Verification of Advances with Special Reference to IRAC Norms

'Advances' is most crucial element for banks, which constitutes a major portion of Asset side of Balance-Sheet besides being a major source of revenue for the bank. The Reserve Bank of India (RBI) has issued various regulatory restrictions and guidelines for the lending activities of the bank, resulting in verification of advances constituting an important aspect of a bank statutory audit. Read on to know more…

The advances can be divided into two broad categories, viz., funded and non-funded. The salient features of various types of advances under these categories, nature of securities accepted and variety of borrowing arrangements are enumerated below:

(i) Funded facilities

Funded facilities are those wherein the actual movement of funds from bank to the account, either of borrower or to an account as per instructions of the borrower occur. The fund based advances can be further divided broadly into two categories, viz., Working Capital facilities and Term Loans. Working capital facilities generally comprises of Cash Credit, Bill Discounting, Overdraft, Packing Credit facilities, Working Capital Demand Loan, whereas Term Loans facilities generally comprises of Demand Loans, Long Term Loans. The major features of each of these types of facilities are as follows:

(a) Cash Credit is usually provided to a borrower for meeting his working capital requirements and is repayable on demand. The terms of

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sanction specify the details of hypothecated primary security which is the net (working capital) amount of summation of value of stock and book debts up to a specified age as reduced by trade creditors, which is further reduced by stipulated margin to arrive at drawing power.

(b) Bill Discounting (which may be backed by Letter of Credit) is sanctioned either by way of purchase of bills, if the same are payable on demand or by discounting of bills, if Bills are usance bills or against bills under collection from the drawees, either through the bankers of the drawee or directly to the drawee.

(c) Overdraft facilities are sanctioned against various types of securities (like Term Deposit Receipts of the bank, NSCs, LIC Policies and other similar government securities, Gold, any other marketable securities like listed shares, bonds, units of Mutual Funds, Immovable Property, etc.) depending on the credit policy of the bank.

(d) Working Capital Demand/Term Loans (WCDL/WCTL) is sanctioned against the security of components of working capital, usually in the cases wherein the working capital of the borrower is stressed or in the cases wherein a portion of working capital of the borrower is constantly used. The terms of repayment of can be either bullet payment, i.e., wherein the repayment of principal and interest is done at the end of the tenure of the loan or can be in instalments. The tenure of the WCDL/WCTL is usually not more than twelve months.

(e) Term Loans are repayable in instalments spread over the tenure of loan. The term loans can be short term as well as long term. The repayment of term loan can be with or without moratorium period and can be either in the form of Equitable Monthly Instalment (EMI) or Principal plus interest and the instalments can be with or without ballooning.

(f) Agricultural Advances are the facilities sanctioned for the purpose of direct or indirect Agricultural activities. The agricultural advances can be of two types, i.e., Cash Credit (ACC) or Term Loan (ATL) with the end use as for the purpose of meeting working capital needs and/or procurements of movable or immovable assets. The frequency of debiting of interest in case of Agricultural advances is on six-monthly basis unlike that of other types of advances wherein it is on monthly rests.

(g) Export Credit are the facilities extended to the exporters either in the form of pre-shipment or post-shipment. The pre-shipment facilities are given to an exporter to procure the material and incur overheads for the production of goods or services for export and bring the deliverables to the exportable state. The pre-shipment facilities can be either revolving or consignment-based. The post-shipment facilities are the credit facilities availed by the exporter subsequent to the export of deliverables. The export proceeds are expected to be received in 180 days from the date of shipment and in genuine cases, said period is extended by Authorised Dealer or by Reserve Bank of India, subject to operating instructions issued by Reserve Bank of India from time to time and conditions stipulated in Exchange Control Manual.

(h) Foreign Currency Loans- The banks are permitted to lend in foreign currency subject to compliance of EXIM Policy and guidelines issued by Reserve Bank of India from time to time. The Foreign Currency Loans can be in the nature of Term Loans or Working Capital Finance.

