Bank's Credit Portfolio– Unit Inspection by the Auditor

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A large number of credits provided by commercial banks in India turn into Non-Performing Assets (NPA) in, on an average, just three years of their commencement. The situation calls for urgent attention of the bank managements and the auditors concerned. The 'Unit Inspection' technique is an effective mode that an auditor can safely resort to in this scenario. The article delves into various facets of this technique

The general trend of a substantial number of bank credits becoming non-performing assets in just three years of commencement continues unabated in India. As such, it is high time that the technique of "Unit Inspection" is effectively utilized by the auditors concerned in addition to proper monitoring of credit by the bank officials.

The Committee on Financial Systems, set up by Reserve Bank of India (RBI) under the chairmanship of Mr. M. Narasimhan, had made several recommendations concerning accounts of banks in its report in 1992. Consequently, the RBI issued guidelines that are now referred as prudential norms to be followed by all scheduled commercial banks (excluding regional rural banks) for income recognition, assets classification, provision and other related matters. By virtue of the implementation of the Committee's recommendations (w.e.f 1-4-1992) on classification of assets, income recognition and provisions, the maintenance of quality of assets has become the core content of Bank's Credit Portfolio. It has come to occupy highest priority in the credit portfolio management. The Bank's very viability may be at stake if this aspect is not taken seriously as no income could be accounted for from non-performing assets unless actually received as against the earlier basis of accrued income.

The quality of a bank's assets is bound to suffer unless the viable performance of the small scale units are carefully and regularly monitored and timely actions are taken to help them out in the present scenario of cut-throat competition. .

In this background, the "Unit's Inspection" through an Auditor is a key option available for banks. Having good rapport with units through regular visits and exhaustive interaction with the key functionaries in the units help regularise the "out of order" or "past due" accounts. The "Unit Inspection" technique has a great potential to transform the NPAs into Performing Assets. The post sanction follow up of credit outweighs even the appraisal part of credit, which is considered by many in Banks a special skill in Banking Sector.

In this regard, a profile data of commercial banking and credit sanctioned by the commercial banks in India for two years is given below which reflects the necessity of credit portfolio management.

Credit Portfolio Management

Banks lend money by granting loans or overdrafts to the customers. The banks should provide credit after verification of credit worthiness of the borrowers and with proper approvals. The documents should be provided by the borrowers and should be complete in all aspects. Documents such as agreements, demand promissory notes, letters of hypothecation should be kept in safe custody by the banks. The RBI directives regarding security, margin and interest rate should be followed. The borrowers should get the securities registered in the name of the bank. The securities should be verified

Commercial Banking at a glance		
Important Indicators	March 2001	March 2002
No. of Commercial Banks	301	299
No. of Scheduled Banks	296	294
No. of Non Scheduled Banks	5	5
No. of Bank Offices	65908	66276
Deposits of Scheduled Commercial Banks Rs. crore	950705	1097049
Credit of Scheduled Commercial banks Rs. crore	556436	683591
Source : - RBI Bulletin on Banking Statistics		

physically before providing credit and the value of securities should be checked and compared with the market value. The hypothecated assets should be verified regularly by the field officers of the bank. Any significant fluctuations in the market value of the securities are to be observed. The credit amount should be within the limits of the drawing power of the borrower and approved limits of the bank authorities. In case it exceeds the limits the same should be brought to the notice of the authorities concerned, and regularized.

The third Schedule to the Banking Regulation Act, 1949, requires classification of advances made by a bank from three different perceptions viz., nature of advances, nature and the extent of security and place of making advance (i.e., whether in India or abroad). Accordingly, the advances should be classified in the Schedule 9 to the Balance Sheet as follows.

A. Bills purchased or discounted
   Cash credits, Overdrafts and loans repayable on demand
   Term loans
B. Secured by tangible assets
   Covered by bank / Government guarantees Unsecured
C. Advances in India
   Advances outside India

Monitoring the Non performing Assets

A non-performing asset can be defined as a credit facility in respect of which the interest and/or installment of principal has remained past due for a certain period of time as specified by RBI from time to time.

