

Audit of advances & NPA



CA .Rajkumar S Adukia

**B.Com(Hons.) FCA, ACS, MBA, AICWA,
LLB,**

Dip IFRS(UK) Dip LL& LW

09820061049/09323061049

rajkumarfca-subscribe@yahoogroups.com

rajkumarfca@gmail.com

www.carajkumarradukia.com



Major Policy Guidelines related to Audit of Advances

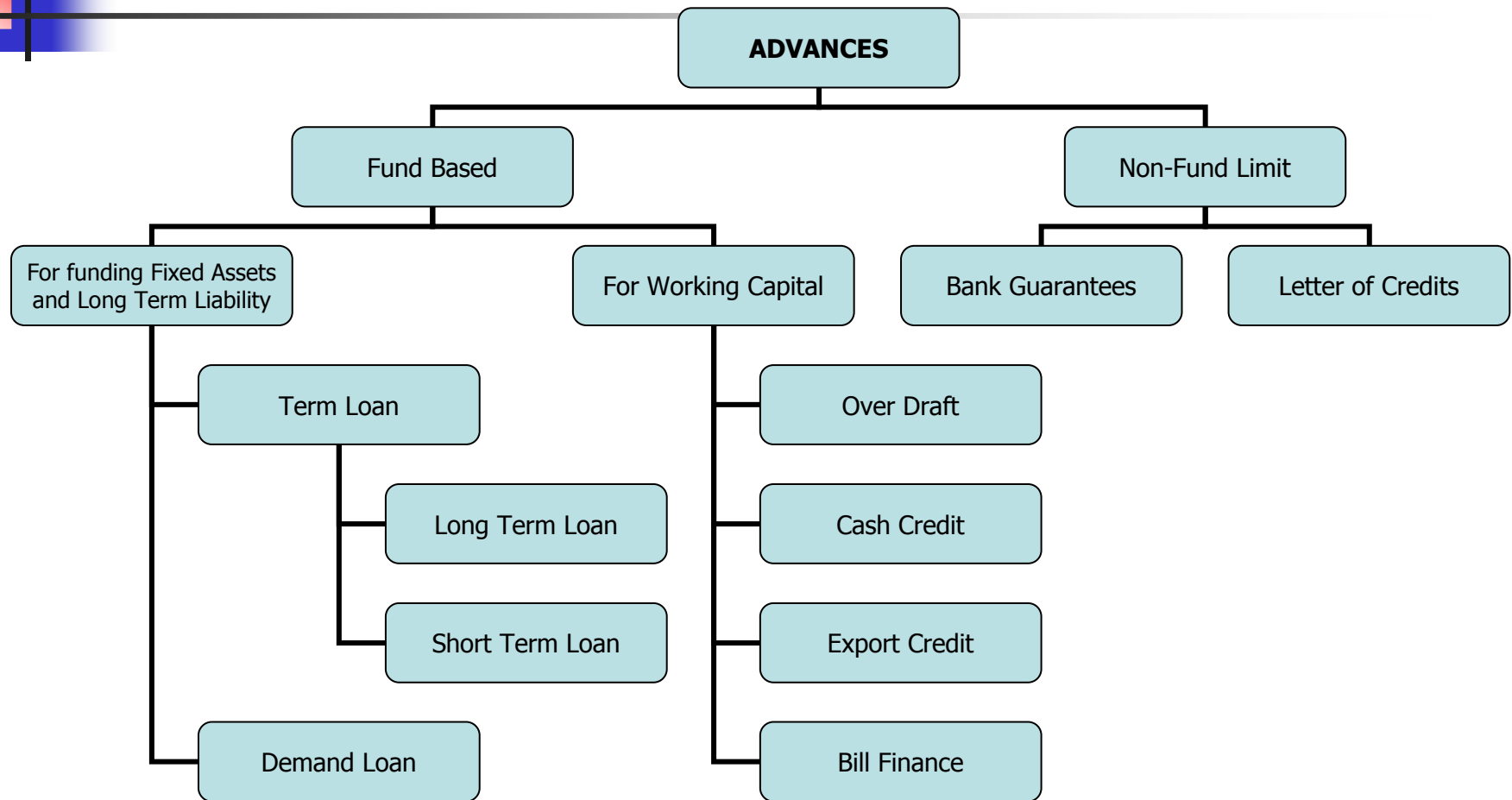
- **RBI Guidelines (Master Circulars)**
- **Loan Policy**
- **Recovery Policy**
- **Guidelines on Documentation**
- **Books of Instructions of the Bank supplemented by circulars/guidelines from time to time.**



