Audit of Advance Portfolio of Banks

Advances constitute the assets of Banks and audit of the same demands greater efficiency and understanding of the system. Every bank has got its own rules/ regulations, within the legal requirements under Reserve Bank of India Act and its guidelines for granting advances for its constituents. These guidelines include, limit for lending to a single entity, group exposure, sensitive sector etc. But the core generalities remain the same everywhere. Here an auditor is expected to assess and comment on the qualitative and quantitative aspects of advances. A progressive and amenable set of rules will make the assets of a Bank vibrant and yielding. Otherwise they will be static and dormant.

Advances are broadly classified into Fund based and Non-fund based credit limits. There again the Fund based advances may be further broken into Working Capital Funding, in the forms of Cash Credit, Bill Discounting etc., and Term lending. The working capital finance is concerned with the current assets and current liabilities and the term lending relates to Fixed Assets and Long Term Liabilities of the borrowing unit. An audit should cover assessing the quality of advances, provisioning requirements and disclosure in the balance sheet. The audit process should include the following:

A. Application:

The process of granting advances is initiated on receipt of an application from the intending borrower outlining his requirements and detailing his financial strength. The auditor should check that the application received from the borrower is in the prescribed format furnishing all his borrowing requirements. The credit limits sanctioned to the borrower by the Bank should be in line with the application submitted by the borrower. Along with the application the borrower should have submitted copies of audited financial statements and projected profit and loss and balance sheets and cash flow statements apart from the basic information about the borrower's personal profile as required by Reserve Bank of India guidelines for "Know Your Customers". He has to draw a suitable audit programme depending on the extent of the deficiency in this regard.

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B. Processing:

A statutory auditor has to verify whether the branch has complied with general guidelines and procedures of the bank for lending, while processing the proposal. These guidelines includes assessing the technical feasibility, economic viability and industry performance etc. The auditor should verify that both the receipt of application and processing of the same are properly recorded and documented by the branch. The auditor should also check that the same has been sent to the controlling/sanctioning authority within the time-frame for sanction.

C. Sanctioning:

Every bank has got various layers of sanctioning authorities. It is incumbent on the auditor to test check whether the sanctions have been made by particular sanctioning authorities and whether the terms of sanction like margin, rate of interest and repayment terms are correctly conveyed to the borrower in line with the sanction. Any advance without a valid and current sanction advice should be enquired by the auditor and reported appropriately. Every sanction should also be recorded at the branch level and banks normally prescribe periodical returns on advances sanctioned/disbursed by the branch to its controlling authority. The auditor should scrutinise these returns to have the knowledge of advances sanctioned /disbursed during the period covered under audit. The auditors should also verify for all critical sanctions made during the year under

audit that the credit limits and the terms and conditions therein are conveyed and duly accepted by the borrower.

D. Documentation:

One of the prime functions of the auditor is to verify the documents executed by the borrowers of loans granted during the period under review. He has to verify whether all documents were executed in the prescribed forms prescribed by the bank and duly stamped. The lending is properly secured by way of mortgage deeds/ hypothecation deeds/ guarantees etc., as per the sanction terms. The loan documents are to be necessarily in the printed formats of Bank. Further, the auditor has to verify creation of charge with ROC in case of limited companies. The signatures in the loan documents and affixing of common seal, if necessary, are to be in line with the constitution of the borrowers. Normally, in case of large advances, the documents executed by the borrower are scrutinised by the banks' legal department or by an advocate in their panel. The auditor may rely on the opinion of them for the enforceability of the documents executed by the borrower. The auditor should also ensure system of safe custody of the documents at the branch level.

E. Disbursement:

The fresh loans sanctioned and disbursed during the year under audit should be ensured for proper utilisation and end use of borrowed funds as per sanction. In case of term loans, the banks generally, disburse directly to the vendor on the basis of pro forma invoices and supported by requests of the borrower. The auditor should verify the invoices of machinery and other capital expenditures with proper supporting. Further, auditor should enquire/verify about the report submitted to the sanctioning authority about the post disbursement inspection done by the branch officials.

F. Monitoring:

Monitoring by the branch ensures assess the quality of advances and each bank prescribes various norms for the same. These norms include, receipt of Stock/book debt statements from the borrower, periodical physical inspection of the borrowing unit, review of account operations and submission of review report to sanctioning authority based on the financials of the borrower and his operation at periodic intervals. The auditor should have a clear understanding of the process of monitoring and its documentation by the branch. The auditor may rely on the concurrent audit/inspection audit reports in this regard and based on the same he can draw his audit programme for performing substantive checking.

