Interpretational Issues in Bank Audit

Thanks to the prescriptive approach adopted by the Regulator, banking has seen a sort of convergence *vis-à-vis* the accounting aspects. But given the diversity of the users, however much one tries, different interpretations do exist in the reading of guidelines and circulars issued by the regulator from time to time. This article tries to track down such differences.

On Advances

Funded Interest Term Loan:

It appears that some banks accrue interest on Funded Interest Term Loans (FITL) if the account is standard and do not make provisions for such accounts. Such an accounting practice in our opinion leaves a lot to be desired.

Citing Para 4.2.15.6 (a) of the Master Circular on prudential norms, which says that:

> *"Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest has been funded. If however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for".*

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In the same Master Circular under Para 13 of Part B, the regulator has identified the mode of accounting both the asset and the income thereon. The extract reads as follows:

> ***Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments***
>
> *13.1* ***Asset classification norms***
>
> *The FITL/debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified.*

Further movement in the asset classification of FITL/debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

13.2 ***Income recognition norms***
13.2.2 The unrealised income represented by FITL/Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalisation)".
13.2.4 Only on repayment in case of FITL or sale/redemption proceeds of the debt/ equity instruments, the amount received will be recognised in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

Thus, under para 13.2.2 of Master Circular, the regulator wants the unrealised income to have a corresponding credit in an account styled as "Sundry Liabilities Account (interest capitalisation)". In the case of standard FITL accounts, the regulator has no objection in the banks increasing its operating profit by accruing interest income, but all the same seeks a provision to the extent of the unrealised portion. However, in the case of FITL accounts which are NPAs, the regulator categorically asserts that income should be accounted only on cash basis.

Hence, any practice of accruing interest income on FITL accounts which are standard without making a provision for the same, does not appear to have the regulator's nod. However, the Regulator may provide more clarity on the matter.

Restructured Accounts:
Some banks, which are part of the multiple banking arrangements implementing a CDR package despite being a dissenting minority, on a later date, are forced by circumstances to reschedule the borrower's account in their books. They claim that their rescheduling efforts should not be taken as a second restructure (the first being the CDR) since they were never a party to the CDR.

As the restructure is being attempted for the first time on their own initiative in the books, they argue that the account should not be christened NPA but should be considered performing. Having not exercised the exit options, it is a moot point as to whether their argument is tenable.

It is also common to see cases of those borrowers who get their accounts earlier restructured individually with the lenders, later go in for a CDR and claim immunity from being called NPA. For them, the CDR does not fall under the category of second restructure.

Also, if one goes through CDR Master Circular, a re-work of a package would not be considered as a repeated restructure, if there is no negative NPV on discounting of cash flows provided account is fully secured. Borrowers and professionals seek a definitive response from the regulator on this issue.

In some cases, as a part of the restructure package, banks extend a holiday period for interest servicing. Though in essence it is akin to funded Interest Term Loan, banks continue to account for accrued income during the period of such deferment, citing the parallel of project loans which enjoy moratorium of interest. Even here, the issue is not altogether free from doubt either.

Treatment of Interest Accrued But Not Due on Advances:
Before the advent of the concept of system driven NPAs, banks were debiting interest in demand loan accounts such as Cash Credit, Over Draft etc. on the last day of the month. Now to effect a better follow up, some banks have switched over to debiting interest to such accounts around the 24th. With the CBS structure to help them, these banks are able to calculate the interest accrued for the period 25th to 31st and accrue them to their income. Coming to the aspect of debiting, some take the debits to advances while others strictly go by the Regulators diktat in 1992 and hold it under Interest Accrued but not due, under Other Assets. The accounting treatment of adding such interest accrued but not due to advances, apart from not being in conformity with the RBI guidelines, also makes

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interbank comparison difficult. In all fairness, since this part of interest component was always a part of the advances, the regulator may do well to revisit its stipulations.

On Investments

Depreciation on HTM Investments:

Banks are allowed shifting between categories (HTM and AFS) only once and that too at the beginning of the year. RBI requires banks to disclose market value of the investments held in HTM and the quantum of excess of book value over market value (for which no provision has been made), in case the transfers/ sale from Held To Maturity (HTM) category, account for an amount in excess of 5 % of book value of the opening HTM figure. (RBI has excluded for this purpose transfers effected under one time shifting).

