single-window operator Manoj Kharat — operated this mechanism unchecked, exploiting the absence of maker-checker controls on SWIFT transactions.

How Auditors Missed the EWS

- Concurrent and statutory auditors never reconciled SWIFT outflows with CBS contingent liabilities
- LoUs were off-balance-sheet instruments — not captured in the bank's trial balance
- Repeated rollovers of LoUs by the same counterparties were not flagged as a stress pattern
- RBI inspection teams did not test the SWIFT-CBS integration interface during IS audits

Key Learnings

- Mandatory real-time integration of SWIFT with CBS is now enforced by RBI circular
- Trade finance exposures must be reflected in contingent liabilities and reviewed by auditors
- Dual authorisation with independent system-generated alerts for all nostro/vostro commitments
- Branch-level concentration risk in LoU issuance must trigger automatic escalation
- Statutory auditors must specifically test off-balance-sheet items in trade finance portfolios

7

Financial Early Warning Signals — Deep Dive

Reading the Numbers Before the Default

Financial EWS are the most auditable signals — they are embedded in the financial statements and bank account statements that the branch should possess. The ICAI GN 2026 requires auditors to verify that the bank has obtained and reviewed audited financials of borrowers annually, particularly for accounts above INR 1 crore.

Debt Service Coverage Ratio (DSCR) Below 1.0

A DSCR falling below 1.0 means the borrower cannot service debt from operating cash flows. Branch auditors should compute DSCR independently from the P&L and cash flow — not accept the borrower's assertion. Trend analysis across 3 years is mandatory per GN 2026

Current Ratio Deterioration

A current ratio declining from, say, 1.5 to below 1.0 over two years signals acute liquidity stress. Check whether the working capital limit was enhanced despite deteriorating ratios — a classic red flag indicating imprudent lending or relationship-driven evergreening

Frequent Overdrawals & Ad Hoc Limits

Repeated requests for ad hoc limits beyond sanctioned amounts, or accounts consistently running close to the drawing power ceiling, indicate that the borrower's business is cash-starved. Per RBI IRAC norms, persistent overdrawal may itself trigger NPA classification

Delay in Submission of Stock Statements

Non-submission or late submission of QIS / stock statements is a proxy for operational disorder. Under RBI guidelines, CC/OD accounts where stock statements are not submitted for 3 months must be treated as irregular — verify this diligently in the LFAR

8

Banking Behaviour Signals

What the Account Statement Tells You

The bank account statement is a goldmine for early warning signals. The branch auditor should examine at least 12 months of transactions for all accounts classified as standard but carrying any observable stress.

Routing of Funds to Other Banks

Significant credits immediately transferred out to accounts in other banks — suggests income being routed away from the lending bank, potentially to avoid set-off or to service other creditors first

Return of Cheques / ECS Mandates

Frequent return of outward cheques or ECS mandates is a direct signal of cash-flow stress. Even one or two instances in 90 days should trigger enhanced scrutiny

Stagnant or Declining Credits

A CC account showing flat or falling monthly credits despite the business claiming stable operations — reconcile credits with sales reported in GST returns (GSTR-1 and GSTR-3B matching is now a standard audit step)

Audit Technique — GST Return Cross-Check: For any CC/OD account above INR 25 lakh, obtain GSTR-3B for the last 4 quarters and compare taxable turnover with credits in the CC account

A significant mismatch (>20%) must be reported in the LFAR and may indicate diversion of business through other banks or undisclosed entities.

The ICAI GN 2026 specifically highlights that the branch auditor should use data analytics — including GST return reconciliation, ITR comparison, and CIBIL/CRIF alerts — as standard audit procedures for large borrowal accounts.

9

CASE STUDY 02

Yes Bank — Governance Collapse & Asset Quality Concealment

What Went Wrong

Yes Bank's crisis unfolded between **2018 and 2020** through a combination of reckless credit expansion, promoter-level governance failure, and systematic under-reporting of Non-Performing Assets (NPAs). The bank aggressively lent to stressed infrastructure, real estate, and NBFC borrowers — including IL&FS, DHFL, Café Coffee Day, and Reliance ADAG — well after stress signals were publicly visible. RBI's Asset Quality Review (AQR) of FY2019 revealed divergence of **₹5,277 Cr** between reported and actual NPAs. Founder MD & CEO Rana Kapoor's term was curtailed by RBI in January 2019. By March 2020, the bank was placed under a moratorium; SBI-led reconstruction followed.

