Audit of Non Performing Assets

Advances constitute the largest item on the asset side of the balance sheet of a bank and therefore audit of advances is one of the important parts of bank audit. In case an advance account is classified as NPA, primary responsibility of making adequate provision for diminution in value of advance is that of the bank management and the statutory auditors. It is therefore imperative for the statutory auditors, to have thorough knowledge of "prudential norms on income recognition, asset classification and provisioning pertaining to advances" (IRAC Norms) prescribed by the Reserve Bank of India (RBI). The prudential norms are formulated on the basis of objective criteria rather than on any subjective consideration. This has brought in uniform and consistent application of the norms and greater transparency in published accounts of banks. The article discusses some important aspects of audit of NPAs. Read on to know more…

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RBI has been issuing Master Circulars on various aspects of Banks including on IRAC Norms every year. However from 2016, RBI has started issuing Master Directions wherever necessary. Accordingly after 1st July 2015, no Master Circular has been issued on IRAC Norms. The latest Master Circular No. *DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015* issued by RBI contains IRAC norms which are applicable for the statutory audit of banks for the year ending 31st March 2017.

Audit of NPA would basically involve identification of an account as NPA, its correct classification, income recognition, provisioning, if an account is restructured, compliance of various conditions as enumerated in the Master Circular etc.

Asset Types

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

Non-Performing Asset (NPA): An asset becomes NPA when it ceases to generate income for the bank. This would mean that an account would be classified as NPA on the basis of record of recovery rather than security charged in favour of the bank in respect of such account. Thus an account would become NPA if interest charged to that particular borrower is not realised within the prescribed time frame despite the account being fully secured.

Identification of Account as NPA

RBI has laid down the undermentioned criteria for classification of various types of advances as NPA which is based on record of recovery:

(i) **Term Loan:** Interest and /or instalment of principal remain overdue for a period of more than 90 days.

It is very important to note here that as per para 2.1.3. of the master circular, an account would be classified 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. E.g. Interest is charged on 30th November, 16 in a term loan account. If it is not serviced within 90 days from 31st December, 16 then term loan account would become NPA, not otherwise.

(ii) **Overdraft/Cash Credit:** If an account remains out of order, it would become NPA.

For this purpose an account would be treated as 'out of order' if:

a) The outstanding balance remains continuously in excess of the sanctioned limit/drawing power for 90 days or more, or

b) Even if the outstanding in the account is less than the sanctioned limit/drawing power, there are no credits in the account continuously for 90 days as on the date of the Balance sheet, or

c) Credits in the account are not sufficient to cover interest debited during the same period.

As on 31st March 2017, if any of the above criteria is satisfied, the account would be classified as NPA.

Auditor should verify stock statement to check the correctness of drawing power and whether the same is calculated in accordance with the approved policy of bank. Auditor should not assume sanctioned limit to be the drawing power. There may be instances where drawing power would be less than the sanctioned limit. Sanctioned limit of an account may be ₹25 lakh but the drawing power of the account may not necessarily be ₹25 lakh but it could be less than that. A Cash Credit/Overdraft account which is classified as standard may get classified as NPA because of an error in calculation of drawing power.

(iii) **Bills Purchased/Discounted:** If the bill purchased or discounted remains overdue for a period of more than 90 days from its due date.

(iv) **Agricultural Advances:** A Loan granted for

a) Short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons.

b) Long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and NPA date would depend on crop cycle, which is decided by State Level Bankers' committee in each state.

(v) 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.

(vi) In respect of 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.

(vii) A credit card account will be treated as NPA, if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the statement.

