



March 18, 2023

IRAC Norms and Asset Verification

CA Suresh Agaskar

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Non-regulatory developments during FY 22-23

- ❖ Rising interest rates- improvement in operating income of banks, sustainability of same?;
- ❖ Lagging growth in deposits vis-à-vis credit growth – pressure on banks for liquidity – **auditor to be watchful for mis-selling;**
- ❖ Recent layoff in the IT and other industries could bring some pressure on retail portfolio of bank- **see portfolio mix at branch;**
- ❖ RBI focus on- **asset quality**, IT investments, functioning of DBU – recent discussions in meeting;
- ❖ Central Bank Digital Currency (CBDC)- **counterfeit**, cash management, cost saving etc.;- launch of **e₹-R** on pilot basis from 1st December 2022- **classification & treatment in FS**
- ❖ Increased focus on responsibilities of regulated entities employing recovery agents- impact on overall recovery & collection efficiency – **could be area for LFAR reporting in case of any complaints/specific directions by RBI to bank;**

Bank Branch Audit- recent development

❖ Coverage of advances: FY 2022-23:-

2019-20	2020-21	2021-22	2022-23	2023-24
90%	90%	80%	70%	Bank specific policy

- ❖ **FY 2023-24 onwards:** coverage of branches under audit need to be determined as per Board approved policy – impact on no. of branches
- ❖ **Branch audit Fees:** increase of 10% audit fees, Fees for LFAR & Certificate to be decided by management- impact on total remuneration
- ❖ **Prior approval of RBI:** general permission to PSBs for appointment/re-appointment of SBAs- no need for prior approval from RBI
- ❖ **Branches per firm-** maximum two branches each SBA(earlier three branches)- opportunities for more firms

Challenges for Bank Audit -FY 2022-23

- ❖ IRAC Norms 2.0- reporting on implementation issues in - **daily NPA classification through system with minimum or no manual intervention, out of order in CC a/c** etc. as per new norms
- ❖ COVID-2.0- Restructuring Scheme- **Post implementation compliances including classification on account as NPA – date of NPA**
- ❖ Monitoring pool of restructured account- **accounts under various restructuring schemes with different criteria for upgradation etc.**
- ❖ Retail loan portfolio- increase in interest rates leads to **increase in the default risk which may lead to possible evergreening & negative amortisation**
- ❖ Certificates & reporting- **reasons for limited assurance in the certificates** & reporting on **process of internal weakness in critical process**

❖ Certificates: (SCA/SBA)

d) SCAs/SAs should verify and certify as to whether the bank is in compliance with guidelines on exposure norms under Large Exposure Framework contained in circulars DBR.No.BP.BC.43/ 21.01.003/2018-19 dated June 03, 2019,

¹ SCAs/SAs shall indicate in every certificate as to whether the same has been issued with limited assurance or reasonable assurance. In case of limited assurance, the SCAs/SAs shall indicate the reasons for the same.

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❖ Reporting- (SCA)

5. Further, banks shall advise their SCAs/SAs to (i) examine the efficacy, adequacy and quality of the mechanism put in place to identify and remediate the weaknesses in critical processes, and (ii) report deficiencies observed, if any, to the Audit Committee of the Board (ACB)/Local Management Committee (LMC) and SSM, RBI, respectively.

6. Please acknowledge receipt.

Yours faithfully,


(B Sivakumar)
Chief General Manager

Relevant Circulars applicable for FY 2022-23

Master Circular/Master Directions:

- ❖ Master Circular Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances April 2022– **New Changes [Consolidated Circular]**
- ❖ Master Directions on Frauds – Classification and Reporting by commercial banks and select FI- July 2017- **RFA & EWS mechanism**
- ❖ Master Direction-Priority Sector Lending-Targets and Classification (amended from time to time)- **Certificate from SBA's**
- ❖ Master Direction - Know Your Customer (KYC) Direction, 2016- **LFAR clauses**
- ❖ Master Circular - Guarantees and Co-acceptances

Relevant Circulars applicable for FY 2022-23

Other Circular/Notifications:

- ❖ Master Direction on Financial Statements - Presentation and Disclosures (amended time to time)- **mainly for SCAs**
- ❖ Master Direction – Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022- **effective from April 01, 2022**
- ❖ Consolidated Circular on Opening of Current Accounts and CC/OD Accounts by Banks dated April 19,2022 - **LFAR Reporting**
- ❖ Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021- **mainly for SCAs**
- ❖ Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021- **mainly for SCAs**

Other Circular/Notifications:

- ❖ Automation of NPA- Classification & Provision- September 14, 2020
 - To be implemented by **30th June,2021**;
 - Manual intervention- on classification & provisioning to be removed;
 - NPA classification to be made as day-end process- **Daily NPA**;
 - System should be audited by independent expert

- ❖ Reserve Bank of India (Financial Statements - Presentation and Disclosures) Directions, 2021 - Disclosure of Divergence in Asset Classification and Provisioning- October 11, 2022- **mainly for SCAs**

- ❖ Reserve Bank of India (Financial Statements - Presentation and Disclosures) Directions, 2021 - Disclosure of material items- December 13, 2022 -**mainly for SCAs**

- ❖ Outsourcing of Financial Services - Responsibilities of regulated entities employing Recovery Agents-August 12, 2022

Guidance Note on Audit of Banks (2022 Edition)

Attention

Members' attention is invited to relevant directions/circulars issued by the Reserve Bank of India up to January 31, 2022 available on ICAI website for ease of use and reference. Members are advised to keep track of legislative/regulatory developments, for example, circulars of the Reserve Bank of India, issued subsequent to the aforementioned date and having a bearing on the statutory audit of banks/bank branches for the year ended March 31, 2022.