How Auditors Missed the EWS

- Restructured accounts were evergreened through fresh disbursements to avoid NPA classification
- Auditors accepted management's optimistic valuation of security and recovery estimates
- Related-party transactions between Yes Capital and bank borrowers were not adequately scrutinised
- Liquidity Coverage Ratio (LCR) deterioration and wholesale deposit concentration were not highlighted

Key Learnings

Governance

RBI strengthened fit-and-proper criteria for bank promoters and imposed tenure limits on MD & CEOs of private banks

NPA Recognition

AQR divergence above a threshold must now trigger mandatory auditor reporting and board disclosure

Concentration Risk

Single-group and sectoral concentration limits tightened; auditors must flag breaches in long-form audit reports

Deposit Monitoring

Sudden outflows and wholesale deposit dependency must be treated as early warning triggers under ICAAP framework

10

CASE STUDY 03

UCO Bank — EWS Acted Upon, Impact on Financial Statements

UCO Bank's turnaround story from FY2018–FY2022 provides a rare positive example of early warning signals being systematically identified and acted upon, ultimately restoring the bank to profitability and enabling it to exit the RBI's Prompt Corrective Action (PCA) framework in September 2022.

What Branch Auditors Did Differently

LFAR Red-Flagging

Branch auditors at UCO Bank proactively identified accounts showing declining credit summation, frequent overdrawal requests, and non-submission of stock statements — and reported them in LFAR with specific account references

SMA Classification Verified

Auditors cross-verified SMA-0, SMA-1, SMA-2 classifications with actual DPD data from CBS — catching cases where branch management had not upgraded the SMA classification despite qualifying events

Impact on Financial Statements

The proactive EWS identification led to:

- Higher NPA recognition in FY2018–19 and FY2019–20 — short-term pain through higher provisioning
- UCO Bank's Gross NPA declined from **24.64% (FY2018)** to **4.78% (FY2024)** — one of the most dramatic turnarounds in PSB history
- Bank returned to profitability in FY2022 (Net Profit ₹1,027 crore) after years of losses
- RBI removed UCO Bank from PCA framework in September 2022 — a direct result of improved asset quality

Lesson: Honest EWS identification causes short-term provisioning pain but creates long-term financial health — and protects auditors from professional liability.

11

Audit Procedure Deep Dive

Step-by-Step Audit of the Advances Portfolio

The ICAI GN 2026 prescribes a risk-based approach to advances audit at branch level. The following sequence represents best practice for the FY 2025–26 audit cycle.



Obtain Reports → Verify Classification → Test Large Accounts → Reconcile GST/ITR → Review Restructures

Each step must be documented with working papers. The GN 2026 emphasises that professional scepticism must be applied at every stage — the burden of proof lies with the auditor to demonstrate that the portfolio was examined with rigour, not merely that the bank's representations were accepted.

12

Evergreening — The Silent Killer

Identifying Evergreened Accounts — A Critical Skill

Evergreening — the practice of renewing or restructuring loans to avoid NPA classification — is one of the most pervasive issues in PSB branch audits. The ICAI GN 2026 devotes considerable attention to this, requiring auditors to look through the form of transactions to their economic substance.

1

New Loan to Repay Old EMI

A fresh term loan or CC enhancement sanctioned whose first outflow is to service overdue instalments on an existing loan — the classic evergreening structure. Verify disbursement instructions and end-use.

2

Associate Entity Round-Tripping

Funds disbursed to Borrower A flow to an associate entity B, which then repays loans of another associate C in the same group — resulting in all accounts appearing regular. Map the group structure and trace fund flows.

3

Restructuring Without Genuine Stress Test

Loans restructured under OTS or one-time restructuring schemes without evidence of genuine recovery viability. Per RBI norms, restructured accounts must be tracked as SMA unless specific conditions are met.

4

Repeated Ad Hoc Limit Renewals

Ad hoc limits sanctioned multiple times in a year — with each sanction just below the authority level requiring higher approval — is a procedural red flag and often masks persistent overdrawal.

