

Audit of Advances other than Agriculture Advances

Banks are the backbone of economy and Chartered Accountants in India are entrusted with the responsible task of carrying out their audit. Considering the new and innovative ways of committing frauds and misappropriation of funds in the present scenario, effective audit and raising red flags in critical issues is of utmost importance. Advances, the main part of the Bank audit, are a very large area and detailed guidance for the same is available in the 'Guidance note on Audit of Banks' published by the ICAI. This article is an endeavour to summarise some key points to be considered while carrying out audit of Advances portfolio of a Bank Branch and documentation requirements under various standards on auditing (SA). Read on...



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A. Planning the audit of Loans and Advances

Considering the limited time available for Branch Statutory audit, preparation of effective audit plan becomes essential. SA 300 (Planning and audit of Financial Statements) issued by ICAI requires an auditor to plan audit assignment and document the same. Loans and advances being a crucial area under Branch audit, would be the main part of overall audit planning document.

B. List of requirements to be communicated to Branch to be audited

A short visit to the Branch or advance communication with Branch head is required in order to obtain following information related to advances may be very useful. This would be a part of overall list of requirements:

- a. Borrower-wise Break up of various categories of advances (including non-funded) viz., CC/OD, Term Loans (further bifurcation into, Business, Housing, Vehicle, Other retail, Commercial, Loans against shares etc.), Guarantees and LCs etc.;
- b. List of top 25 top borrowers of the Branch at end of the year and beginning of the year;
- c. Latest report of irregular accounts or overdue statement;
- d. Party-wise statement of movement in NPA accounts along with MOC statement for previous financial year (for reference);
- e. Concurrent audit reports for the year under audit of the Branch and Branch responses on the observations;
- f. Special Mention Accounts (SMA) reports for each quarter end;
- g. Details of accounts classified as fraud and wilful defaulter and accounts restructured;
- h. List of accounts where stock audit is mandatory as per sanction terms.

C. Selection of the borrower accounts to be audited and to be reported under branch LFAR

Considering the nature and volume, it may not be possible for the Branch auditor to verify 100% of the accounts. Hence, selection of appropriate samples of advance accounts is critical. Here SA 320 (Materiality in Planning and Performing an Audit) and SA 530 (Audit Sampling) need to be considered. There are no specific rules for selection of samples for verification of advances and auditor will have to use his/her own judgement based on preliminary review of the documents stated above. However, following accounts must be included for verification:

- a. Accounts appearing in the overdue statement;
- b. Accounts upgraded by the branch to standard category;
- c. Top 10 borrower accounts by outstanding at end of the year depending upon size of branch under each facility and some accounts randomly selected from other retail loan portfolio;
- d. Top 5 or 10 accounts sanctioned during the year apart from above accounts;
- e. Accounts having adverse comments in the concurrent audit report of the Branch;
- f. Accounts reported in the previous year LFAR with adverse comments of branch statutory auditor;
- g. Accounts appearing in the SMA account statement of the branch;
- h. Accounts restructured during the year.

Apart from the above, auditor may also look at overdue accounts at the beginning of March and at end of the year to see if there are any advances appearing at the beginning of the month but are missing in the statement at end of

the year to ascertain how these accounts were regularised so near about the year end. Similarly, the overdue statement for days till issuance of the branch audit report may be taken to see if any of such advance account is reappearing in the statement through temporary arrangement done to keep the account out of NPA category and reporting.

D. Important points to be considered while verification of advances selected based on above criteria

1. *Sanction of facility:* Check if the advance is sanctioned by appropriate authority as per the lending powers of the Bank/branch
2. *Creation of Master for borrower:* After sanction, the Master would be created for new borrowers. In case of existing borrowers, the Master may be modified based on the latest sanction terms. These fields would typically include following:
 - a. Repayment Schedule,
 - b. EMI,
 - c. Rate of Interest (normal and penal),
 - d. Drawing Power,
 - e. Classification of advance (secured/unsecured, nature of security and priority/others)

These parameters are keyed in System and after disbursement, many functions such as charging of interest, processing fees, penal interest, category classification, overdue status etc., would be based on the above data. Hence, it is very important that auditor checks correctness of these inputs for selected samples to ensure system applies its parameters correctly.