Audit Pre-Requisites

- Previous year audit report
- Monthly concurrent audit report
- Stock audit report

Types of Advances





Auditors Concerns

- Whether asset is stated at its fair value
- Whether it is recoverable as expected
- Whether it's classification is correct.
- Whether the necessary guidelines & procedure were followed in exercising the powers
- Whether proper disclosure have taken place.

Auditors should exercise his judgment over there questions and arrive at the conclusion



At the beginning

- Please read audit instruction carefully
- Carefully read concurrent audit report & preferably follow the trail through out the year. This will help you reset your mind & focus on the critical area.
- Obtain Trial Balance
- Assess the various types of advances given by the branch



Audit Sampling

- Generally ensure that at least 75% of the value under each category is covered.
- Ensure that connected advances under same company/group are selected simultaneously.



Term Loans

- Usually term loans will not be standalone unless they are retail in nature .
- Standalone industrial term loans, if any may require grater degree of vigilance.
- Simply calculate DP based on installments from the disbursement date.
- Any difference in the value so arrive may have to be look into.
- Based on checking the classification may be confirmed.



Term Loan Monitoring

- **Periodical Inspection of Assets (1 or 2 times in a year)**
- **Adequacy of Insurance with Bank's clause**
- **Valuation of Assets at stipulated intervals. (Normally, once in a period of 3 years)**
- **Follow up for recovery of Interest & Installments.**



Working Capital

- Checking of working capital requires greater degree of skills owing to the multiple facets involved.
- Unlike term loan where fresh term loans require detailed checking, there is no distinction to be made among the fresh and old advances for working capital since they are expected to renewed every year.



The Audit Process

- The audit process of checking of advances revolves around one principle.

D - ocumentation

O - perations

S - anction & disbursement

A - ppraisal



Operations

- Check for the flow of debit/credit transaction in the accounts.
- Summations of debit/credit.
- Overall conduct of the account.
- Stock valuation of previous year V/s stock statement.
- Any adhoc/enhancement during the year.
- Check for the correspondence with the client to assess management quality.
- Servicing of interest.

- **Cash Credit:**

- **Timely Submission Of Stock/Book Debt Statement.** Latest stock/book statement should be on record.
- **The system should be in place to scrutinize the stock / book debt statements by Bank Officials for calculating Drawing Power.** (Due to current melt-down, extra care should be taken to look after position of long outstanding debtors and volume of creditors and its effect on DP)
- **Drawings should be within limit or D.P, whichever is low.**
- **Periodical Inspection Of Stocks & Book Debts.**
- **Stock Audit**
- **Forward rates contract**
- **Review of Limits.**



Bill Finance

- Clean Bill & Documentary Bill
- Demand Bill & Usance Bill
- Bills to be related to genuine trade transactions & should not be an Accommodation Bill.
- Drawee - wise Sub-limit
- Payment history of the Drawee.
- System in place for follow up of realization of discounted Bills.
 - Bills drawn under L/C: Documents should be L/C compliant.
 - If Bills discounted/ purchased are adjusted by allowing excess drawings or adhoc or TODs, the same should be commented upon by the Auditor.



Export Credit

The following check points are for conducting the audit from “Credit angle”. It is also required to conduct the audit of export credit from “Forex angle” for which separate set of guidelines are available.