13

Secured vs Unsecured — Valuation Matters

Security Valuation — The Hidden Provisioning Risk

Why Security Valuation is an EWS Issue

An account may appear adequately secured — and hence require lower provisioning — but if the underlying security is overvalued, the true provisioning requirement is far higher. This is a material risk area in PSB branch audits, particularly for:

- Real estate collateral (current market value vs. registered value)
- Plant & machinery (book value vs. realisation value)
- Stocks pledged under hypothecation (actual vs. reported stock)
- Personal guarantees from insolvent guarantors

Audit Checks — Security Valuation

- **Verify Empanelled Valuer's Report Date**

  Per RBI guidelines, immoveable property collateral must be revalued at least once every 3 years by an empanelled valuer. Check whether the valuation on file is current and whether the valuer is on the bank's approved panel.

- **Stock Audit Report — Mandatory for Large CC**

  For CC/OD accounts above INR 5 crore, annual stock audit by an independent CA firm is required. Verify whether this has been conducted, and review the findings for any adverse observations on stock quality or quantity.

- **Ownership Title Search**

  Verify that the property offered as security is actually owned by the borrower/guarantor — title disputes and encumbrances are frequently discovered only at enforcement stage, rendering the security worthless.

14

Special Categories Under Scrutiny

Agricultural & Priority Sector Advances — EWS Unique Considerations

Priority sector advances — particularly agricultural loans — present unique EWS challenges. Crop failures, waiver announcements, and kisan credit card (KCC) misuse are sector-specific red flags that the branch auditor must evaluate in the context of the branch's geographical location and agricultural season.



KCC Account Monitoring

Kisan Credit Card accounts must show annual credit (harvest proceeds) followed by debit (next season input). An account showing only debits with no seasonal credit for 12+ months is a strong NPA signal. Verify KCC drawings against sanctioned crop loan limits and land holding documents.



MSME Restructuring Schemes

MSME accounts restructured under COVID-19 Relief Schemes (2020–21) or ECLGS must be re-examined. The restructuring moratorium has ended; accounts that have not resumed regular repayment must now be classified per IRAC norms without any forbearance. The GN 2026 explicitly addresses this vintage restructuring review.



Real Estate & Builder Loans

Project finance to real estate developers — common at large urban branches — requires verification of RERA registration, project completion status, and sales velocity. A stalled project with loan serviced from fresh drawdowns is a classic EWS that often precedes a fraud classification.

15

LFAR — Your Primary Accountability Document

Long Form Audit Report — Advances Section Essentials

The LFAR is the branch auditor's most important deliverable. The advances section of the LFAR, if completed rigorously, provides the SCA with sufficient information to form a view at the bank level. Underreporting or vague responses in the LFAR expose the branch auditor to professional liability.

Critical LFAR Questions — Advances

LFAR Question	What to Actually Check
Are there accounts where limits have been frequently exceeded?	Pull overdrawal report from CBS; quantify and name accounts
Are stock statements received regularly?	Check date of last stock statement for each CC account; flag gaps
Are inspections of securities conducted?	Verify inspection registers; check for accounts where inspection is overdue >6 months
Are there cases of diversion of funds?	Trace fund flows using bank statements; flag routing to non-borrower accounts
Adequacy of provisioning	Recompute independently using CBS DPD data

ICAI GN 2026 — Paragraph 6.89: The branch auditor should not merely answer LFAR questions in 'Yes/No' format. Where an adverse observation exists, the response must include the number of accounts affected, the aggregate outstanding amount, and the estimated financial impact. Vague responses do not constitute an adequate LFAR.

In addition to LFAR, branch auditors must issue a separate report under Section 143 (3) of the Companies Act, 2013, and must consider whether any observations warrant a qualification or emphasis of matter in the main audit report.

16

Fraud Risk & Reporting

When EWS Become Fraud Indicators — Auditor's Obligations

The RBI Master Direction on Frauds (2024 update) and the ICAI GN 2026 both place explicit obligations on branch auditors when EWS coalesce into potential fraud indicators. The auditor's obligation is not merely to report to management — it extends to reporting to the SCA and potentially to regulatory authorities.