(vii) Guidelines for classification of projects loans where projects are under implementation are as under:

	Before commencement of commercial operation	**Fails to commence commercial operation within two years (IS)/ one year (NIS) from Date of Commencement of Commercial Operations (DCCO)**	**Restructuring due to court cases (Refer note e)**	**Restructuring due to other reasons (Refer note e)**
Infrastructure Sector (IS)	Classify as NPA if interest / instalment is 90 days overdue.	Classify as NPA even if it is regular as per record of recovery unless restructured and eligible to be classified as Standard.	a) Can be retained as Standard if restructured within two years from original DCCO. b) DCCO can be extended up to 4 years beyond the original DCCO, in case reason for extension is arbitration proceeding or court cases.	a) Can be retained as Standard, if restructured within two years from original DCCO. b) DCCO can be extended up to 3 years beyond the original DCCO, in case reason for extension is beyond the control of promoters.
Non Infrastructure Sector(NIS)	Classify as NPA if interest / instalment is 90 days overdue.	Classify as NPA even if it is regular as per record of recovery unless restructured and eligible to be classified as Standard.	Not applicable	a) Can be retained as Standard, if restructured within one year from original DCCO. b) DCCO can be extended up to another one year (beyond the existing extended period of 2 years i.e total extension of 3 years).

Note

a) 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.

b) '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.

A credit card account will be treated as NPA, if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the statement.

c) The above asset classification norms would apply to the project loans before commencement of commercial operations.
d) The above guidelines would not be applicable for restructuring of advances which are dealt with different sets of guidelines.
e) Any change in the repayment schedule of a project loan would not be treated as restructuring if :
i) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.
ii) The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.
iii) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCP.
iv) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

Exceptions/Clarifications

(i) **Accounts with temporary deficiencies:**
An account should not be classified as NPA, if the deficiencies like non submission of stock statement, non renewal of facility in the account are temporary in nature. RBI guidelines in this regard as under:
a) Drawing power is required to be arrived on the basis of the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. A CC/OD account would become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days.
For example: if borrower is allowed drawing on the basis of stock statement of August '16 for next three months, then it would be irregular from December '16. If the borrower does not submit fresh stock statement then the account would be considered as NPA in March '17.
b) An account where the regular/ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/date of ad hoc sanction will be treated as NPA.

An account which is generally irregular where a solitary or a few credits are recorded before the balance sheet date should be carefully checked. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.

(ii) **Asset Classification to be borrower-wise and not facility-wise**
Once an account has been classified as NPA, all the facilities granted to the borrower will be treated as NPA except in respect of Primary Agricultural Credit Societies (PACS)/ Farmers Service Societies (FSS). Also, in respect of additional facilities sanctioned as per package finalised by BIFR and/ or term lending institutions, provision may be made after a period of one year from the date of disbursement in respect of additional facilities sanctioned under the rehabilitation package. The original facilities granted would however continue to be classified as sub–standard/ doubtful, as the case may be.
(iii) **Advances under consortium arrangements**
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.
(iv) **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. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.
(v) **Government guaranteed advances**
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.
(vi) **Upgradation of loan accounts classified as NPAs**
If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no

longer be treated as non-performing and may be classified as 'standard'.

(vii) **Accounts regularised near about the balance sheet date**

An account which is generally irregular where a solitary or a few credits are recorded before the balance sheet date should be carefully checked. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the auditors must obtain satisfactory evidence about the manner of regularisation of the account to eliminate doubts on their performing status.

Income Recognition:

i) As per AS 9 on Revenue Recognition and as per the master circular of the RBI, income should be recognised when there is a reasonable certainty about its realisability. In respect of NPA there is no reasonable certainty about realisability of interest, therefore it is booked as income only when it is actually realised. If bank follows policy of charging interest in NPA account then same should not be taken to income but to unrealised interest or interest suspense account.

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.