(ii) Non-Funded facilities

Non-funded facilities are those, which do not involve flow of funds from bank to the borrower. Common examples of non-funded facilities are letters of credit, bank guarantees, letter of comfort etc. A non-funded facility may subsequently turn into a funded facility, e.g., where the bank makes payment under a letter of credit issued by it, by way of disbursement of a credit facility. Various types of non-funded facilities are explained below in brief:

(a) Letter of Credit (LC) is an important payment mechanism in domestic as well as international trade. The customers open LC to facilitate import or purchase of goods. By means of such letters, the customers take advantage of the credibility of the bank in as much as the exporter or the seller relies upon the promise of a reputed bank instead of the customer. LC is an undertaking by a bank to the payee (the supplier of goods and/or services) to pay to him, on behalf of the applicant (the buyer) any amount up to the limit specified in the LC, provided the terms and conditions mentioned in the LC are complied with and the documents specified in the LC

are submitted by the payee to the LC opening bank through the medium of a bank. In case of a lacuna in the document submitted by the payee, a ratificatory confirmation can be obtained from the payer in order to confirm the compliance to the terms of LC and waiver of such lacunas in the documentation by the payer.

(b) Bank guarantees are required by customers for submission to their buyers to guarantee the performance of a contractual obligations undertaken or satisfactory performance of goods supplied by them or for submission to certain departments like, GST, Electricity Boards, or to suppliers of materials, etc. in *lieu* of the stipulated security deposits. A bank guarantee is a contract between the bank and the beneficiary of the guarantee which is independent of the contract between the bank and its customer on whose behalf the guarantee is issued by the bank. This implies that in case the beneficiary makes a demand on the bank for payment of any money under the guarantees, the bank is obliged to unconditionally pay the sum so demanded, within the amount guaranteed, provided the guarantee has been invoked by the beneficiary strictly in accordance with the terms outlined in the guarantee deed. The guarantees are for a specified amount and a specified period. Banks are expected to get back the original guarantee deeds from the beneficiary within a reasonable period after their expiry of the period of guarantee or on completion of the obligations thereunder, whichever occurs earlier, and to reverse the contingent liability in their books. In practice, however, banks remove this item from their books of account shortly after the expiry of the period of validity of the guarantee after sending a negative letter to the beneficiary to that effect.

(c) Letter of Comfort: In Indian context, Indian Banks issue a letter of comfort to Overseas Banks in the course of Buyer's Credit facilities availed by its customer. Buyer's Credit is a facility provided by an Indian bank to its customers (importer) for payment of imports in India, through an arrangement on behalf of the importer through an overseas bank which extends the said facility on the strength of the Letter of Comfort issued by the Indian Bank. It is advisable for an auditor to go through the documentation and flow of transaction and verify the same in context with the accounting treatment as given in the books of accounts of the bank.

Verification of Advances

The auditor needs to obtain necessary evidence and information in order to have a reasonable assurance about the proper disclosure of Advances through verification of advance. The verification of advances can be broadly divided into three parts–firstly, the pre-sanction process which includes the credit appraisal and sanction, secondly disbursement which includes the execution of documents and ensuring end-use and thirdly, the post-disbursement monitoring part which includes monitoring of accounts operations, renewal of facilities, inspection/physical verification of securities at regular intervals, etc. As regards the extent of checking, an auditor cannot practically verify all the advances accounts, but can verify the advances on test check basis. An auditor may select samples on following basis: (a) All large advances whose year-end balance is in excess of ₹2 crore or 5% of the aggregate year-end advances of the branch, whichever is less (All large advances are required to be commented in LFAR and therefore, all large advances need to be verified), (b) Advances which are adversely commented by RBI inspection team, concurrent auditors, stock auditors, bank's internal inspection, etc. (c) Advances which are sanctioned during the year; (d) The accounts identified to be problem accounts. Such accounts can be identified from control returns which are sent periodically to controlling offices; (e) Other small advances on a selective basis by ensuring that at least few accounts of each type of advances are covered.

The check-points for each stage of verification are as follows:

Pre-sanction Process: The auditor should go through the appraisal note and documents executed by the bank and ensure that the same and sanction letter are in compliance with Credit Policy. Further, the auditor needs to verify the documents executed (as well as obtained like valuation report, title clearance report, CIBIL Report, etc.) with consideration of legal compliance, terms of sanction, creation of charge/lien on (primary/collateral) security and the documentation policy of the bank. Further, the auditor needs to also verify the eligibility of the borrower for availing the type of facility sanctioned and also to verify the compliance with

the exposure norms as stipulated by RBI as well as the bank internally.