In case of a running limit like Open Cash Credit (OCC), the auditor should check whether the monthly interest has been paid regularly. There should be sufficient credit in the account to set off the interest debits. Every borrowal account has got a Credit Limit beyond which drawals are not permitted, unless under special circumstances. In case of running limits like OCC, Packing Credit etc., there is one more concept called the 'Drawing Limit' (DP), which should also be checked. Drawing limit is the limit up to which drawings are allowed to the borrower within or equal to the sanctioned limit. This limit is arrived at in the first week of every month. There will be records and entries in the system to denote the drawing limit, as distinct from the sanctioned limit, of any borrowal account. As a general rule the drawing limit cannot exceed the overall sanctioned limit. Any drawings over and above the drawing limit should have specific prior approval by the appropriate authority. In the absence of prior approval the same should be ratified. Otherwise the drawings are to be classified as "Clean Drawings", which will attract penal interest. In case the auditor observes excess Drawings without ratification or delayed reporting, the same should be brought out in the Long Form Audit Report suitably. In the case of consortium accounts the DP for every month will be calculated and advised by the Lead Bank. The communication in this regard has to be verified by the auditor.

How is the Drawing Limit Calculated?

Generally working capital limits are sanctioned to borrowers based on inventory and book debts. Though all current assets are reckoned for arriving at the Maximum Permissible Bank Finance, drawing limit is arrived at based on paid stocks and debtors only. Every borrower is required to submit a statement of stocks as at the last day of every month. In the case of debtors too, the sanction will stipulate the level up to which debtors can be reckoned for DP. For example a sanction may stipulate that debtors up to 90 days only can be taken for fixing the drawing limit.

Following example will illustrate how a drawing limit is arrived at every month in Banks:

Inventory as on 31-12-2006	Rs. 75.00 lacs
Creditors for Purchases	Rs. 15.00 lacs
Then paid stock will be	Rs. 60.00 lacs
Margin as per Sanction (25%)	Rs. 15.00 lacs
Hence Drawing Limit against Stocks will be	Rs 35.00 lacs....(i)
Debtors as on 31.12.2006	Rs 125.00 lacs
Less: Debtors more than 90 days	Rs 15.00 lacs
So eligible debtors will be	Rs 110.00 lacs.
Margin as per Sanction (30%)	Rs 33.00 lacs
Hence Drawing Limit against Debtors will be	Rs 77.00 lacs...(ii)

Total DP for the month of January 2007 will be (i) + (ii) = Rs. 112 lacs. Accordingly the total drawings on any day in January 2007 cannot exceed Rs. 112 lacs. If it exceeds, it should be with permission and the portion of the drawings beyond the DP should be charged penal interest. Auditor should check that penal interest is automatically charged by the system in a computerised environment, whenever the actual drawings by the borrowers exceed the DP. The auditor may cross verify the stock statement submitted for the month of March and that reported in the audited balance sheet submitted by the borrower.

Auditor should check the stock statements at random and verify whether drawing limits are arrived at every month and whether the drawings beyond the DP are properly recorded and reported to the higher authorities.

Further, to receipt of stock and book debt statements, branch officials visit the borrower's unit at periodical intervals for physical verification of stocks and its performances. The banks also have stock audits conducted by external auditors in case of large advances. The auditor should scrutinise these reports for assessing the quality of the advances.

Bill Discounting:

Working capital funding includes Bills purchased and Discounted by the banks. The funding is made available to borrower based on the supply of goods/services to its customers and accepted by them. The borrower sends the bills through the funding bank who lend it based on supplies made. The bill may be payable on demand or within a specific tenor. The auditor should ensure that the branch has sufficient internal monitoring system for follow up of realisation of bills discounted. In case of recovery from cash credit/overdraft account by overdrawing, the same should be treated as sanction of fresh loan against overdue bills.

G. Asset Classification:

In the course of verifying the quality of advances the auditor should also confirm to the classification of advances as Performing and Non Performing Assets. The banks should follow the Reserve Bank of India's extent guidelines to classify an advance as Non Performing Asset (NPA) and it is the primary responsibility of the bank's management for proper classification of advances. The auditor should assess the system put in by the management in identifying NPA and various returns submitted by the branch in this regard to the sanctioning authority during the year under audit. On scrutiny of these returns the auditor comes to know the weak advances and specifically identify these accounts for further verification. The auditor should also check the movement of NPA during

the year, such accounts that are upgraded and recovered etc. for proper classification.

From the Asset Classification angle the auditor should also verify the following:

1. Every sanction should be current and live. If any sanction has expired there should be proper extension or renewal. If any borrowal account remains in the 'expired limit' category for more than 3 months, (as on 31st of March) then it has to be classified as NPA.
2. Similarly non-receipt of stock statements from the borrower for 3 months (as on 31st of March) and/or not arriving at DP continuously for a period of 3 months (as at 31st of March) will make the account NPA.
3. If any borrowal account remains continuously irregular for a period of 90 days it will be classified as NPA.
4. Any credit of round sums in the account during the last few days of March should cause further enquiries by the auditor. He has to verify the operation in the account during the subsequent month also. He should also probe the source of credit and satisfy himself that they are genuine.

What are Term Liabilities?