For example: A borrower has taken loan of ₹1 lakh against term deposit of ₹1.25 lakh. Balance in the account as on 31st March 17 is ₹1.10 lacs. Even though account is over drawn income would be recognised since value of deposit is more than the balance outstanding.

ii) Income on standard advances is recognised on accrual basis except in case of income on Central Government guaranteed advances, which would have otherwise become NPA, income is recognised on realisation.

iii) In the case of accounts where the pre-restructuring facilities were classified as 'sub-standard' and 'doubtful', interest income on the additional finance should be recognised only on cash basis.

iv) In Projects loans, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

The finance charge component of finance income [as defined in 'AS 19 – Leases' issued by the Council of 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.

v) If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted into equity.

vi) The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognised only on redemption of such instrument.

vii) Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

Reversal of Income

i) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised during the year under audit. This will apply to Government guaranteed accounts also.

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

iii) The finance charge component of finance income [as defined in 'AS 19 – Leases' issued by the Council of 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

In case of any recovery in NPA, the application of recovery towards interest/principal should be based on the agreement with the borrower. In the absence of a clear agreement, banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner. Thus as per the consistent policy of the bank recovery may be appropriated towards interest or principal.

Asset Classification

Having identified an account as NPA, it is further required to be classified into

a) Sub-standard Assets
b) Doubtful Assets
c) Loss Assets

i) **Sub-standard Assets:**
An account which is classified as NPA for the first time, is categorised as Sub Standard for a period of less than or equal to twelve months from the date of advance becoming NPA. However in following circumstances, the NPA should be straightaway classified as doubtful/loss asset.

a. 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. When erosion in the realisable value of the security is more than 50 % of the value assessed by the bank or accepted by RBI at the time of last inspection, NPAs should be straightaway classified under doubtful category.
c. If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the NPA should be straightaway classified as loss asset.

ii) **Doubtful Assets:**
An account is classified as doubtful if it has remained in the sub-standard category for a period of twelve months.

iii) **Loss Assets:**
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 (less than 10% of balance outstanding).

Special Dispensation due to Demonetisation

(Ref: Circular DBR.No.BP.BC.37/21.04.048/2016-17 dated Nov 21, 2016 and No BP.BC.49/ 21.04.048/2016-17 dated Dec 28 2016)

Vide above circulars, it has been decided to provide additional 90 days beyond what is applicable for recognition of loan account as Sub Standard in the following cases:

i) Running working capital accounts (OD/CC)/ Crop loans, sanctioned limit whereof is ₹1 crore or less
ii) Term Loans, the original sanctioned amount whereof is ₹1 crore or less.

It is important to note that the above dispensation will apply only to dues payable between November 1, 2016 and December 31, 2016

Prudential Guidelines on Restructuring by Banks

The Master Circular issued by RBI on 1st July 2015 has separate Part B only on restructuring. Classification of various categories of restructured advances should be done as per Para 10 to 18 of this chapter. Some of the important aspects relating to restructuring are highlighted below.

Restructuring of Advances-Important Aspects (Part B of Master Circular)

(i) **Eligibility**

- ✓ Any account classified as standard, sub standard or doubtful.
- ✓ Restructuring cannot be done retrospectively and usual asset classification norms would continue to apply.
- ✓ Restructuring should be subject to customer agreeing to terms and conditions.
- ✓ Financial viability should be established.
- ✓ Borrowers indulging in frauds and malfeasance are ineligible.
- ✓ BIFR cases eligible for restructuring subject to approval from BIFR.

(ii) **Asset Classification Norms**

- ✓ Restructuring of accounts could take place in following stages:
  - Before commencement of commercial production.
  - After commencement of commercial production/operation but before the asset has been classified as 'Sub Standard'.
  - After the commencement of commercial production/operation but after the asset has been classified as 'Sub Standard' or doubtful.
- ✓ Standard Asset would get reclassified as sub standard and account which is already NPA would continue to have the same classification.
- ✓ Additional finance would be treated as standard up to a specified period.
- ✓ All restructured accounts, classified as NPA upon restructuring would be eligible for up gradation after observation of satisfactory performance during specified period.