Fraud Indicators at Branch Level

- Multiple loans against same property (check CERSAI)
- Accommodation bill / LC discounting without underlying trade
- Loan against fabricated invoices (GST mismatch is the audit test)
- Fictitious borrowers/ Benami transactions

Auditor's Reporting Obligation

- Report to SCA in writing immediately upon detection
- Report under CARO 2020 — Clause 11 (i) if fraud by/on company detected
- Consider emphasis of matter / qualified opinion if material
- The GN 2026 clarifies: silence on known fraud creates professional and legal liability

Protection for Auditors

- Document every adverse observation with date, account reference, and evidence
- Issue Management Representation Letter specifically on fraud
- Maintain complete audit working papers for minimum 7 years
- ICAI's Quality Review Board scrutinises bank audit working papers post-fraud events

17

Practical Tools

EWS Audit Checklist — Deploy at Your Branch Assignment

This checklist synthesises the RBI EWS Framework, ICAI GN 2026 requirements, and best practices from regulatory enforcement actions. It should be used for all accounts above ₹1 crore and selectively for material smaller accounts.

1 **Financial Indicators**

☐ DSCR computed independently from audited financials ☐ Current ratio trend analysed (3 years) ☐ Leverage ratios checked against sanction conditions ☐ Turnover reconciled with GST returns (GSTR-3B) and ITR ☐ Drawing power recomputed from latest stock statement

2 **Banking Behaviour**

☐ DPD report obtained from CBS independently ☐ Cheque/ ECS return instances counted ☐ Account credit summation compared YoY ☐ Fund routing to other banks/ entities verified ☐ Ad hoc limit frequency reviewed for last 12 months

3 **Security & Collateral**

☐ Valuation report date verified (within 3 years for immoveable) ☐ CERSAI charge registration checked ☐ Stock audit report obtained and reviewed ☐ Insurance validity confirmed ☐ Title documents/ ownership verified for top 10 collaterals

4 **External & Operational**

☐ CIBIL/CRIF alerts checked for borrower and guarantors ☐ News search conducted for adverse media ☐ IBBI/ NCLT proceeding search for group entities ☐ GST registration status verified (suspended = red flag) ☐ MCA filings reviewed for management changes/ ROC charges

18

Professional Liability & Ethics

The Auditor's Responsibility — What is at Stake

Regulatory & Legal Consequences of Failure

ICAI Disciplinary Action

Post PNB (LOU), ICAI's QRB has actively taken up matters against bank auditors who issued clean reports despite visible EWS. Penalties range from reprimand to cancellation of membership.

RBI Action on Audit Firms

RBI can delist audit firms from its approved panel for PSBs — effectively barring the firm from bank audit assignments for up to 5 years. This is a severe reputational and commercial consequence for CA firms dependent on bank audit income.

NFRA Scrutiny

The National Financial Reporting Authority (NFRA) has jurisdiction over auditors of listed entities and banks. NFRA's enforcement orders carry monetary penalties and professional debarment, which are independent of ICAI proceedings.

What Protects You as an Auditor

Professional liability is mitigated not by doing less work – but by doing documented, evidence-based work.
The ICAI GN 2026 provides a safe harbour for auditors who

- Followed the prescribed audit procedures and documented the same
- Applied professional scepticism – questioned representations and obtained corroboration
- Issued a qualified or emphasis of matter opinion where warranted – even if unpopular with branch management
- Reported all adverse observations in LFAR with quantification
- Retained working papers for the prescribed retention period

The standard of care is not perfection – it is due diligence, documented.

19

Key Takeaways

Closing Summary — Your Advances Audit Action Plan

Start with CBS Data

Always extract DPD reports, SMA classifications, and top-borrower lists independently from CBS — never rely solely on management schedules

Use Financial EWS Systematically

Compute DSCR, current ratio, and drawing power independently. Reconcile CC credits with GSTR-3B. Flag deteriorating ratios even in "standard" accounts

LFAR is Your Voice

Use the LFAR to document every adverse observation with account names, amounts, and impact. Vague LFAR responses are no defence in regulatory proceedings

Be Bold, Be Documented

Qualify, emphasise, or escalate when EWS are material and unaddressed. The GN 2026 and case law both vindicate the auditor who raised concerns — not the one who stayed silent

Remember: The branch auditor is the first line of external assurance on the quality of the advances portfolio. Your LFAR and audit report form the foundation on which the SCA builds the bank-wide audit opinion. The price of professional courage is low; the price of professional silence is catastrophic

20



21