Disbursement: The auditor should verify the process of disbursement considering the various aspects such as ensuring of the end-use of the funds, reference to the credit policy of the bank as regards disbursement of the loan, verification of disbursement being in compliance with the sanction terms of the advance. Further, the auditor needs to verify as regards the completeness of the documentation as well as compliance of terms and conditions as specified in the Sanction Letter.

Post-disbursement monitoring: There are various aspects to be verified by the auditor post-disbursement such as (i) In case of CC accounts, the calculation of the drawing power, review of stock statements, ensuring of end-use, etc.; (ii) Review of financials and QIS reports which are stipulated by the bank; (iii) Review of Stock/Credit audit reports; (iv) Verification of the renewals/enhancements/ short reviews/restructuring of advances, if any undertaken; (v) Review of Irregularity/Overdue Reports; (vi) Valuation Reports

Types of Securities

The bank finance can be either secured or unsecured. The types of securities are as follows:

Primary and Collateral Securities

The term 'primary security' refers to the security acquired by the borrower with bank finance or the one against which credit has been extended by the bank. Primary security is the principal security for an advance, whereas a collateral security, is a security, obtained in addition to the primary security, which acts as a cushion for the bank. The calculation of drawing power (especially in case of working capital finance) is always based on the primary security and not on the basis of value of collateral security, though the value of primary as well as collateral security is considered for the purpose of provisioning under IRAC Norms. There are certain types of security, which are not considered for the purpose of security valuation by the bank like personal guarantee by the borrower or guarantor in the form of salary deduction. The personal security of guarantor comprises a guarantee by a third party for payment of outstanding(s) in the event of default by the borrower. No charge is created on the guarantor's movable or immovable assets. The personal security of guarantor can be enforced only through the competent Court of law. The value of personal security is considered as "Nil" by the bank.

Fixed and Floating Charges

A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The borrower cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender) (e.g.: Immovable Property, Vehicle). A floating charge, on the other hand, is an equitable charge on the assets, present as well as future. A floating charge attaches to assets whose condition varies from time to time in the ordinary course of business (e.g.: book debts, stock on hand, work-in-process). A floating charge crystallises (i.e., becomes a fixed charge) when money becomes repayable and the holder of the charge (i.e., lender) takes necessary steps for the enforcement of the security.

Nature of Borrowing Arrangements

Sole Banking

In this arrangement, the borrower obtains credit from a single bank. This is the simplest form of tie-up and is operationally convenient for both the lender and the borrower.

Consortium Arrangement

In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. The consortium has a formal leader, called the 'lead bank' (normally, the bank with the largest exposure, though at times the same depends on the choice of the borrower, too). There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also. The lead bank is responsible for overall monitoring of the overall facilities which includes allocation of drawing powers amongst the consortium members. The member banks of the consortium have rights over the security in an agreed proportion. The borrower maintains direct business relationship with all member banks of the consortium.

Multiple Banking

In this type of arrangement, there is no formal arrangement amongst the lending banks. Each of them has its own set of loan documents, securities and mode of lending, independent of other lending

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banks. The borrower has to deal with each of the banks separately. The lending banks do not necessarily have exchange of information amongst themselves, though it is advisable and the assessment and allocation of drawing power is done by each lending bank independent of other lending banks.

Income Recognition and Asset Classification (IRAC) Norms

The Audit of Advances can never be said to have concluded without verification of classification, income recognition, provisions w.r.t. Advances.

The classification of assets of banks has to be done on the basis of objective criteria, which would ensure a uniform and consistent application of the norms. The provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof. It is expected that the bank should establish appropriate internal system for proper and time identification of NPAs. There is no grace period granted for asset classification, but a time period of one month as given by RBI is to settle the doubts in asset classification due to any reasons.