3. *Compliance with sanction terms:* Auditor may check

compliance of terms of sanction including creation of security/mortgage, NOC from other Bank/Fl, registration of charges, CERSAI report etc., Also, it needs to be checked if the disbursement of advance is done only after compliance of the terms of sanction.

4. *Review of account operations:*
 - a. Review of ledger for various facilities of large borrower samples selected should be done to get idea on operations of account. Generally, interest application, penal interest etc., would be done by system. However, it is advisable to check for few samples whether amount of interest is correct.
 - b. Check if there are frequent delays in payment of dues of loans or overdrawn in case of CC/OD accounts. Apart from this, devolvement of LCs, regularisation in account around critical dates such as dates for consideration as NPA, etc., are some examples, which may require detailed review of the account operations. Auditor may check the latest audited financial statements of the borrower, qualifications of borrowers' statutory auditors if any, transactions with related parties etc., Here one should also check if the account is regularised at end of the financial year by showing cheque deposited under bank reconciliation and subsequently reversed in the following year indicating possible evergreening.
 - c. Inquire into significant differences observed

between the amounts of stock and receivables as per statement submitted by the borrowers and the amounts stated in audited financial statements. This aspect is overlooked many times by branch. Borrowers having financial difficulties may submit statements with inflated numbers and tend to show receivables beyond permissible period, under different category and within permissible time limit. In the event such discrepancy is noticed, auditor may ask branch management to immediately seek clarification and apply the correct value of stock and receivable for calculation of Drawing Power (DP). Correct application may result the account becoming overdue beyond 90 days and turn NPA.

Since the DP is manually fed in the System, based on such stock statements with higher value, System may not identify the account as overdue and it would result in incorrect classification. In most cases, this is the reason for non-identification of NPA by system and hence auditor should be careful in reviewing such accounts.

- d. In case of large advances, annual stock audit and inspection would normally be one of the sanction conditions. We need to check if the stock and receivable audit has been conducted as per the terms and if there are any significant observations or remarks by the auditor, which may impact the

operations of account or may indicate inherent weaknesses. Also, auditor should check if the branch has obtained necessary explanations and responses on stock audit reports, from the borrowers and considered necessary remarks while computing DP.

- e. In case of bill discounting, most Banks have policy of recognising interest over period of the bills. Such interest collected in advance is kept under other liabilities in balance sheet of the branch. Bill wise break up of the same may be taken and mapped with the interest on balance period of outstanding bills discounted. In case if difference is noticed, auditor may ask explanation from the branch and insist for passing necessary entry through profit & loss account to match the actual interest that ought to be kept under "interest received in advance" at the year end.

E. Non-funded advances

List of Letters of Credit (LC) (Inland and Foreign) and Bank Guarantees (Inland and Foreign) should be obtained borrower-wise. Check if LCs are outstanding against borrower having frequent overdrawing in other limits. In case of invocation/devolvement of LCs, operative CC/OD account of the borrower is to be debited and not to be parked in a separate account to consider the overdue position in the account. Guarantees, should be checked with the dates of expiry and verified whether all the expired guarantees have been removed from the System. Guarantees are classified in Performance and Financial. Correct

classification of nature of guarantee is very important as it will have implication on the Risk Weighted Assets of the Bank for its Capital Adequacy requirements. On sample case selected, commission on LCs and guarantee fees need to be checked along with adequacy of cash collateral margin.

