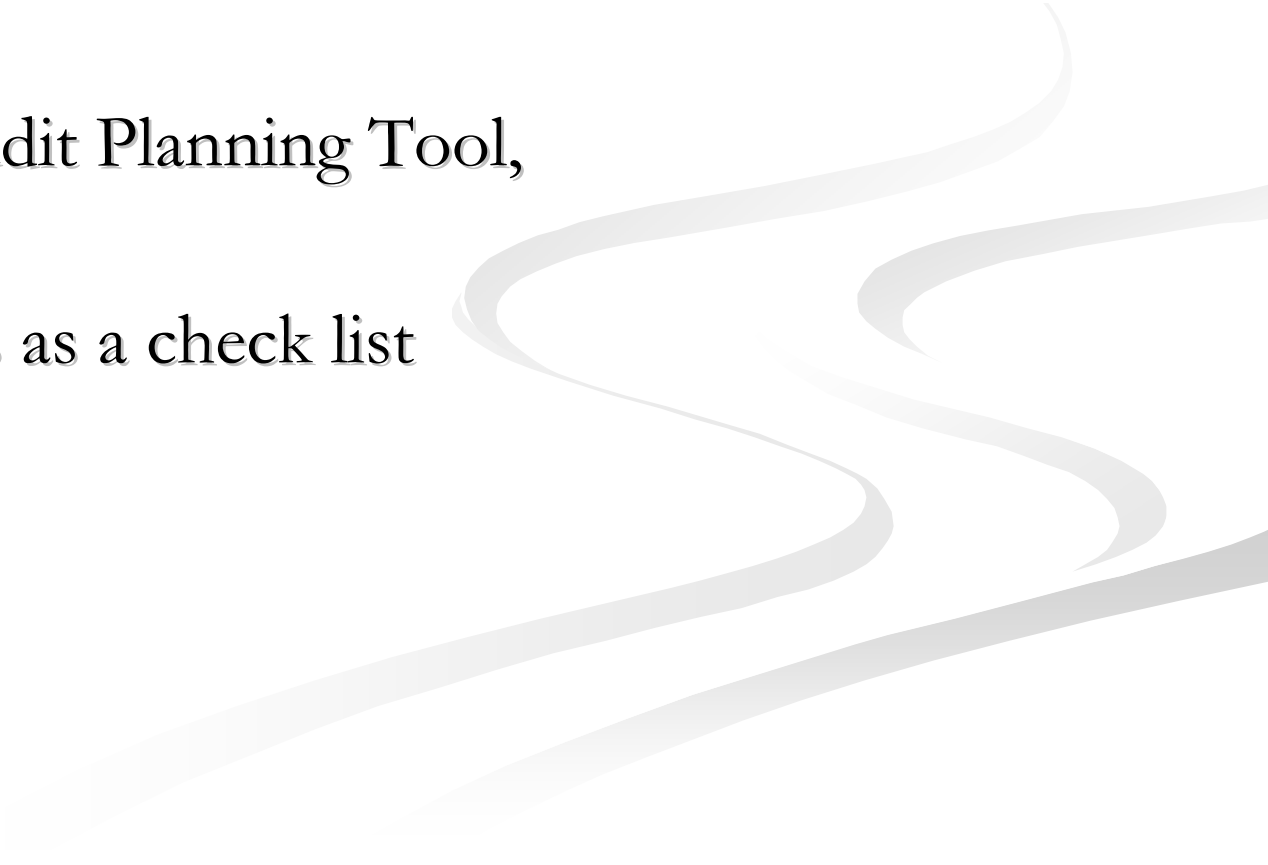


LFAR: Purpose

- ➔ Address Systematic Issues In Bank.
 - ➔ Whistle Blower For Irregularities.
 - ➔ Excellent Audit Planning Tool,
 - ➔ LFAR serves as a check list
- 
- A decorative graphic consisting of several overlapping, wavy, light gray lines that flow from the right side of the slide towards the left, positioned behind the bottom half of the list.

IMPORTANT ASPECTS

- ➔ Plan your work at the beginning of audit.
- ➔ Obtain information/details from the Branch
- ➔ Go through previous years' report, Inspection report, etc.
- ➔ Main Audit Report and LFAR are two separate reports.
- ➔ Comments in LFAR should be specific and not vague or general.