(iii) **Provisioning Norms**

- ✓ Total provision required would be normal provision plus provision in lieu of diminution in fair value of advances.
- ✓ Diminution in fair value would be required to be recomputed on each balance sheet date.
- ✓ Banks have option of notionally computing the diminution in fair value and providing at 5% in case of all restructured accounts where the total dues to bank is less than one crore.

With effect from April 1, 2015, a standard account (for reasons other than change in DCCO) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

Provisioning Norms

(i) Sub-standard Assets

A general provision of 15 % on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.

The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10%, i.e., a total of 25% on the outstanding balance. However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20% instead of the aforesaid prescription of 25%.

(ii) **Doubtful Assets**

a) 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis (unsecured portion).

b) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful.

Period for which the advance has remained in 'doubtful' category	Provision requirement (%)
Up to one year	25
One to three years	40
More than three years	100

(iii) Loss Assets

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 % of the outstanding should be provided for.

(iv) Accelerated Provisioning: In case banks fail to report SMA status of the accounts to CRILC, accelerated provisioning would be required to be made as per para 31 of the Master Circular.

With effect from April 1, 2015, a standard account (for reasons other than change in DCCO) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

(v) Standard Assets

a. direct advances to agricultural and SME sectors at 0.25%

b. advances to Commercial Real Estate (CRE) Sector at 1%

c. advance to Commercial Real Estate – Residential Housing Sector at 0.75%

d. Housing loan at teaser rates 2% and 0.40% after 1 year from the date on which the rates are reset at higher rates

e. all other loans and advances not included in (a), (b), (c) and (d) above at 0.40%

f. Restructured project loan classified as standard would attract higher provision. Para 4.2.15.3(iv) of Master Circular may be referred for the same.

(vi) Valuation of Security for provisioning purposes

(a) There are specific guidelines in para 5.4(iii) of the Master Circular for consideration of security in respect of infrastructure projects. The same may be referred

(b) In cases of NPAs with balance of ₹5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board of the bank would be mandatory. Collaterals such as immovable properties charged in favour of the bank should be valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

(vii) Provisions under Special Circumstances:

a. Provision on additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, need not be made for a period of one year from the date of disbursement.

b. Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, and life policies would attract provisioning requirements as applicable to their asset classification status.

c. Advances against gold ornaments, government securities and all other kinds of securities are not exempted from provisioning requirements.

d. Advances covered by ECGC/CGTSI guarantee:- In the case of advances classified as doubtful and guaranteed by ECGC/CGTSI, provision is required to be made only for the balance in excess of the amount guaranteed by the Corporation. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by the Corporation and then provision should be made.

Having discussed the salient features, audit steps in brief for verification of NPA and some important issues are discussed here:

1) Generally, all the banks have automated system in place for classification of account as NPA. Verify the system, various parameters and controls to ensure the accuracy of classification, reversal of unrealised interest/income, categorisation of account into substandard or doubtful I, II, III, calculation of provision, carry forward of classification of NPA date etc.

2) Some of the critical areas in CC/OD accounts which auditor need to verify are determination of correct drawing power, temporary deficiencies, fresh sanction to regularise an account, regularisation of account near about the balance sheet date through genuine sources etc.

3) Reversal of unrealised interest on classification of an account as NPA and non-recognition of income subsequently.

4) Accounting and recognition of income in NPA accounts on recovery.

5) If an account is classified as NPA, all the facilities of the borrower should be classified as NPA.

6) Upgradation of accounts from NPA to Standard if any and whether the same is in accordance with the guidelines given in the Master Circular.

7) Verification of secured and unsecured portion and provisioning. Many times valuation report of securities is not available. In such cases, auditor will have to be careful in evaluating the valuation of securities and take an appropriate view.

8) If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account should also be treated as part of the borrower's principal operating account for the purpose of prudential norms on income recognition, asset classification and provisioning. (para 4.2.7(ii) of Master Circular)

9) If an account is restructured, ensure that guidelines as prescribed in the Master Circular are followed and upon restructuring the account is downgraded as NPA. ■