Usually term loans are sanctioned by Banks to create fixed assets like land, building, machinery etc. These loans carry fixed repayment schedule besides stipulations as to margin, rate of interest etc. In most of the loan accounts the repayments are now through EMI apart of servicing of interest as and when charged. The auditor has to verify the account and find out whether any installment has become due beyond 30 days. If repayments are through EMIs then repayment may be in any day of the month till the last day. Hence, the auditor has to look for installments, which are due and not paid for 30 days from the end of the month in which they became due. For example, if ABC has to repay Rs. 2 lacs every month. If he has not remitted Rs. 2 lacs in the month of January and further he has not remitted that January installment even up to 29th day of following February then the installment has become due as on 30th of January and on 1st of March, the account will become NPA if the installment is not paid up to 31st March also.

All Banks have got specific schemes for lending to various sections of society like Housing Loans, Home Improvement Loans, Traders Loans, loan against Rent receivables, Education loans etc. Auditor has to familiarise himself with the covenants of such schemes before drawing up an audit programme. In all those loans, provisions as to margin, rate of interest and repayment schedules should be carefully studied and verified for compliance.

In the case of term loans, the terms may stipulate repayment holiday for commencement of commercial production or from the date of first disbursement. Auditor should under stand the terms of sanction clearly and verify the loan account for compliance of sanction terms and for proper classification.

Provisioning Requirements:

Reserve Bank of India has prescribed well defined rules for making provisions in the case of advances. The provisions are normally calculated at the branch level for Non performing assets and duly verified by the auditors. In case of Standard Assets, the bank normally makes provision globally at the Head Office level. Auditor should go through these guidelines carefully before checking the provision calculations. Since the provision for advances is related to the security, auditor should carefully compare the security available vis-à-vis the security stipulated in the sanction advice. Moreover he should also verify the mortgage/hypothecation documents and ensure that the securities stipulated are in fact available legally to the Bank. Similarly valuation of the fixed assets like land, building and machinery etc., are critical item in the calculation of provision requirements. Banks' normally obtain valuation reports once in three years in case of immovable properties. If the available valuation is more than 3 years old, then the auditor should insist for a fresh valuation to arrive at the deficiency in the value of securities. In case of stocks, auditor should verify whether there are

unmoving or dead stocks which cannot form part of security and in case of machineries, necessary depreciations may be considered.

If the securities are to be shared by different banks that have financed a borrower in consortium the value of the securities should be allocated on *pari passu* basis.

In the case of loans against its own deposits, banks need not make any provision. However, the auditor should ensure that proper lien has been marked for the loans granted and verify whether the properly discharged deposit receipt is available with the Bank. If the deposit has expired, auditor should carefully verify whether the deposit has been repaid to the customer without closing the loan account. In some cases, the depositor requests the bank to issue duplicate deposit receipts while the original deposit receipt (against which loan has been sanctioned to the depositor) is with the custody of the Bank. Hence the auditor should verify the records of duplicate deposit receipts and compare the same with the deposits against which loans have been permitted.

In case of export advances, which have been identified as NPA, the auditor should verify the ECGC cover considered by the branch and enquire about the correspondence with ECGC for enforceability of claim. If in the opinion of the auditor, the claim is under dispute, the auditor should treat it properly while making provisions.

Non Fund Based Limits:

These are so called since banks do not part with funds immediately on issuing a Letter of Credit or a Bank Guarantee. These are guarantees in writing issued by a bank guaranteeing the repayment of the loan or completion of performance by the borrower. These letters of credit and Guarantees should be studied as on 31st of March every year. There may be cases of huge Letters of Credit having been devolved on the last week or the last day of the financial year, which if paid, will substantially alter the provisioning requirements of the bank. Auditor should carefully verify the registers of Letters of Credit and Guarantees to ensure that there is not liability that crystallises, which were reported as contingent liability as on 31st March.

Recovery:

In case of advances, where the bank has initiated legal action and instructed the branch to ensure recovery of advance by sale or auction of the borrower's securities, the auditor should ensure that the branch has taken necessary steps as directed by the controlling office. In Case of attachment of property under SARFASI Act, the bank should comply with servicing of notice within the prescribed period and the auditor should verify limitation of time prescribed. In cases, where the bank would have entered/ accepted a compromise from the borrower for one time settlement, the auditor should study the terms of compromise and performance of the borrower as on the balance sheet date for proper treatment in the books. The commitments that are fully met by the borrower should be treated as recovery towards principal or interest in that order as laid down by the bank's policy. The auditor should identify the unfulfilled terms of compromise by the borrower as on the date of balance sheet and report in Long Form Audit Report suitably.

In case of write off of advances, which are normally accounted at Head Office, the auditor should verify the communication received from Head Office, and passing of necessary entries in the Branch Books. The banks might have followed technical write off of advances, by keeping the advance under memorandum of records for the purpose of monitoring recovery and ensuring legal recovery. The auditor should check that these cases are not included in the gross advances of branch.

The auditor may not be able to verify all the transactions of the bank during the year under audit. Hence, he has to randomly select the cases to be covered based on size so as cover reasonable portion of advance portfolio of the branch and design the audit programme. The auditor should cover all the above factors for selected cases, properly document the basis of selection and his findings. ❐