F. Restructured advances and stressed assets

Restructuring is an act in which Bank, for economic or legal reasons relating to the borrower's financial difficulty, grants concessions to the borrower. It refers to modification in terms of repayment in order to provide relief to the borrower who could otherwise default in repayment. Restructuring generally involves reducing the rate of interest, extending period of repayment, providing additional finance to borrower and funding of interest on existing facilities etc.,

- a. *Classification on restructuring:* The auditor may obtain a list of all the accounts restructured during the financial year. Upon restructuring, the accounts classified as 'standard' should be immediately downgraded as non-performing assets (NPAs), i.e., 'sub-standard' to begin with. The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring. Accordingly, the provision requirements on NPA are also required to be complied with.
- b. *Conditions for upgrading accounts which are restructured:* Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the lenders may be upgraded only when satisfactory performance is demonstrated in all the outstanding loans/facilities of the borrower during the period from the date of implementation of resolution

plan (RP) up to the date by which at least 10 percent of the outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is repaid. Provided that account cannot be upgraded before one year from the commencement of the first payment of interest or principal (whichever is later) on the credit facility with longest period of moratorium under the terms of RP.

- c. *Income recognition:* Income recognition norms for restructured advances are the same as normal advances and are applied based on the respective classification of account except that unrealised income represented by FITL / Debt or Equity instrument, can only be recognised in the profit and loss account as under:
1. *FITL/debt instruments:* only upon receipt of the loan or sale/redemption, as the case may be;
 2. *Unquoted equity/ quoted equity (where advance is classified as NPA):* only on sale;
 3. *Quoted equity (where Advance is classified as standard):* market value of the equity as on the date of upgradation, not exceeding the amount of unrealised income converted to such equity. Subsequent changes to value of the equity should be dealt with as per the extant Prudential Norms on Investment Portfolio of Banks.
There are many other aspects related to stressed assets and for detailed guidance, one may refer to RBI notification on Prudential Framework for Resolution of Stressed Assets (DBR.No.BP. BC.45/21.04.048/2018-19) dated June 7, 2019.

G. Identification of additional NPA

Based on various documents and checks applied as discussed in the above paras, when the auditor identifies NPA accounts with incorrect classification, following needs to be ensured:

- a. All the accounts of the borrower irrespective of regularity of payment with other facilities are classified as sub standard
- b. Unrealised income in all above accounts is reversed as on the date of NPA classification
- c. Provision amount is arrived at in terms of the IRAC norms prescribed by RBI
- d. In case of substantial erosion in value of security, the account need not go through various stages of NPA and it may straight be classified as doubtful or loss account, based on such erosion in the realisable value of security.
- e. Passing of necessary entries for the above through Memorandum of Changes (MOC)

H. Verification of existing NPAs

Apart from correct classification into Standard and NPA and further classification of NPA category into sub-standard, doubtful and loss, it is also important to check the correctness of provision created on existing NPA accounts. Though generally accounting entry for provision of NPA accounts is posted centrally at Head Office, it is based on the numbers certified by respective branch auditors. Sometimes, if the classification of advances is found correct, amount of provision against individual borrower accounts is assumed to be proper and branch auditor may tend to ignore detailed verification of computation of such provision. However, in terms of master circular on IRAC norms issued by RBI, if the valuation report is not obtained for 3 years in case of

immovable property and 1 year in case of other assets including stock, the value of security would be considered NIL and 100% provision would be required to be created on outstanding amount. Hence auditor may check all the cases of doubtful loans if latest valuation report is obtained as required. Date of classification of account into substandard category is also very important since the subsequent category/classification and provision would be based on that date.

I. Other important aspects

A few other important aspects that may be kept in mind which will help conducting effective audit for Advances Portfolio of the branch are:

- a. *Understanding Bank's software:* Most banks in India are on Core Banking Solution (CBS). Finacle is one such software used by many banks. Manual intervention is reduced to a large extent due to implementation of CBS and hence it has become essential for an Auditor to have a working knowledge of Finacle or other CBS software in order to conduct Bank Audit.
- b. *Exception reports:* Auditor may request branch management for a list of exception reports that are generated by system. A few important reports related to advances are, excess drawing permitted over sanctioned limit through TOD, changes done in master data of borrowers, Interest rate changes etc.
- c. *Analytical procedures:* Variance analysis of important ledgers related to advances, including interest earned and commission charged for comparable previous period many time throw up major exceptions which help auditor to find discrepancies. SA 520 also requires an auditor to perform analytical procedures.
- d. *Concurrent audit report*

observations: Branch auditor should obtain the concurrent/internal audit reports and check their comments on advances and verify the accounts where negative observations or accounts with irregularities have been commented upon. Also, if the discrepancies noticed have been resolved or satisfactorily answered. This will help also since concurrent/internal audit may have some observation on areas which the Branch Auditor has not covered in his sample.