Pre Shipment (Packing Credit):

- Normally disbursed on order to order basis. In few cases allowed as running account facility.
- To be released against confirmed Export Orders or L/Cs (except running account).
- Pre shipment credit should be adjusted from Export proceeds.
- If adjusted from local funds, commercial rate of interest to be charged.
- Interest Subvention, if any to be claimed.
- ECGC covered (Policy / guarantee)
- Special approval list

Post Shipment Credit

(Four major products)

- Negotiation of Bills under L/C
- Purchase or discounting of Export Bills
- Post Shipment Demand Loan (Advance against Bill for collection)
- Advance against Duty Drawback receivable from Government

- **Auditor should satisfy –**
 - The advance to be granted against the genuine trade transaction.
 - Proof of Export should be on record.
 - Post shipment credit to be first utilized for liquidating the pre-shipment credit, if any, outstanding against the same export order.
 - Proper system should be in place for follow-up the realization of export bills.
 - Reporting of Overdue Export Bills in XOS statements.



Appraisal

- Review of all working capital facilities must take place every year.
- Go through the entire appraisal note done by the branch.
- Ensure that the necessary information/ documents are submitted by the borrower .
- Ensure that the bank own policy & guidelines are followed.
- Generally there are 4 broad principles used for appraisal.
 - Borrowers financials
 - Borrowers commercials
 - Management quality
 - Industry segment



....Appraisals

Application should be in prescribed format with all information & details.

All relevant documents should be attached like Borrower's Financials, IT Returns, Project report, quotations, Worth report on Borrower and Guarantor, etc.



Sanctions

- Sanctions should be within delegated powers.
- The discretionary powers to be judiciously exercised.
- All the required terms and conditions should be properly mentioned and there should not be any ambiguity.
- Sanctions to be properly recorded & reported to various authorities as per Bank's guidelines.
- Sanctions are properly communicated to the Borrower and unqualified acceptance to be on record.



Disbursements

- End use of Bank's funds to be satisfied upon.
- All invoices, stamped receipts related to loan disbursements & Post Disbursement inspections to be on record.
- Required margin is raised as per terms of sanction.
- Working Capital Limits are disbursed after satisfying that necessary infrastructure including Plant & Machinery, etc is in place.
- Drawl in Working capital Limits should be related to business activities of the borrowers.



Documentation

- Documents are required for :
 - To legally establish borrowers liability towards the Bank
 - To create legal charge on various securities in favor of the Bank like pledge, hypothecation, mortgage, assignment, lien, etc.
- The documents should be duly filled in & properly executed and adequately stamped.
- The charges should be properly recorded (ROC,RTO,Sub Registrar ,etc.)
- Vetting of Documents
- Safe keeping of the documents



Non Fund Limits

Letter of Credit

- L/Cs to be issued within sanctioned limits.
- L/Cs to be in conformity with the Borrower's Application and advised to the beneficiary's Bank immediately.
- For Import L/ Cs, the UCPDC of ICC, FEMA Stipulations, RBI directives & FEDAI guidelines to be adhered to.
- Liability entries passed in the books of Bank.
- The Bills are in conformity with L/ C terms & to be paid on due date by the borrower.
- Care in case of devolved L/Cs.
- Devolved amounts adjusted by allowing excess drawings or adhoc or TODs, should be commented upon by the Auditor.

Bank Guarantee:

- Issued within the sanctioned limit.
- Proper Liability Entries are passed
- Should not have any onerous clause.
- The limitation Clause, in regard to amount and time, to be incorporated in each guarantee.
- Repeated extensions of guarantee should be carefully looked into.
- Payment of Invoked Guarantees
- Non-reversal of Expired Guarantees to be looked into carefully.



Master Data

- **The major areas which auditor should satisfy about proper creation of master data through test checks are -**
 - **Repayment schedule (Demand Loan / Term Loan)**
 - **Rate of interest (income leakage)**
 - **Drawing Power (Monitoring of drawing in Cash credit/ overdraft account)**
 - **Customer ID (Same customer ID to be allotted for different accounts of the same client)**
 - **Classification of advance (Sectoral classification, secured / unsecured classification, etc.)**
 - **Master data directly affect the calculations of overdues, classification of advances as well as the income of the Bank and also the BASEL-II statement.**



Restructuring of Advances Accounts

RBI has issued several guidelines on restructuring of the advances from time to time. Such guidelines (other than those restructured under a separate set of guidelines issued by RPCD of the RBI on restructuring of advances on account of natural calamities) are divided into four categories :