Under the guidelines, income recognition and provisioning in respect of a credit facility are based on its status as performing or non-performing. A credit facility becomes non-performing when it ceases to give profit to the bank. In India the size of gross non performing assets (GNPA) of public sector banks has been expanding continuously except in 1995 at a trend rate of 4% asshown in the table.

Critical study of borrower accounts and other related records such as periodical stock statements, financial statements etc., and unit inspection definitely throw light on serious lapses or deficiencies in the affairs of the unit as given below, which will provide guidance to the bank for taking remedial action.

- Maximum balance in cash credit account remains for long period
- Default in making payment of installments of principal and interest on loans

* Gross NPAs of Public Sector Banks in India		
Year	Rs. billions	US $ billions
1993	392.5	12.81
1994	410.4	13.08
1995	383.8	12.22
1996	416.6	12.45
1997	435.8	12.28
1998	456.5	12.28
1999	517.1	12.29
2000	530.3	12.24
2001	546.7	11.97
2002	564.7	11.84
2003	540.9	11.18
Source: - Report on Trends and Progress of Banking in India, RBI, various issues		

- Irregularities in cash credit account such as overdrawing and non maintenance of stipulated margin are not made good by the unit
- Non-submission of stock statements or submission of stock statements with deficiencies
- Return of cheques frequently
- Continuous decline in production, sales and profit
- Continuous increase in inventory levels and accumulation of slow or non-moving or obsolete items
- Continuous default in making statutory payments such as excise duty, sales tax, income tax, provident fund, etc.,
- Utilisation of credit for the purposes other than those specified in the agreement
- Non-cooperative attitude of personnel of the unit during unit visit and non-submission of required information in time
- Diverting the sale proceeds or receivables through non-lending banks

- Larger and longer outstanding in bill accounts
- Non-clearance of bills/bank documents which are routed through bank for longer period
- Recession in economy
- Frequent stoppages of the production due to inefficient management, strained relations with the labor, outdated technology, product obsolescence, shortage of raw materials, shortage of power, etc.,
- Non-performance due to pricing policy, market competition, change in demand for product or technical defects in end products
- Over-trading or over-loaded by heavy sundry creditors or sundry debtors
- Overrun of project -cost at implementation stage.

Process of Unit Inspection

The entire gamut of operations under credit portfolio management could be divided and sub-divided into several categories. The credit portfolio can be categorised in two parts— pre-sanction credit and post sanction credit. The Unit Inspection by the auditor falls in the category of post sanction credit.

Unit Inspection is mainly for scrutiny of records and verification of the assets and stocks, which were pledged or hypothecated to the bank.

Unit Inspection includes not only the examination of registers, records and documents but also discussions, meetings, and interviews with the officials of the unit. Studying and analysis of the records, statements and documents also forms part of Unit Inspection.

The process of Unit Inspection involves three steps as follows: --.

1. The first step is desk review or preparatory work for the unit inspection and collection of data by the Auditor at branch level.
2. The second step is visit to factory for (a) scrutiny of books, files and accounts (b) physical verification of assets and inventory.
3. The third step is submitting inspection report to the authorities concerned in case of any deviations are noticed in working of the unit as against the projections or discrepancies found in the inventory to that of stock statements during inspection of the unit.

In most cases the unit's visit could be intimated in advance so that all the necessary records are available in the unit.