A plain reading of this directive seems to suggest that banks can effect transfers *to/from* HTM at any time during the year in addition to what is done at the beginning, which may be the unintended fallout of RBI's directive.

The circular of 06-08-2010 refers to sale and transfer of securities *to/from* HTM category. The words *to/from* is interpreted by a few as to mean the same scrip being transferred to HTM and on a later date transfer *from* HTM, (that is the words "one time" is read with "transfer to' once and again with "transfer *from*') suggesting such a move as the Regulator's consent. This sort of interpretation needs a clarification from RBI.

Circular of 01-11-2010 went about stating that the one time transfer stands excluded while computing 5% cap. In our opinion, the transfer of securities referred to in the circular dated 6th August, 2010, could and should mean the one time transfer only, the reason being that even in the Master Circular of July 2011, RBI emphasised that transfer from/to HTM can be done only once a year.

Having extended a relief to the banks by asking them not to provide for any depreciation on investments under HTM since they are meant to be held till their maturity, the Regulator is not happy when banks use HTM as a trading book defying its original intent. Hence, when the threshold is breached, the regulator wants the banks to disclose the unprovided depreciation of the investments held as at the year end. The Regulator may provide the necessary clarity in this regard.

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We also understand that provision for depreciation on shifting is accounted by some banks as a deduction under "Other Income" as "Loss on Revaluation of Investments", while many book it under provision and contingencies. True, the net Profit does not get affected but the impact on operating profit can be substantial.

Provision on Non Performing Investments:

In 1992 when the Balance Sheet format was introduced, the concept of non performing investments had not come in. Subsequently, around 2000, it was thought necessary that investments which were not performing, should also suffer a provision in Profit and Loss account in addition to erosion as reflected by the market. Cases where interest/installments and principals were due for a period exceeding 90 days; cases where any credit facility made by the issuer of investments happens to be NPA; preference shares where dividends remained unpaid, equity shares of companies whose latest audited accounts are not available; investments in bonds/debentures more in the nature of advances etc., which got classified as non performing assets –are all investments described to be non performing and had to be provided for. Question arose as to whether such erosion is to be treated on par with depreciation on investments and get reduced from gross investments or whether they should be knocked off from the gross value of investments or alternately, be held under Other Liabilities and Provisions (Schedule 5). There is a school of thought which recommends reflecting such depreciation under Schedule 5 since according to them, the format does not provide for their deduction under Investments. But mostly, we find banks treating them on par with depreciation, deducting such erosion from the Gross Value of such Investments and explicitly stating so.

Valuation of Treasury Bills and Zero Coupon Bonds:

While both Treasury Bills and Zero Coupon Bonds are to be valued at carrying cost, for the purpose of

disclosure, interest accrued upto the year end but not due, is added on to the Investments in the case of Zero Coupon Bonds under the specific directive of the regulator but when it comes to Treasury Bills, the interest so accrued but not due is held under other assets. It is felt that a benefit similar to the privilege enjoyed by the Zero Coupon Bonds may also be extended to Treasury Bills.

Capital Adequacy

While the method of measurement can vary between BASEL I and II, the components, in our opinion, cannot. Some banks take deferred tax asset on net basis (net off Deferred Tax Liability) for BASEL II and at its Gross for purposes of BASEL I calculation. The Regulator may clear the air.

Loans carry risk weight and such loans as foreign currency loans as well. When these foreign currency loans are further covered by forward contracts, such forwards carry additionally a risk weight. It is inexplicable to hold that a bank which has taken more protective measures to cover its loans, should hold more capital. Perhaps the intention of the Regulator was that no foreign currency loan should be left uncovered, but the commercial banks, under the borrowers' instructions, felt no need for a forward cover – even given the fluctuations witnessed these days. This is an anomaly necessitating a course correction.

Disclosures

Regulator had asked banks to disclose details of such of those loans which carry intangibles such as rights, licenses, assignments, authorisations etc. These were to be disclosed under the caption Unsecured Loans. Banks whose sanction terms did not consider such intangibles as security chose not to report any figure under this caption. Banks which had such loans covered by other tangible securities ignored reporting under the said disclosure. If the intention of the regulator was to capture data of the exposure banks had to such companies whose main manufacturing/service base was such intangibles, the purpose does not get served. The Regulator may clarify its intent more expressly.

Thus, the banks and the professionals look to the regulator for an early smoothening of these rough edges. ■