Advances – Funded and non Funded with special emphasis on Fraud detection.

By

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A Bank is a financial institution which accepts deposits from public to lend money. It pays interest on deposits keeps with them (other than Islamic Banks and Portuguese Banks) and earns interest on loans and advances. In short, the income of the Bank largely comes from Interest earned. All the closing balances of Loans and various types of advances are assets of the Bank and shown on Asset side. From this we can determine the responsibility of the Auditor to assure that:

1. The Bank has earned correct interest. In other words, the interest is charged as per the sanctioned rate of interest. The existence of computers need not mislead you into complaisance of accuracy. Some user setting and even programming errors are well known to be arithmetically inaccurate.
2. The value of assets shown by the Bank is as per accounting principles and prudential norms. Prudential norms is covered under a separate topic. More important, <u>all the advances need to be accounted for</u> either 'above the line' in the Balance Sheet or as contingent liability for non-funded advances.

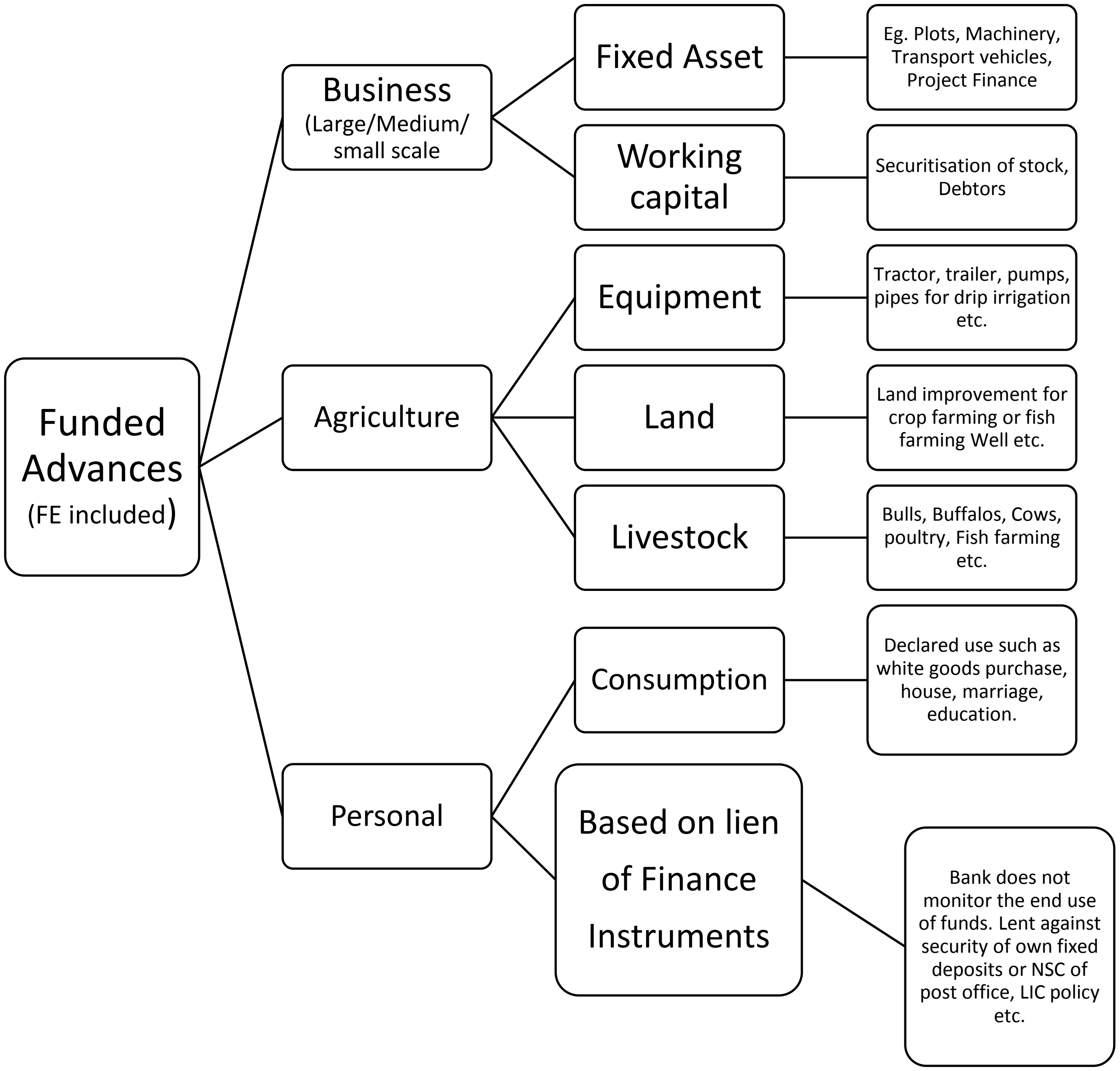
Each of the above points has the lethal potential to explode into a large number of critical checkpoints which will be covered later and in the presentation by the speaker.