- Guidelines on restructuring of advances extended to industrial units
- Guidelines on restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism
- Guidelines on restructuring of advances extended to Small and Medium Enterprises (SME)
- Guidelines on restructuring of all other advances



.....Restructuring

The guidelines are divided into four parts :

- **General Principles and Prudential Norms for Restructured Advances**
 - Eligibility Criteria for restructuring of advances
 - Asset Classification norms
 - Income Recognition norms
 - Provisioning Norms
- **Prudential Norms for Conversion of Principal into Debt/Equity**
- **Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments**
- **Special Regulatory Treatment for Asset Classification.**



Special Regulatory Treatment

- RBI has stipulated Special Regulatory Treatment for Asset Classification. It is available to borrower engaged in important business activities.
- Under these guidelines benefit of classification would apply to the eligible accounts. However it cannot be extended to the following categories of accounts:
 - Consumer and personal advances
 - Advances classified as capital market exposure.
 - Advances classified as commercial real estate exposures



Special Regulatory Treatment - Conditions

- It is applicable for fully secured accounts, however following exceptions are permitted :
 - SSI borrowers where outstanding is up to Rs.25/- lacs.
 - Infrastructure project :
 - Cash flow is adequate for repayment of advance
 - Escrow mechanism is in place
 - Bank has clear and legal first claim on this cash flows.
 - Unsecured portion of WCTL (subject to additional provision)
- Promoter to contribute 15% of the bank's sacrifice
- Personal guarantee of promoters
- Restructuring only once.



Special Regulatory Treatment - Conditions

- The accounts which were standard accounts would be treated as standard accounts on restructuring provided the restructuring is done within 120 days for CDR & 90 days for others from the date of application.
- The unit should become viable in 10 years if it is infrastructure activity and 7 years in other cases.
- Repayment period of restructured advance including moratorium period if any should not exceed 15 years in case of infrastructure advance and 10 years in other advance.
- The ceiling of 10 years repayment period is not applicable for housing loan.



Eligibility Criteria for restructuring of advances

- Accounts classified under 'standard', 'sub-standard' and 'doubtful' categories can be restructured.
- Borrowers indulging into fraud and malfeasance will not be eligible.
- Willful defaulter will be eligible if willful default is rectified.
- BIFR cases will be eligible with express approval of BIFR.

Proviso.....

- **The financial viability is to be established and there should be reasonable certainty of repayment as per terms of restructuring package.**
- **Any restructuring done without looking into cash flows of the borrowers and assessing the viability of the project / activity would be treated as an attempt of 'evergreening' a weak credit facility and would invite supervisory concerns / action.**



Provisioning Norms (Restructured Assets)

- Normal provision as per existing provisional norms.
- Additional provision for **diminution in the fair value of restructured advances** which is to be recomputed on each balance sheet date till satisfactory completion of all repayment obligations.
- Additional provision for unsecured portion of WCTL.



CAR under BASEL -II

- The banks are expected to calculate capital adequacy under BASEL-II as well.
- The credit rating must be obtained from rating agency under following criteria
 - Average last 3 years turn over of Rs. 50. cr.
 - Sanctioned facility above Rs. 5 Cr.



Disclosure norms

- Exposure to real estate sector
- Exceeded prudential exposure limit.
- Unsecured advances.
- Letters of comfort issued
- Sector wise NPAs

Assets Classification

Type of Asset

- STANDARD ASSET / PERFORMING ASSET

The account is not non-performing and does not carry more than the normal risk attached to the business.