A. Desk Review or Preparatory work: The auditor can do it in the bank office. The auditor obtains primary information and acquires knowledge about the unit through verification of the documents available at bank before visiting the Unit. The auditor should verify the procedure followed in loan sanction, purpose of the loan, project report, financial statements of the unit, stock statements, statutory returns, internal reports, board resolutions, in house publications, etc. It involves collection of data and necessary information for verification as given below.

a. Stock Statements – To collect latest stock statements submitted by the unit during the visit
b. Bills / Book Debts – List of Bills outstanding with a noting of long outstanding bills to scrutinise the unit's bill books and to satisfy that the bills are realised and routed through bank accounts. To discuss the reasons for delay in realisation of bills and steps being taken to realise the same.
c. List of Assets– A list of assets pledged as primary or collateral should also be taken to the unit.
d. List of Stocks / Inventory - A list of stocks hypothecated should also be taken to the unit.
e. Status of Account – In case the account is irregular, the amount of irregularity and the age of irregularity should also be noted for discussion with the unit.
f. Insurance coverage – The unit, at the time of visit should be reminded of insurance coverage and payment of premium and revival of documents.
g. Record of projections - Before starting for visit of the unit, the auditor should have a record of projections and assessments made while sanctioning limits to verify with the records and accounts that the unit has nearly achieved the projections. Otherwise, the auditor has to discuss about the plans in achieving the balance of projections during the coming period, so that the viability of the unit will not be impaired. It should also be noted whether any bills are due under letter of credit and to discuss about the steps taken for payment of bills in time.

B. Visit of Unit / Factory: During the visit of the unit, all the data and information collected at the time of desk review in the bank should be cross-checked

and thoroughly discussed with the functional managers of the Production Department, Engineering Department, Purchase and Stores Department, Marketing Department and Accounts Department of the Unit.

The Auditor should conduct the inspection in the unit premises through following activities.

- Physical verification of assets and stocks
- Scrutiny of Records
- Interview of key personnel / discussions
- Analysis of data and finalisation of report

1. **Physical Verification of assets and stocks** – Physical verification should be conducted in respect of the assets which were created in either movable or immovable / primary or collateral / current or fixed. The assets consist of land, buildings, plant & machinery, inventory of stores & spares, stocks of raw materials, stocks of finished goods & semi finished goods. Perhaps these are inclusive of receivables and payables representing sundry debtors / creditors. The auditor should also obtain technical details of process-undertaken, inputs, outputs, etc. In addition to physical verification of quantity and quality of assets, the auditor is required to examine whether the assets are acceptable in the market at prices fixed, current market prices and their acquired or manufactured cost. It is also to be verified whether insurance coverage is adequate in respect of assets and stocks under charge with the bank. The following factors should be considered during this activity.
   - Quantity of assets
   - Quality of assets
   - Valuation of assets
   - Turnover of assets
   - Storage of stocks
   - Insurance coverage
   - Unit's working
   - Unit's financial records / files
   - Upkeep of accounts
   - Bank's possession or charge
2. **Scrutiny of Records** - The following records should be scrutinised in the unit's premises to assess the upkeep maintenance of accounts and status of various parameters both in terms of quantity and values.
   - Purchase book
   - Sales book
   - General Ledger
   - Subsidiary Ledgers/ party ledgers
   - Inventory Ledger of stores and spares
   - Physical verification statement of stores and spares
   - Insurance Declarations / Claims Statements
   - MIS Plant Report
   - Register of daily receipt, production, consumption and stock of raw materials, fuels, products, by products
   - Down time reports of equipment, plant and machinery
   - Physical verification or stock taking report of raw materials / finished goods / semi- finished goods
   - Periodical reports to Government and other Agencies
   - Register for exports
   - Bank statements / Monthly stock statements to the banks
   - Agreements & Contracts

The following Financial Statements should be verified to assess the financial soundness of the unit

- Trial Balance
- Profit & Loss Account,
- Balance Sheet,
- Annual Report

The following Audit Reports should be verified to assess the compliance of statutory provisions of various acts and impact of comments of auditors on the unit

- Statutory Audit Report
- Cost Audit Report
- Tax Audit Report
- Sales Tax / VAT Audit Report
- Energy Audit Report
- ISO Audit Report
- Special Investigation Report
- Special Audit Report