It is now appropriate to examine the type of Advances made by the Bank.

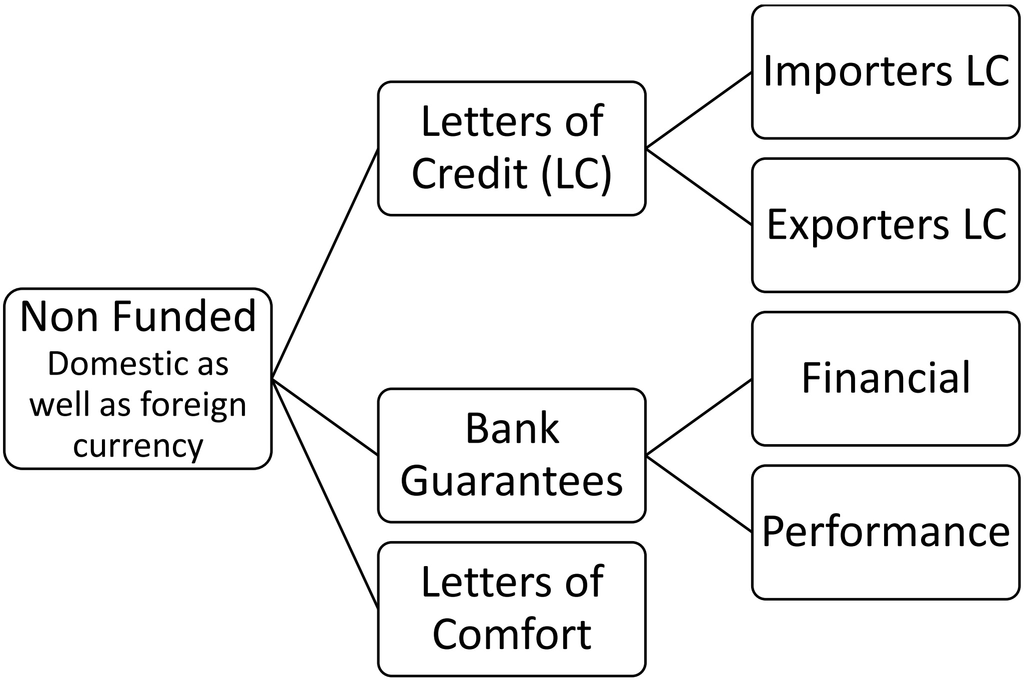
Again, the business needs may be in domestic currency or foreign currency. Each Bank has its own nomenclature for each type of advance. For example, Loan against fixed deposit may be called LABOD in one Bank but FDR Loan in another Bank. But the principle remains the same. (Loan Against Bank's Own Deposit created acronym LABOD)

In principle, the advances by type and purpose of borrower can be classified as:

Classification of Funded Advances

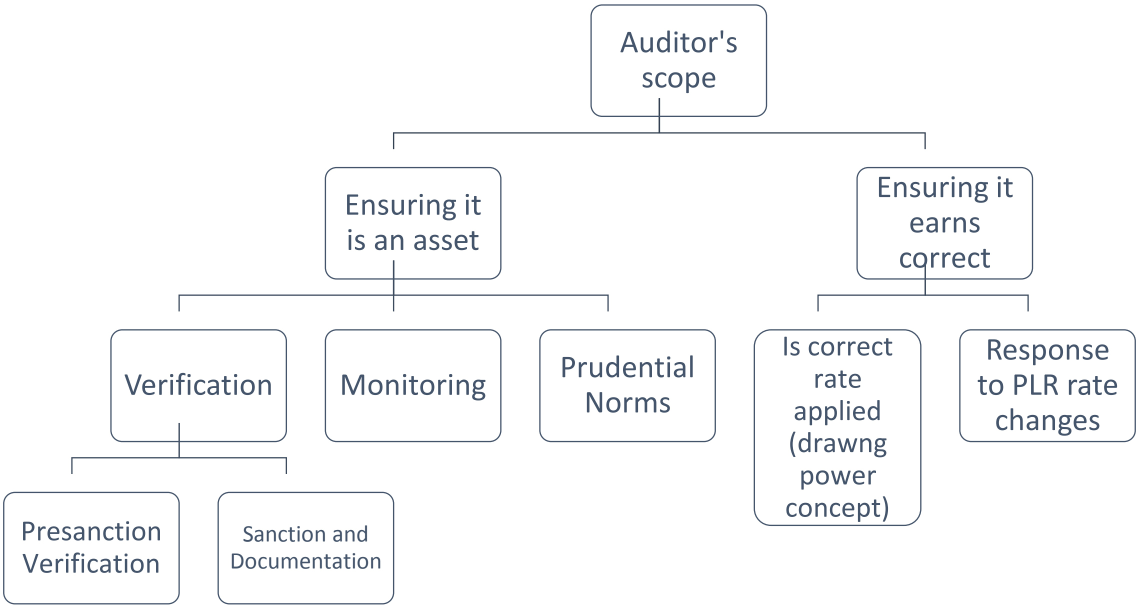


Classification of Non Funded Advances



Non Funded facility becomes funded on the happening of event(s).

Primary Duty of the auditor



Clarification of Sanction Limit, Drawing Power and Drawing limit

1. Santioned limit is the amount of facility granted to borrower. This is the UPPER limit the borrower can draw from the Bank. In case of a loan, the sanctioned limit would mean the maximum number of capital expenditure he can make. For Working capital against the Book Debts and inventory, it is the maximum amount the account can be in debit. For our understanding let us assume a borrower is granted Rs. 10 lacs against stock and book debts.
2. Drawing power: Any facility is sanctioned with a margin. Bank does not fund 100% of the requirement. 20% or above investment of the borrower is insisted upon. This is called margin. In a working capital facility the value of stock goes up and down as per the level of stock at the end of the month on which the Drawing power is calculated. Therefore in our example let us assume Rs. 10 lacs granted is against 20% margin of Book debts and Stock. If the stock and book debts are Rs. 14 lacs then the margin is Rs. 2.8 lacs. This gives a Drawing power of Rs. 11.2 lacs.
3. Drawing limit: This is the easiest to define. It is least of the above two. Thus, if Drawing limit is above the sanctioned limit, then sanctioned limit is the Drawing limit. If Drawing power is lower than the Sanctioned limit then Drawing power is the Drawing Limit.