IMPORTANT ASPECTS (Cont'd)

- ➔ Give instances of short coming.
- ➔ Mention about extent of checking, test checking, representation received etc. be mentioned in the report.
- ➔ LFAR is of utmost importance to the management as well as the Central Auditors.
- ➔ Finalize Statutory Report and LFAR simultaneously.

COVERAGE OF LFAR

<i>Assets</i>	<i>Liabilities & Other</i>
<ul style="list-style-type: none">• Cash Balances• Bank Balances.• Money at call and Short Notice• Investments• Advances• Other Assets	<ul style="list-style-type: none">• Deposits• Other liabilities• Contingent Liabilities• Profit & loss A/c.• General• Specilised Branches.

CASH

- ➔ Cash balance which vary significantly from the limit fixed by controlling authorities.
- ➔ Excess balance reported to the controlling authorities.
- ➔ Adequate Insurance Cover.
- ➔ Joint custody.
- ➔ Refer Instructions, Key Movement Register.
- ➔ Periodic checking of cash balance.
Ascertain procedure and observe during audit
General scrutiny of cash book.

BALANCE with RBI, SBI and BANKS

- ➔ Obtain balance confirmation.
- ➔ Report differences.
- ➔ Observation on differences.
- ➔ Cash transactions remaining to be responded.
- ➔ Revenue items requiring adjustment / write offs.
(issue MOC / Qualify report)

BALANCE with RBI, SBI and BANKS

- ➔ Old outstanding balances remaining unexplained and age wise analysis.
- ➔ Item requiring special attention of management.
 - Reconciliation not done / procedure not followed.
 - Material amount unadjusted for a long time.
- ➔ Items affecting financial statements may be reported in the Statutory Report.

MONEY AT CALL and SHORT NOTICE

- ➔ Report even if a single transaction
- ➔ Confirm that the transaction is as per the procedure.
- ➔ Investments
- ➔ Physical verification on behalf of H.O.
- ➔ Ensure that income earned on such Investments is not accounted by Branch.

ADVANCES

- ➔ Examination of all large advances and a test check of other advances.

- ➔ Questionnaire in four Broad categories
 - Appraisal
 - Sanctioning / Disbursement
 - Operations
 - Documentation

- ➔ Annexure to the LFAR for Large advances

CREDIT APPRAISAL [Clause 5(a)]

- ➔ Opinion is sought on compliance of Procedure / Instruction of controlling authorities.
- ➔ Whether loan application in prescribed format.
- ➔ Whether intelligent appraisal done by competent person.
- ➔ Adequate appraisal documentation

SANCTIONING / DISBURSEMENT

[Clause 5(b) u/s (ii)]

- ➔ Credit facilities beyond the delegated authorities.
- ➔ Are such cases promptly reported to higher authorities?
- ➔ Advances disbursed without compliance of terms of sanction (give details)
e.g.: Necessary funds not brought in by the borrower.

SANCTIONING / DISBURSEMENT (Cont'd)

- ➔ Net worth of the guarantor not furnished.
- ➔ Unit not inspected.
- ➔ End use of the funds not verified.
- ➔ Borrower continuing to have operations with other Banks.

DOCUMENTATION

[Clause 5(c) (i) to (iii)]

- ➔ Instances of credit facilities released without execution of all the necessary documents
 - Verify legal status.
 - Government recognized status.
 - Type of Loan.
 - Securities.

- ➔ Instances of deficiencies in documentation, non registration of charge etc., (give details)

DOCUMENTATION (Cont'd)

- ➔ Some instances of deficiencies
 - Documents left blank.
 - Overwriting in documents, change in hand writing, incomplete documents.
 - Joint documentation in case of consortium advance.
 - Documents inadequately stamped.
 - Documents time bared.
- ➔ Additional reporting requirement on advances against lien of deposits.

REVIEW/MONITORING/SUPERVISION [Clause 5(d) (i) to xvi)]

- ➔ Periodic review of advances including balance confirmation / acknowledgement of debts etc.
 - Analysis of such accounts overdue for review.
- ➔ System of receipt of Stock / Book Debt and other statement and scrutiny thereof.
- ➔ System of obtaining Stock Audit Report.
- ➔ Audited accounts as per RBI guidelines from non corporate entities with limit beyond Rs. 10 lacs.