- NON-PERFORMING ASSET (NPA)

The asset ceases to generate income for the bank. (Para 2 of the Master Circular)

NPA (Non-Performing Assets)

RBI Reference



- Master Circular dated 1st July 2011 on IRAC Norms.
- Circular dated 09.01.2012 - Interest Subvention Scheme - 2 per cent interest subvention and 3 per cent additional subvention for short-term crop loans in 2011-12.
- Circular dated 09.12.2011 - Compensation structure for delay in payment of interest and/or principal.
- Circular dated 16.09.2011 - Repayment of loans of non-resident close relatives by residents

Classification of Accounts as NPA



- Regular/ad-hoc limits need to be reviewed /regularised not later than 3 m from due date/ date of adhoc sanction. if not done within 180 days, then NPA
- Erosion in value of security :Where erosion of security is to the extent
50% of outstanding NPAs--- doubtful
90% of outstanding NPAs--- loss
- Projects under implementation – separate set of guidelines under Master Circular



Classification of Accounts as NPA

Agricultural Advances

1) Long Term Crop

- Interest or Instalment remaining overdue for more than one crop season

2) Direct Agricultural Advances & Short Term Crop Loans

- Interest or Instalment remaining overdue for more than two crop season

Agricultural Advances

Exception to NPA

Exception

- Other Agricultural Advances for allied activities such as Animal Husbandry are not covered under this exemption.
- Agricultural advances affected by natural calamities, wherein repaying capacity of the borrower is impaired and where relief measures such as re-schedulement of repayment period or sanction of fresh short term loan is granted, such loans may be treated as current dues and need not be classified as NPA.

Non-agricultural Advances



- Interest remaining Overdue for 90 days or more
- Instalment remaining overdue for 90 days or more
- If Bills discounted remains overdue for more than 90 days.

Cash Credit & Overdrafts



- Account remaining overdrawn continuously for 90 days or more at any time during the year.
- If there are no credits or credits are insufficient to cover the interest debited during that 90 days during the year when the acc remained overdrawn.
- Stock statements are not received for 90 days or more and/or not arriving at the DP continuously for a period of 3 months (as at 31stMarch) will make the acc out of order and consequently NPA.



Common exceptions for assets classified as NPA

- Loans and Advances given Exclusively against Bank's own deposits, NSC eligible for surrender, IVPs, KVPs, Life Insurance Policies, etc. shall not be classified as NPA, provided the stipulated margin is maintained and the security is marked as lien.
- If any account of the borrower is classified as NPA during the year, all other advances given to him shall be classified as NPA.

Provisions for NPA

RBI 2010-11/529 DBOD.No.BP.BC.

94/21.04.048/2011-12 dated May 18, 2011

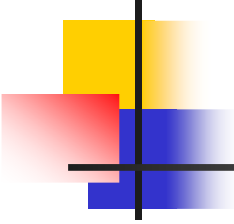
Standard Assets	Sub Standard	Doubtful	Loss
Does not carry any risk	A Fully Secured Asset remaining NPA for less than or equal to 12 months.	Partly Secured NPAs; • Asset remaining NPA for more than 12 months or it has remained in Sub-standard category for a period of 12 months.	<ul style="list-style-type: none">• Advances having no security; or• If the Balance Amount O/s is less than Rs.25000/-; or• If the realizable value of security is less than 10% of Balance O/s.

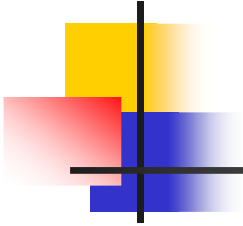


Provisions Required

Sub Standard	Doubtful	Loss Assets
<p>15 % of Balance Outstanding the “unsecured exposures” classified as sub-standard assets will attract an additional provision of 10%</p>	<p>For Secured Portion:</p> <ul style="list-style-type: none"> •Asset remaining doubtful for 1 year or less- 25% •Asset remaining doubtful for more than 1 year up to 3 years- 40% •Asset remaining doubtful for more than 3 years- 100% <p>Unsecured Portion- 100 %</p>	<p>100% of the O/S balance</p>

Income recognition

- 
- Banks should not book income by way of interest on NPA
 - However, interest on advances against TD, NSCs, IVPs, KVPs (check for fraudulent documents) and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts
 - If Government guaranteed advances become NPA, interest on such advances should not be taken to income account unless the interest has been realised
 - Verify whether Interest calculations are correct or not– Sample basis and Check Systems also.
 - If any advance, including Government guaranteed, bills purchased and discounted, becomes NPA as at the close of any year, interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised.



THANK YOU