The following table will clear the position. Auditor has to take care that even the computer application is calculating correctly as it has revenue implications of Penal interest and Risk implications. Assume sanctioned limit of Rs. 10 Lacs with a margin of 20%

Rs. In lacs	Case 1	Case 2	Case 3
Sanctioned Limit (A)	10.00	10.00	10.00
Amount of Stock & Debtors (B)	14.00	10.00	8.00
Less Margin 20% (C)	2.80	2.00	0,80
Drawing Power (B)-(C) (D)	11.20	8.00	7.20
Drawing Limit Minimum of (D) or (A)	10.00	8.00	7.20

Nature of Advances

Fund based advances are the one wherein the actual movement of funds from bank is certain

1. **Cash Credit**

   Cash credit facility is provided mainly to individuals or enterprises engaged in manufacturing and trading activities to enable them to meet the gap in their working capital requirements and are repayable on demand. The amount of cash credit facility to be sanctioned to a unit is need-based and is worked out as per well-defined parameters in each bank; the guidelines of the RBI may also affect the quantum of the facility in some cases. The cash credit facility is generally granted against the security of stocks of goods, standing crops, bills / book debts representing genuine sales – all belonging to the borrower. These assets are 'primary' security for the advance.

2. **Overdrafts**

   Overdraft facility may be secured or unsecured and generally does not carry a specific repayment schedule. Most common form of security offered are fixed deposit receipts with same branch, LIC policies, Shares, NSC receipts etc.Under the arrangement, the customer can draw upto an agreed sum in addition to his credit balance in the account. The overdraft facility may be either secured or clean (I.e. without security) and does not generally carry a repayment schedule. Mode of operations is same as cash credits.

3. **Bills**

   While the cash credit finance against stocks is intended to be used for financing the pre-sales stages, i.e., procurement of raw materials, their processing and conversion into finished goods to bring them into saleable condition as well as to carry reasonable quantities of these goods lying in various stages, the finance against bills is meant to finance the actual sale transactions. The finance against bills can be in any of the below mentioned form:

   Purchase of bills by the bank if these are payable 'on demand'.

   Discounting of bills by the bank if these are usance (or time) bills.

   Advance against bills under collection from the drawees, whether sent for realisation through the bank or sent directly by the drawer to the drawees.

4. **Term Loan**

   Loans are repayable in instalments spread over a period of time. Loans with repayment periods beyond 36 months are usually called 'Term Loans' whereas loans with repayment period up to 36 months are termed as 'demand loans or short term loans'. However both are similar in many respects: both have pre-determined repayment schedule. The basic difference between the two is that term loans are for acquisition of capital assets, which then becomes the security for the loan, i.e., end use of funds is fixed. There are various types of terms loans as depicted in flow chart above. Various loans are given with different objective however nature of operations will be same such as one time disbursement and repayment through instalment with interest may be EMI.

5. **Foreign Currency Loans**

   Banks are authorized to lend in foreign currency. These loans are given as per the EXIM policy and guidelines issued by Reserve Bank of India from time to time. Foreign currency loans may be in nature of term loans or working capital loans

6. **Export Credit**

   Exporters are also granted facilities in the form of cash credit and bills only but, being of a special nature, require a separate mention here.

   a) **Pre-shipment credit**

      In pre-shipment credit all advances required to finance the production cycle – from procurement of raw materials to bringing them to the port for despatch. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. This also can be in foreign currency more popularly known as PCFC.

   b) **Post-shipment credit**

      The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/ services.

Non Funded

1. **Letter of Credit(LC)**

   Letter of credit is an undertaking by the bank to the payee (supplier of goods and services), on behalf of the buyer as per the terms of the LC.

2. **Bank Guarantee**

   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 of any money under the guarantees, the bank is obliged to unconditionally pay the sum so demanded, within the amount guaranteed.

3. **Letter of Comfort**

   Banks issue a letter normally to their correspondence to confirm that they have created charges on securities of the correspondent's borrowers, on the strength of which the said correspondent releases financial assistance to the borrower. Such letters are called 'letters of comfort'.

Nature of Borrowing Arrangement

1. **Sole Banking**

   This is the most preferred arrangement where the borrower banks with one Bank only. And in most cases it is a single branch. However, in case of multi location borrowers, multi branch was common to sea which is redundant today in environment of Core Banking systems.