REVIEW/MONITORING/SUPERVISION (Cont'd)

- ➔ Physical verification of securities as per procedure laid down?
- ➔ Deficiencies in value of securities, frequent/unauthorized drawings, inadequate insurance etc.
- ➔ Clauses relating to lease finance activities and credit card dues.
- ➔ Clauses relating to Prudential Norms.

REVIEW/MONITORING/SUPERVISION (Cont'd)

- ➔ Compliance by Branch with Recovery Policy / in respect of Compromise / Settlements / Write off.
- ➔ Major deficiencies in credit review / monitoring / supervision.
- ➔ Clause relating to guarantee and letter of credit (clause 5 (e)).

OTHER ASSETS

- ➔ Stationery and Stamps. [Clause 6(a)]
- ➔ Comment on existence and compliance with.
- ➔ Internal control system over valued stationery with regard to issue and custody.
- ➔ Instances of missing or lost items of stationery to be given.

OTHER ASSETS (Cont'd)

- ➔ Suspense Accounts / Sundry Assets.
- ➔ Critically Scrutinize these accounts.
- ➔ Details and clarification in respect of old unadjusted entries be obtained.
- ➔ Balances which in your opinion are not recoverable.
- ➔ e.g.: Advance against traveling.
 - Payment to merchant establishment,
 - Legal expenses
 - Dividend / Interest paid.

OTHER ASSETS (Cont'd)

➔ Unusual items in these accounts be reported

- ➔ e.g.: Cash in transit
- Difference in balancing.
 - Difference in cash.

DEPOSITS

- ➔ Compliance with guidelines in respect of inoperative accounts.
- ➔ Instances if not complied with the guidelines.
- ➔ Seek clarification for unusual movements after balance sheet date.
- ➔ Quantification of Overdue / Matured term deposits at the year end.

BILLS PAYABLE /SUNDRY DEPOSITS / CONTINGENT LIABILITIES.

- ➔ Details of old items to be reported.
- ➔ Unusual items and pre-matured withdrawals or debits to be reported along with their nature and amounts.
- ➔ List of major items of contingent liabilities other than Guarantees, L/Cs, Endorsements, Acceptances etc.,

PROFIT & LOSS ACCOUNTS

- ➔ Compliance with Income Recognition Norms
- ➔ System of estimation and provision of Interest on overdue matured term deposits.
- ➔ Divergent trends in major items of P & L A/c if not satisfactorily explained.

GENERAL

- ➔ Proper maintenance of manual Books of Accounts.

- ➔ In respect of Computerized Branches number of areas prescribed.

- ➔ Inquire about
 - Banks policy
 - Compliance of the policy
 - Internal Control & Security measures.
 - Backups and Disaster Recovery Plans

GENERAL (Cont'd)

Suggestions for the improvement in the system

- ➔ Reconciliation of control and subsidiary records.

- ➔ Inter Branch Accounts, (Very Important area)
 - Understand the system
 - Daily Communication to HO/Designated cell statement of debit / credit transaction.
 - Agreement between balance in HO Account Branch Accounts.
 - Old outstanding debits in the Head Office Account

GENERAL (Cont'd)

- ➔ Window dressing to be reported
e.g.. Large deposit at year end.
- ➔ Underutilised facilities converted in Deposits.
Unsecured loans shown as secured.
- ➔ Maintenance of Fixed Assets Records.
 - Documents of title in relation to branch
 - Any other matter

SPECIALISED BRANCHES

- ➔ Foreign Exchange Transactions.
- ➔ Recovery of NPA'S.
- ➔ Clearing house Operations.
- ➔ Large Corporate branches (Advances in Excess of 100 crore).

Prudential Norms

- **DEFINATION**
- **INCOME RECOGNITION**
- **ASSET CLASSIFICATION**
- **PROVISIONING NORMS**
- **GUIDELINES ON SALE OF FINANCIAL ASSETS TO SECURITISATION COMPANY (SC) RECONSTRUCTION COMPANY (RC)**
- **GIUDELINES ON PURCHASE/SALE OF NON PERFORMING ASSETS**
- **WRITING OFF OF NPAs**
- **Prudential guidelines on Restructuring of Advances & Agricultural Debt Waiver and Debt Relief Scheme, 2008 (ADWDRS)**

Prudential Norms

- 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.

