

## Verification of Advances with Special Reference to Income Recognition and Asset Classification (IRAC) Norms



*The article attempts to cover verification of advances with special reference to income recognition and asset classification (IRAC) norms, which are also known as non-performing asset (NPA) norms and prudential norms. The article also covers a summary of key requirements applicable, based on the Reserve Bank of India (RBI) prudential norms, but it does not cover norms on restructuring of advances by banks and agricultural debt waiver and debt relief scheme. Read on...*

### Overview

The overall economic scenario is in berry phase; as per the press reports, various banks have written off ₹1.14 lakh crore of bad debts between financial years 2013 and 2015, much more than they had done in the preceding nine years. The RBI disclosed that while bad debts stood at ₹15,551 crore for the financial

year ending March 2012, they had shot up by over three times to ₹52,542 crore by the end of March 2015. Situation calls for auditors to be more vigilant while discharging their duties.

We have the constraint of limited time to complete the bank-branch audit. Normally, we receive the appointment letter in mid-March and we have to complete the audit by the first or the second week of April.

Further reason of concern is that the banking sector is fraud prone and it again increases our responsibilities in carrying out bank-branch audit. There have been many frauds in the banking sector. In the current fiscal till half year ending September 2015, as many as 861 cases of frauds relating to



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advances have been reported (all cases above ₹1 lakh) involving ₹4,920 crore; this figure in the last full year (FY 2014-15) was 1,651 cases amounting to ₹11,083 crore.

In bank audit, we need to plan very well so we are able to carry out audit effectively. There are various laws applicable in bank audit, but we must be updated with the latest RBI guidelines and requirements for the the banking sector. All related circulars are available on the Reserve Bank of India's website i.e. [www.rbi.org.in](http://www.rbi.org.in).

Verification of advances is one of the important aspects of bank audit. While doing verification of advances, impact of irregularities needs to be seen from the point of view of its asset classification. Advances are classified based on RBI guidelines.

Originally, RBI had health code system which was replaced by IRAC norms in 1992-93. Now, income recognition is made an objective based on record of recovery.

Any irregularities having bearing on NPA (non-performing asset) status of the advances need to be examined carefully. In other words, while examining any advances, we need to check what will be the impact of irregularity in advance on its NPA status. As per the RBI circular, when asset ceases to generate income, it becomes NPA.

Reserve Bank of India, every year, issues Master Circular for norms for classification of advances into various categories of NPA. This year like every year, RBI has issued Master Circular on 1<sup>st</sup> July 2015. Key points of the circular are summarised as under:

Type of facility	To be classified as NPA if
Term Loan	Interest and/or installment of principal, remain overdue for a period more than 90 days.
Working Capital Finances (Over draft and Cash Credit)	If accounts remain out of order for more than 90 days. Out of order: An account should be treated as ' <b>out of order</b> ' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of balance sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as ' <b>out of order</b> '.
Bills	The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
Agricultural Advances	<b>Short duration crops</b> The installment of principal or interest thereon remains overdue for two crop seasons. <b>Long duration crops</b> The installment of principal or interest thereon remains overdue for one crop season. <b>Natural calamities</b> Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own, as a relief measure, conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines contained in the RBI circular <i>RPCD. No.PLFS.BC.3/05.04.02/2012-13 dated July 2, 2012</i> .
Liquidity Facilities	The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
Derivative Transactions	The overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment
Banks should classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter	

# Bank Audit

Further, advances need to be classified into categories as Standard, Sub-standard, Doubtful and Loss Asset. Following are criteria for classifications of NPA:

NPA Category	Criteria for classification						
Sub- Standard Asset	Which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the <i>banks will sustain some loss, if deficiencies are not corrected.</i>						
Doubtful Asset	An asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub standard, with the added characteristic that the weaknesses make collection or liquidation in full,—on the basis of currently known facts, conditions and values— <i>highly questionable and improbable.</i> For provisioning, doubtful assets are further classified as per age in doubtful category, in sub-categories generally called as D-1, D-2 and D-3.						
Loss Asset	A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has <i>not been written off wholly.</i> In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.						
Accounts where there is erosion in the value of security/frauds committed by borrowers	In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, <b><i>it will not be prudent that such accounts should go through various stages of asset classification.</i></b> <i>In cases of such serious credit impairment, the asset should be straightaway classified as doubtful or loss asset as appropriate:</i>						
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## Internal Control Systems to Eliminate the Tendency to Delay or Postpone the Identification of NPAs

Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. The banks may fix a minimum cut off point to decide what would constitute a high value account depending upon their respective business levels. The cut-off point should be valid for the entire accounting year. Responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that *doubts in asset classification due to any reason are settled through specified internal channels within one month*

from the date on which the account would have been classified as NPA as per extant guidelines.