2. **Consortium Arrangement**

In this arrangement, the number of lending Banks is more than one. This is usual in case the advance is too large for one Bank either due to risk or statutory obligations like the advance would exceed the permitted percentage of share capital of the Bank or permitted exposure to one borrower or group. Salient features of this type are:

i) The Banks recognize a head Banker known as ‘Lead Banker’. This Bank is normally the largest lender to this borrower.
ii) Borrower signs common set of documents. Lead Bank obtains documents on behalf of participant Banks.
iii) Lead Bank is responsible for overall monitoring which is shared with participating Banks in regular meetings.
iv) All participating Banks have right on security in agreed proportion.
v) The borrower maintains direct business relation with all member Banks.
vi) Borrowing outside the consortium is not permitted without permission of the consortium.

3. **Multiple Banking**

In this type, there is no formal arrangement between the Banks. The borrower signs separate documents with each Bank and deals with each Bank separately.

Audit Actions

VERIFICATION

Scope of Verification

It is not possible to verify all the advances. The auditor has to choose a sample. Formal points should be considered in choosing sample.

1. Cover accounts which are negatively remarked by RBI inspectors, Concurrent auditor or internal inspector to see compliance or risk mitigation if any.
2. All advances granted during the years.
3. Large advances (even the old advances). LFAR required you to comment on large advances in excess of Rs. 2 crores or 5% of year end advances.
4. Problem accounts normally seen in control returns sent to HO/RO.
5. Other small advances on selective basis.

Stages of Verification

1. Pre-sanction – In case of second facility or enhancement, if the correction position is reported.

2. Security valuation report – reasonableness. Whether the valuer is black listed in other Banks (check if it is black listed in same Bank first) . If so then valuation should be re-verified in detail.

3. In case of shift of Banker, whether NOC and confidential report is obtained and placed on record before the sanctioning authority.

Sanction Document

1. Sanctioning authority is permitted as per the discretion policy of the Bank.

2. Sanction terms: Whether all are executed. Some are standard and some are customized.

3. Is the security secured before the disbursement is done.

Documentation

1. Are the requisite documents taken?
2. Are the stamps adequate where the documents need to be franked/stamped/ on stamp paper.
3. Is signature obtained on each page, where things are physically written and at the end of the document?
4. Are these documents kept under lock and key in fireproof cabinet? After all these are documents to the assets of the Bank.

Monitoring and Supervision

1. Are stock/debtors statements sent on time to the branch?
2. Are final accounts supported by Income tax returns sent to branch to facilitate review?
3. Does the review note communicate application of mind and calculation?
4. Is the unit visited for inspection and are there any serious adverse comments.

Notes and Notings

Definition of Wilful Defaulter

RBI has introduced the concept of 'wilful defaulter' and the following categories of borrowers are treated as wilful defaulters:

- Unit defaulting inspite of having the capacity to pay; or
- Diversion of funds; or
- Transfer or disposal of assets given as security without the knowledge of the bank. Unless the banks are in a position to establish dishonest intention and false representations on the part of borrowers, it is difficult to initiate criminal proceedings against borrowers for wilful defaults. As far as banks are concerned, bonafide decisions to lend further money to revive and turn around a stressed account should not be questioned. Unless bankers are assured such comfort, accounts under stress will not get funded at the right time with adequate loans, which will aggravate the problem instead of resolving it.

The Companies Act, 2013, has created a new offence of fraud in relation to the affairs of a company, which provides that any act or omission, concealment of any fact or abuse of position committed by any person with intent to deceive or to injure the interest of the company or its shareholders or creditors, whether or not there is a wrongful gain or loss, can be investigated by Serious Fraud Investigation Office (SFIO) established under the Act and any violation is punishable with imprisonment of up to 10 years. Cases of wilful defaults can, therefore, be entrusted to the SFIO to investigate whether such default amounts to serious fraud under Section 447 of the Companies Act.