A Standard Asset can be defined as an asset which does not carry risk more than normal banking risk, whereas a Non-Performing Asset (NPA) is the one which either carries risk more than normal banking risk or ceases to generate income for the bank. The RBI has defined various objective criteria as regards classification of advances, which are as follows:

Firstly, one has to acquaint oneself about the definition of Overdue which states 'If an amount due to bank under any credit facility is not paid on the due date fixed by the bank, such amount would be called as Overdue.' Secondly, the classification of advances would be *qua* borrower unless otherwise stated. Thus, all facilities granted to a borrower shall be treated as NPA and not only that facility which has become irregular.

1. **Term Loan:** If Interest and/or installment remains overdue for a period of more than 90 days. *However, as per Para 2.1.3 of the Master Circular, 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.*
   The exception to the above criteria would be Term Loans with moratorium period granted for interest as well as principal wherein the interest would be accrued and due only after the completion of the moratorium period.
2. **Bills Purchased/Discounted:** If such Bill remains overdue for period more than 90 days.
3. **Agricultural Advances:** If Interest or installment remains overdue for two crop seasons for short duration crop, one crop season for long duration crop. A crop season is defined as 'period up to harvesting of crops raised' as determined by State Level Bankers' Committee (SLBC) and Long duration crop means a Crop wherein crop season is more than 12 months. It is pertinent to note that Banks have discretion of rescheduling the agricultural advances in case of natural calamities, which impair repaying capacity (refer latest Master Direction dated July 03, 2017 by RBI on Relief Measures by banks in areas affected by Natural Calamities Directions 2017).
4. **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.
5. **Liquidity facility:** If it remains outstanding for more than 90 days in respect of Securitisation transaction.
6. **Credit card dues:** If the minimum amount payable is not paid within 90 days from the next statement date.
7. **Cash Credit/Overdraft Account:** The account is treated as NPA if the same is 'Out of Order'. The account is called as out of order if any one of the following conditions is fulfilled:
   a. Outstanding Balance remains continuously in excess of sanctioned limit/drawing power (whichever is lower) for more than 90 days;
   b. No credit continuously for 90 days as on the date of Balance Sheet;
   c. Credits in the account are not sufficient to cover interest debited during the same period.

The RBI has clarified as regards certain exceptions/ clarifications to the above-mentioned criteria as follows:

1. **Non-submission/non-availability of stock statement:** Outstanding Balance in account based on the drawing power calculated from stock statements older than 3 months would be deemed as irregular and if such irregular drawing is permitted for a period of more than 90 days, account needs to be classified as NPA. However, it would be pertinent to note that the relaxation so given by RBI is 'considering the difficulties of large borrowers'.
2. **Non-renewal/Non-regularisation of Regular/ Adhoc limit:** If the same is not done within 180 days from the due date, the account would be classified as NPA.
3. 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, provided Income is recognised subject to availability of margin.
4. Central Government guaranteed advance to be classified as NPA only if Government repudiates the guarantee when invoked. However, income on such accounts is required to be recognised on cash (realisation) basis.
5. **LCBD Facilities:** The Bill discounted against accepted LC would be treated as PA even though rest of the facilities of the borrower are treated as NPA (since the exposure of the bank in such cases would be on the LC issuing bank and not on the borrower).
6. In case of consortium banking arrangements, each member bank shall classify the accounts according to their own record of recovery.
7. **Potential threat of Recovery (Straightway Classification):** Where realisable value of security is less than 50% of the value assessed (by bank or value accepted in last RBI Inspection), account to be straightaway classified as Doubtful Asset and where realisable value (as assessed by Bank/Valuator/RBI Inspector) of security is less than 10% of outstanding balance, account to be straightaway classified as Loss Asset.

Non-renewal/Non-regularisation of Regular/Adhoc limit, if not done within 180 days from the due date, the account would be classified as NPA.

Partial regularisation and regularisation after the balance sheet date of qualifying NPAs not to affect the asset classification as on balance sheet.