The data given in the following statutory returns should be cross verified with periodical statements submitted to the bank and accounting records maintained by the unit

- Income Tax Return
- Sales Tax / VAT Return
- Royalty / Cess Return
- Excise Returns - ER-1 monthly return
- Excise Returns ER-2 return by 100% EOU,
- Excise Returns ER-3 quarterly return
- Excise Returns ER-4 annual return
- ST-3 Half yearly return
- Other periodical returns to various Government Agencies

3. **Interview of key personnel / discussions** – It involves the following activities

- Raising the relevant issues
- Asking the questions and obtaining answers from the management

- Discussion on future course of action in respect of deficiencies and irregularities

In respect of irregular accounts, the discussion should be pulled around with the unit as to how and when the accounts will be regularised. In respect of term loans, the number and amount of installments overdue have also to be recorded for discussions with the Chief Executive of the Unit later.

4. **Analysis and finalization of report** - It involves the following activities
   - Studying the statements, returns and reports
   - Analysing certain aspects
   - Trend analysis which involves comparing operations and sales from year to year
   - Analysis of financial ratios
   - Making certain evaluations
   - Arriving at certain conclusions
   - Finalisation and Preparation of the Report

C. Submission of the Audit/ Inspection Report to Bank: After the completion of visit the auditor should submit the report to the bank authorities narrating the irregularities noticed during verification of records and physical verification of assets and stocks. The remedial action may also be suggested so that the bank authorities can ask the unit to rectify the irregularities providing a time frame to them.

Inspection report should contain the following factors, which the auditor observes during a visit to the unit.

a. *Level of operation* – Whether the unit is reached to the production, sales and profit levels as per assumptions made for credit sanctioned. Whether it is achieving the projected profits.
b. *Management* – Whether unit's affairs are running smoothly by the management i.e., establishing good relations with the workers, staff, customers, suppliers and clients.
c. *Environment* – Whether the unit is adopting any changes in the policies that affect adversely the prospects of the production, sales, profit and finance of the unit.
d. *Commitment* – Whether the unit is complying with the terms and conditions of the bank and honoring the deals with the customers
e. *Marketing* – Analysis of the market trends, pricing pattern, demand, supply for the product.
f. *Financial* – Whether the unit is paying the statutory dues such as Excise Duties, Customs Duties, Service tax, Sales Tax, Income Tax and Provident Fund in time. Whether the unit is conducting its business transactions through the account maintained in their bank. Analysis of the financial dealings with the customers, suppliers and clients to determine whether the inward / outward bills have been realised in time
g. *Compliance of Terms and Conditions* - Any non-compliance or deficiencies in complying the terms and conditions of sanction should also be recorded.

Presumptions for post operation credit

a. The formalities relating to sanction, documentation, stamping, creation of securities, mortgages, insurance and charges are all complete as per the laid down procedures including compliance of instructions relating to provisions of law before stepping into post operation credit.
b. Care is being taken in recording of inspections and frequency depending upon quantum of finance.
c. Information systems are regular for control as in the case of submission of control forms, irregularity reports and periodical follow up reports as per the laid down guidelines to the controlling authority. The unit will be submitting proper stock/Q.I.S./Financial data to the bank regularly and in time. These instruments are generally termed "Credit Control Instruments" which are basics for credit management.

Conclusion

Credit is a vital part of any financial system of a country and organisation. A proper control by banks through effective monitoring of unit can lead to efficient and safe utilization of the funds of the banks. The 'unit inspection' by the auditor and discussions with functional managers of the unit in the process enormously helps in understanding and assessing the working condition of the unit. Such visits enable banks to know the latest position of the unit and thus may lead to timely remedial measures if needed. Such visits and consequent report of the auditor concerned can give early warning signals to the banks and thus can help in resolving a situation before it is too late. ❐