- ✓ Higher risk than normal risk attached to business.

- ✓ Non performing as per various criteria for various types of loans.

Identification of Account as NPA

Loans or Advance	<ul style="list-style-type: none">▪ Interest and/or installment remains overdue for a period of more than 90 days in respect of a term loan.▪ As per para 2.1.3, an account is classified as NPA only if interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.
<i>Exceptions</i>	<ul style="list-style-type: none">▪ Loans with moratorium for payment of interest .▪ Housing Loan or similar advance to staff.

Identification of Account as NPA ...

Bills Purchased and discounted	Bill remains overdue for a Discounted period of more than 90 days.
Agricultural Advances	Interest or installment remains overdue for two crop seasons for short duration crop, one crop season for long duration crop.
Derivative Transaction	Overdue receivables representing positive mark to market value of a derivative contract remaining unpaid for a period of 90 days from specified due date.
Liquidity facility	Remains outstanding for more than 90 days in respect of Securitisation transaction.

Identification of Account as NPA ...

- **Cash Credit / Overdrafts** \Rightarrow Account remains
‘out of order’

The account is treated as ‘out of order’ if :

- ✓ Outstanding Balance remains continuously in excess of sanctioned limit/drawing power (for how many days?)
or
- ✓ No credit continuously for 90 days as on the date of Balance Sheet or
- ✓ Credits in the account are not sufficient to cover interest debited during the same period.

Exceptions / Clarifications

Temporary deficiency

- ✓ Outstanding Balance in account based on the drawing power calculated from stock statements older than 3 months would be deemed as irregular & if such irregular drawing are permitted for a period of 90 days, account needs to be classified as NPA.
- ✓ Non-renewal/ Non-regularisation of regular/ adhoc limit within 180 days from the due date.

Exceptions / Clarifications ...

- Advances against term deposits, NSCs, IVPs, KVPs and Life Insurance Policies need not be treated as NPAs, till security cover is sufficient to cover outstanding balance.
- Income to be recognised subject to availability of margin.
- Advance against gold ornaments / Government securities not exempt.

Exceptions / Clarifications ...

- Central Government guaranteed advance to be classified as NPA only if Government repudiates the guarantee when invoked.
 - Classification Qua Borrower
 - ✓ All facilities granted to a borrower shall be treated as NPA & not only that facility which has become irregular.
- Exception:** Credit facility to Primary Agricultural Credit Society (PACS) and Farmers Service Societies (FSS) under on lending arrangement.

Exceptions / Clarifications ...

Consortium Advances

- Member banks shall classify the accounts according to their own record of recovery.
- Bank needs to arrange to get their share of recovery or obtain an express consent from the Lead Bank.

Exceptions / Clarifications ...

Straightaway Classification

- ✓ Where realisable value of security is less than 50% of the value assessed, account to be straightaway classified as Doubtful Asset.
- ✓ Where realisable value of security is less than 10% of outstanding balance, account to be straightaway classified as Loss Asset.

Exceptions / Clarifications ...

Valuation of Securities

- ✓ In respect of NPAs with the balance of Rs. 5.00 crores & above, bank needs to formulate policy for annual stock audit by external agencies & in respect of immovable properties, valuation to be carried out once in 3 years by approved valuer.

Exceptions / Clarifications ...

Solitary Credit Entry

- ✓ Care should be taken that a solitary or few credits in the account made at/near the balance sheet date extinguishing the overdue interest/principal is not the only criteria for classifying the asset as standard.

Exceptions / Clarifications...

Regularisation of Account

- ✓ Account need not be classified as NPA if account has been regularised by the date of Balance sheet by payment of overdue through genuine sources & not by sanction of additional facility or transfer of funds between accounts.

Classification - Projects under Implementation

- 'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks should fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure.
- For all projects financed by the FIs/ banks **after 28th May, 2002**, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.
- **These asset classification norms would apply to the project loans before commencement of commercial operations.**

Classification - Projects under Implementation...