8. **Fraud Accounts:** In case of Fraud Accounts, 100% provision is to be made irrespective of security, spread over 4 quarters commencing from the quarter in which fraud has been detected wherein the same is reported to RBI and in cases wherein the fraud cases are not reported to RBI, 100% to be provided instantly.
9. **Solitary or few credit entries recorded before Balance Sheet to regularise the account:** In such cases, if the account is exhibiting signs of inherent weakness, such account is required to be marked as NPA and in other cases, the bank needs to evidence the auditors about manner of regularisation of account or otherwise in absence of such evidence such accounts should be marked as NPA. It would be germane to note that regularisation of the account either at year-end or otherwise needs to be out of genuine sources of funds, ideally by way of income generating activities undertaken by the borrower and not by way of availing additional credit facilities to regularise existent credit facilities.
10. **Mandatory Valuation of Securities:** In case of NPAs, wherein the outstanding balance is more than ₹ 5 crore, it is mandatory to conduct stock audit by external agencies and as regards immovable properties taken as securities, the valuation is required to be carried out at least once in three years by approver valuer.
11. **Regularisation of accounts–** Partial regularisation and regularisation after the balance sheet date: In case an account is a NPA, irrespective of whether the account is marked by the bank as NPA or not, the upgradation of the account would be subject to the condition that the entire portion of overdues are recovered (in case of Term Loan Accounts) or the working capital accounts are regularised out of genuine business credits. Further, it would be pertinent to note that regularisation of the account subsequent to the Balance Sheet date does not affect the assets classification as the upgradation of the account would be effected only prospectively on the date of regularisation.

Project Loans

The change in repayment schedule is permitted without change in asset classification if the same is caused due to increase in project outlay on account of increase in scope and size of the project, subject conditions stipulated in Para 4.2.15.5 (ii) of the Master Circular.

The usual classification norms apply before the commencement of commercial operations. However, in case of accounts wherein the borrower fails to commence the commercial operations within two years and within one year from the date of commencement of commercial operations (DCCO) w.r.t. Infrastructure and non-infrastructure sectors respectively, the account needs to be classified as NPA, unless eligible to be restructured and classified as standard asset. The restructuring of Project Loans is permitted with retention of class of asset provided deferent and consequential shift in repayment schedule is for equal or shorter duration as follows:

Particulars	Infrastructure	Non-Infrastructure
Revised DCCO is within	Two years from original DCCO	One year from original DCCO
Revision due to Court Case	2 + 2 Years from original DCCO	1 + 1 Years from original DCCO
Revision due to any other reason	2 + 1 Years from original DCCO	

An additional extension of DCCO is permitted for a further period of two years due to change of ownership of borrower entity, provided the conditions stipulated in Para 4.2.15.4 of the Master Circular are complied with. Further, Financing of Cost Overruns is permitted by way of Standby Credit Facilities, with retention of class of asset subject to compliance of stipulated conditions.

Income Recognition

The income on Standard Assets is recognised on Accrual basis and the same on NPAs is recognised on Cash (realisation) basis. When an account is marked as NPA, the interest/bank charges debited to the account but not serviced as on the date of NPA are required to be derecognised. Interest on additional finance in NPAs should be recognised on cash basis. If interest due is converted into unlisted equity/FITL, the same should be fully provided for and if the same is converted into a listed instrument, the interest should be recognised to the extent of market value of such security on the date of conversion.

In case of recoveries in NPAs, in the absence of clear agreement between the Bank and the Borrower, an appropriate policy is to be followed in uniform and consistent manner as regards order of recovery of outstanding interest and principal amount.

Asset Classification and provisioning requirements

Type of NPA	Criteria	Provision	
		Secured Portion*	Unsecured Portion
Sub-Standard (SSA)	First 12 months from date of NPA	Secured SSA: 10% Unsecured SSA: 25% Infrastructure SSA: 20%	
Doubtful – I	Subsequent one year after SSA	25%	100%
Doubtful – II	Subsequent two years after DA-I	40%	100%
Doubtful – III	After two years in DA-II	100%	100%
Loss	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	100%	100%

**Intangible Security is considered only if backed by legally enforceable and recoverable right over collection and rest of intangibles like rights, licenses, etc. are considered as 'Unsecured'*

As regards the prudential provision on Standard Assets, the same has remained unchanged as provided in Para 5.5. of the Master Circular.

In case the bank fails to comply with mandatory reporting of SMA to CRILC, accelerated provision is required to be as per Para 31 of the Master Circular.

Note: The Reserve Bank of India has stipulated specific guidelines w.r.t. restructuring of advances, CDR mechanism, SDR mechanism, S4A mechanism, etc. which are not covered in the above article. ■