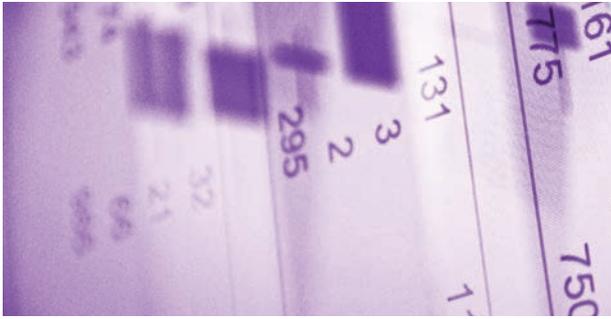
**In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent that such accounts should go through various stages of asset classification.**

**In cases of such serious credit impairment, the asset should be straightaway classified as doubtful or loss asset as appropriate.**

So in any case, let us say, advance was to be classified as NPA or not? Any becoming NPA on 30<sup>th</sup> June 2015 and there such doubt should be resolved by the bank by July was a doubt about whether that advances needs 2015.

**Other Issues in Classification of Advances as NPA:**

Accounts with temporary deficiencies	Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets. Drawing power is required to be arrived at based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power <i>should not be older than three months</i> .
Regular and ad hoc credit limits	Regular and <i>ad hoc</i> credit limits need to be reviewed/ regularised <i>not later than three months</i> from the due date/date of <i>ad hoc</i> sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/review of credit limits is already on and would be completed soon. <i>In any case, delay beyond six months is not considered desirable as a general discipline.</i> Hence, an account where the regular/ <i>ad hoc</i> credit limits have not been reviewed/renewed <i>within 180 days</i> from the due date/ date of <i>ad hoc</i> sanction will be treated as NPA.
Accounts regularised near about the balance sheet date	The asset classification of borrowal accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. <i>Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.</i> In other genuine cases, the banks must furnish satisfactory evidence to the statutory auditors/inspecting officers about the manner of regularisation of the account to eliminate doubts on their performing status.
Loans with moratorium for payment of interest	i. In the case of bank finance given for industrial projects or for agricultural plantations, <i>etc.</i> where moratorium is available for payment of interest, payment of interest becomes 'due' only after the moratorium or gestation period is over. Therefore, such amounts of interest <i>do not become overdue</i> and hence, do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected. ii. In the case of housing loan or similar advances granted to staff members <i>where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.</i> Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates. <b><i>In my view, extension in moratorium period should not be allowed afterwards unless justified by strong convincing reason.</i></b>
Government guaranteed advances	<b><i>Central Government Guaranteed Advances</i></b> The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the government repudiates its guarantee when invoked. This exemption from classification of government guaranteed advances as NPA is not for the purpose of recognition of income. <b><i>State Government Guaranteed Advances</i></b> State government guaranteed advances and investments in State government guaranteed securities would attract asset classification and provisioning norms if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days.



**Asset Classification needs to be done borrower wise and not facility wise, hence even if one small facility is NPA, large borrower's all accounts will become NPAs.**

### Other Points to be considered in Classification of an Advance as NPA:

- ✓ *Asset Classification needs to be done borrower wise and not facility wise, hence even if one small facility is NPA, large borrower's all accounts will become NPAs.*
- ✓ *Consortium Advances: Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks and other aspects having a bearing on the recoverability of the advances.*
- ✓ *Advances against Term Deposits, NSCs, KVP/ IVP, etc.*  
Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.  
Here, plain reading of the RBI circular says advance against life policies need not be treated as NPA. In my personal views, intention must be to exempt only advances against traditional plans issued by the Life Insurance Corporation of India and not advances against life policies such as ULIP or which are issued by private companies may not be covered by this exemption.
- ✓ *Advances against gold ornaments, government securities and all other securities are not covered in the NPA classification exemption.*
- ✓ *Valuation of security for provisioning purposes*  
With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of ₹5 crore and above stock audit at *annual intervals by external agencies*, collaterals such as immovable

properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

### Provisioning Norms

<b>Standard Assets</b>	(a) Direct advances to agricultural and SME sectors at 0.25%; (b) Advances to commercial real estate (CRE) sector at 1.00 %; (c) Advances to commercial real estate–residential housing sector (CRE-RH) at 0.75%; (d) all other loans and advances not included in (a) and (b) above at 0.40 %; Housing loan at teaser rate, it will be @ 2% On newly restructured advances after 1.6.2013 @ 3.5% for March 2014, 4.25% for March 2015 and @ 5% for March 2016. On old restructured advances @ 2.75%.								
<b>Sub-standard Assets</b>	Secured exposure: 15% on outstanding balance Unsecured exposures for escrow accounts available in respect of infrastructure lending, infrastructure loan accounts: 20% on outstanding balance Other unsecured exposures: 25% on outstanding balance								
<b>Doubtful Assets</b>	Unsecured Portion: 100% Secured Portion: Period for which the advance has remained in 'doubtful' category <table border="1" style="width: 100%;"> <thead> <tr> <th>Provision</th> <th>Requirement (%)</th> </tr> </thead> <tbody> <tr> <td>Up to one year–D1</td> <td>25</td> </tr> <tr> <td>One to three years–D2</td> <td>40</td> </tr> <tr> <td>More than three years–D3</td> <td>100</td> </tr> </tbody> </table>	Provision	Requirement (%)	Up to one year–D1	25	One to three years–D2	40	More than three years–D3	100
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<b>Loss Assets</b>	100 %								

### Income Recognition

The policy of income recognition has to be objective and based on the record of recovery. Internationally, income from non-performing assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, the banks should not charge and take to income account interest on any NPA.

However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

**If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods should be reversed if the same is not realised. This will apply to government guaranteed accounts also.**

Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

If government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

### Reversal of Income

If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods should be reversed if the same is not realised. *This will apply to government guaranteed accounts also.*

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if uncollected.

#### *Leased Assets:*

The *finance charge* component of finance income [as defined in 'AS 19 Leases' issued by the Institute of Chartered Accountants of India (ICAI)] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

### Appropriation of Recovery in NPAs

Interest realised on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/additional credit facilities sanctioned to the borrower concerned.

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e. towards principal or interest due), banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

### Fraud Cases

We need to examine critically, fraud cases reported in advances, we need to understand methodology and need to find out whether adequate provisioning is done for the loss or not? Also, we have to see whether such cases are properly reported to the Reserve Bank of India.

#### *Types of Frauds Reported:*

Cases of funds diversions are being reported: loan taken for one purpose and utilised for some other purposes, over valuation of property done to get higher loan than eligible, export finance taken and no money is received from overseas suppliers and ECGC compliances are not done properly, *etc.*

There have been many cases of fraud reported in Gold loans- fake ornaments being given to banks as securities. Many frauds in housing loan area have also been reported, hence, this area also needs to be seen critically. There have been cases where fake income papers have been submitted, there is no borrower in existence, property is not in existence, same property being sold to more than one purchaser, *etc.*

#### Certain Practical Points

- In case of NPA, the auditor should carefully examine security as it will change the amount of provisioning if advances are found to be unsecured.
- The date of advance becoming NPA is an important date and needs to be examined whether the same is correctly determined, as the age of NPA determines its provisioning amount.
- The restructuring of advances should not be repeated restructuring.
- *There are various ever greening techniques being resorted for not classifying advance as NPA, we have to see the advances are being paid off from genuine sources and not by granting fresh advances in any way.*

### Conclusion

As classification, provisioning and income recognition is governed by the RBI norms, we have to carry out audit of advances based on the latest RBI norms and directives. Many a time, changes in directives comes in February and March also, hence, we need to keep our eyes on the RBI website for such changes (if any) being pronounced. The NPA norms have improved overall quality of advances. Looking at frauds reported, we need to be very vigilant in verifying correct application of the NPA norms. ■