- e. *Fraud reporting:* Check with Branch if they generate the suspicious transaction report (STR) or they get the same from the HO or Risk Management department for providing response to the suspicious transactions and how they dealt with closure of the same. It is also important nowadays to check the effective implementation of staff rotation policy.
- f. *Classification of advances:* One should also check other information related to classification of advances such as Priority/non-priority sector, Secured/Unsecured etc., as this information would eventually be compiled and published by the Bank by way of notes. This information is also essential for the Bank to ensure compliance with certain regulatory requirements such as priority sector advances etc.
- g. *Crystallisation of overdue export bills:* When a foreign bill is discounted by the branch and not paid on due date, the AD bank as per policy formulated by it, needs to crystallise the foreign currency liability of the concerned bill. The bill will be crystallised by selling the liability amount in foreign currency at the prevailing TT selling rate or at the original bill buying rate, whichever is higher

and convert the exporter's liability in Rupee terms. Auditor needs to check if interest for the overdue period shall be recovered on the date of crystallisation at the appropriate rate and thereafter till the date of recovery of the crystallised amount.

- h. *Capital adequacy:* There are various formats for reporting to the head office for the purpose of compilation of Risk Weighted Assets (RWA) for computation of capital adequacy. Information contained in these reports is mainly generated from the advance portfolio of the branch. Auditor can check the working/supporting documents from where the information in RWA working sheet is compiled and rating of the borrower and category of advance are two important points to verify.
 - i. *Interest subvention:* Auditor needs to check if the interest subvention benefits have been appropriately passed on to borrowers as per the notification of RBI. Extensions if any, granted for the packing credits/LCs in case of delayed exports/inward remittances and if the same are within the permissible time limit of RBI as subvention may not be available beyond normal permissible period.
 - j. *LFAR reporting:* This is a vast topic in itself and one may refer to the relevant RBI circulars as well as Guidance Note of ICAI on Bank audits. A couple of important points related to LFAR reporting of advances:
 - a. Common irregularities observed such as non-submission of stock statements, frequency of LC devolvement, frequent overdrawn permitted, adequacy of insurance coverage, Stock audit not done, errors in DP calculations etc.,

- b. Obtain detailed annexure to LFAR from branch management and review the same for advances with outstanding balance of ₹ 2 crores and above- (applicable for Branches dealing in Large Advances/Asset Recovery Branches).

J. Obtaining management representation

It is essential to obtain management representation for the branch audit conducted and information related to advances would be a part of the same. This is required as a part of branch audit documentation under SA 500 and SA 580. For content and format of the management representation, one may refer ICAI guidance note on bank audits.

K. Important material and notification/circulars of Reserve Bank of India to refer for audit of advances

- a. Guidance note on audit of banks (2019 Edition) published by the ICAI
- b. Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, DBR.No.BP.BC.2/21.04.048/2015-16
- c. Master Circular- Loans and Advances – Statutory and Other Restrictions, DBR.No.Dir.BC.10/13.03.00/2015-16
- d. Master Circular – Exposure Norms, DBR.No.Dir.BC.12/13.03.00/2015-16
- e. Master Direction-Priority Sector Lending-Targets and Classification, Master Direction FIDD.CO.Plan.1/04.09.01/2016-17
- f. Prudential Framework for Resolution of Stressed Assets (DBR.No.BP.BC.45/21.04.048/2018-19) dated June 7, 2019 ■