- Any change in the repayment schedule of a project loan due to increase in the project outlay would not be treated as restructuring if:
 - ✓ The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.
 - ✓ The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.
 - ✓ The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCP.
 - ✓ On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

Classification - Projects under Implementation...

■ Infrastructure Sector

- ✓ Classify as NPA any time before commencement of commercial operations, if interest/ installment is 90 days overdue unless restructured and eligible to be classified as standard.
- ✓ Classify as NPA if its fails to commence commercial operations within two years from the original DCCO unless restructured and eligible to be classified a standard.

Classification - Projects under Implementation...

✓ Permissible limit for extension of date of commencement of commercial operations.

- Court cases : another two years beyond the extended period of two years
- Other reason: another one year beyond the extended period of two years.

✓ Other conditions:

- Application for restructuring should be received before the expiry of period of two years from original DCCO.
- If there is a moratorium, bank should not recognise income beyond two years from original DCCO.
- Bank should maintain necessary provision as long as these are standard assets.

Classification - Projects under Implementation...

■ Non Infrastructure Sector

- ✓ Classify as NPA any time before commencement of commercial operations, if interest/ installment is 90 days overdue unless restructured and eligible to be classified as standard.
- ✓ Classify as NPA if its fails to commence commercial operations within six months from the original DCCO unless restructured and eligible to be classified a standard.

Classification - Projects under Implementation...

✓ Permissible limit for extension of date of commencement of commercial operations.

- Other reason: another one year beyond the extended period of six months.

✓ Other conditions:

- Application for restructuring should be received before the expiry of period of six months from original DCCO.
- If there is a moratorium, bank should not recognise income beyond six months from original DCCO.
- Bank should maintain necessary provision as long as these are standard assets.

Income Recognition

- For NPA accounts income should be recognised on realisation basis.
- When an account becomes non-performing, unrealised interest of the previous *periods* should be reversed or provided.
- Interest income on additional finance in NPA account should be recognised on cash basis.
- In project loan, funding of interest in respect of NPA if recognised as income, should be fully provided.
- If interest due is converted into equity or any other instrument, income recognised should be fully provided.

Income Recognition...

Adjustment of Recoveries - *Priority*

Unrealised Expenses

Unrealised Interest

Amount of Principal Outstanding

Clarification vide Master Circular - in the absence of clear agreement between the Bank and the Borrower, an appropriate policy to be followed in uniform and consistent manner.

Classification Norms

- **Standard Asset**
The account is not non-performing.
- **Sub-Standard Asset**
A sub standard Asset is one which has remained NPA for a period of less than or equal to 12 months.
- **Loss Assets**
These are accounts, identified by the bank or internal or external auditors or by RBI Inspectors as wholly irrecoverable but the amount for which has not been written off.

Classification Norms...

- Doubtful Asset - Three Categories

Category

Period

Doubtful - I up to One Year

Doubtful – II One to Three Years

Doubtful - III More than Three Years

Provisioning Norms

Standard Asset

- Agricultural and SMEs Sectors .25%
- Commercial Real Estate (CRE) Section 1%
- Others .40%
- ✓ Vide circular dated 23rd December 2010, provision on housing loan accounts has been increased to 2% with immediate effect.

Sub-standard Asset

- 10% of total outstanding
- 20% of total outstanding if loan is unsecured

Provisioning Norms...

Doubtful Assets:

<u>Period</u>	<u>Provision</u>	<u>(Secured + Unsecured)</u>	
Up to 1 year	20%	+	100%
1 to 3 years	30%	+	100%
More than 3 years	100%	+	100%

Loss Asset:

100% should be provided for

Banks should have total provisioning coverage ratio of not less than 70%.

Provisioning for Country Risk

- In respect of a country where its net funded exposure is $\geq 1\%$ of its total exposure

Risk Category	ECGC classification	Provisioning requirement (%)
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very High	C1	25
Restricted	C2	100
Off-Credit	D	100

- Lower provision in respect of short term exposure

Provisioning Norms

Provision Under Special Circumstances

- Advance under rehabilitation programme approved by BIFR / Institutions, Provision should be continued to be made on existing facilities.
- Additional facilities no provision for a period of one year.
- In case of advances guaranteed by CGTSI/ECGC, Provision should be made only for balance in excess of the amount guaranteed by these corporations.



Thank You

CA Sandeep D. Welling