Members are also advised to read this Guidance Note in conjunction with other ICAI publications (Technical Guide on Audit of Internal Financial Controls in Case of Public Sector Banks and Technical Guide on Revised Formats of Long Form Audit Report of AOBs).



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Technical Guide on Revised Formats of Long Form Audit Report



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Technical Guide on Audit of Internal Financial Controls in Case of Public Sector Banks



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Changes in presentation of FS of Banks/BC

❖ Disclosure of divergence in Asset classification & provisioning:

Threshold	2021-22	2022-23	2023-24
Additional provisioning for NPAs to reported profit before provisions and contingencies	10%	10%	5%
Additional Gross NPAs identified to reported incremental Gross NPAs	15%	10%	5%

❖ Disclosure of Material items:

- **Other Liabilities-** Any item under the “Others (including provisions)” exceeds one per cent of the total assets, particulars of all such items shall be disclosed in the notes to accounts
- **Other Assets-** Where any item under “Others” exceeds one per cent of the total assets, particulars of all such items shall be disclosed in the notes to accounts

Changes in presentation of FS of Banks/BC

❑ Example- ABC Bank Limited:

Threshold	For 2021-22 (in Cr.)
Additional NPA -PTC Investments	67.00
Additional Provisioning on above	17.00
Profit before provisions and contingencies	7,262.18
Reported incremental Gross NPAs <u>[only loans & no investments was classified as NPA]</u>	954.05

- ❖ In your view whether ABC Bank required to disclose the above divergence in their Notes to accounts?
- ❖ What will be the situation in FY 2023-24 considering the similar figures?

Journey of IRAC 2.0



Coverage:

- 2.1 **All borrowal accounts**, including temporary overdrafts, irrespective of size, sector or types of limits, shall be covered in the automated IT based system (System) for asset classification, upgradation, and provisioning processes. Banks' investments shall also be covered under the System.
- 2.2 Asset classification rules shall be **configured in the System**, in compliance with the regulatory stipulations.
- 2.3 Calculation of provisioning requirement shall also be System based as **per pre-set rules** for various categories of assets, **value of security** as captured in the System and any other regulatory stipulations issued from time to time on provisioning requirements.
- 2.4 In addition, **income recognition/derecognition** in case of impaired assets (NPAs/NPIs) shall be system driven and amount required to be reversed from the income account should be obtained from the System without any manual intervention.
- 2.5 The System shall **handle both down-grade and upgrade of accounts** through Straight Through Process (STP) without manual intervention.

Changes in IRAC norms, October 1, 2021

❖ Earlier requirements:

Timeline for implementation of viable RP	Additional provisions to be made as a % of total outstanding, if RP not implemented within the timeline
180 days from the end of Review Period	20%
365 days from the commencement of Review Period	15% (i.e. total additional provisioning of 35%)

❖ New requirements: [October 2021 circular]

Timeline for implementation of viable RP	Additional provisions to be made as a % of total outstanding (funded+non-funded), if RP not implemented within the timeline
180 days from the end of Review Period	20%
365 days from the commencement of Review Period	15% (i.e. total additional provisioning of 35%)

Major points of clarifications

- ❖ Specification of due date/repayment date in loan agreement
- ❖ Classification of SMA & NPA –part of day-end process (Same Day vs. Next Day)
- ❖ Clarification regarding **definition of 'out of order'**
- ❖ NPA classification in case of interest payments
- ❖ Income recognition policy in case of loans with moratorium on interest

IRAC Norms – Clarifications, November 12, 2021

❖ Classification of SMA & NPA –part of day-end process:

mention accounts (SMA). In order to remove any ambiguity, it is clarified that the intervals are intended to be continuous and accordingly, the basis for classification of SMA categories shall be as follows:

Loans other than revolving facilities		Loans in the nature of revolving facilities like cash credit/overdraft	
SMA Sub-categories	Basis for classification – Principal or interest payment or any other amount wholly or partly overdue	SMA Sub-categories	Basis for classification – Outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for a period of:
SMA-0	Upto 30 days		
SMA-1	More than 30 days and upto 60 days	SMA-1	More than 30 days and upto 60 days
SMA-2	More than 60 days and upto 90 days	SMA-2	More than 60 days and upto 90 days

What does this mean?

IRAC Norms – Clarifications, November 12, 2021

Classification of SMA & NPA –part of day-end process:

Due date
31/03/22



Due date
31/03/22

Overdue date
01/04/22



Overdue date
31/03/22

SMA
01/04/22



SMA
31/03/22

NPA
30/06/22



NPA
29/06/22

- ❖ Different banks were following different practice of identification of account as NPA- monthly/quarterly/daily
- ❖ September 2020 circular and November 2021 circulars now requires SCB to identify the NPA on daily basis through system- **June 2021**
- ❖ No exceptions are given for Saturday/Sunday/Holidays- NPA process need to run to identify any account as NPA- **LFAR point**
- ❖ Major impact- **total overdue recovery for NPA vs. Partial recovery in Standard accounts**

❖ Clarification regarding definition of 'out of order':

Changes in the wording of definition:

An account should be treated as '**out of order**'

if the outstanding balance in the CC/OD accounts remains continuously in excess of the sanctioned limit/drawing power for 90 days or 1

~~In cases where~~ the outstanding balance in the CC/OD accounts ~~in the principal operating account~~ is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days, ~~as on the date of Balance Sheet~~ or 2

the outstanding balance in CC/OD account is less than the sanctioned limit/drawing power but credits are not enough to cover the interest debited during the same previous 90 days -period, ~~these accounts should be treated as 'out of order'~~. 3

IRAC Norms – Clarifications/changes for Banks

❖ Clarification regarding definition of ‘out of order’:

Existing practice for classification of account as NPA- under 3rd condition- quarterly basis:
Testing 3rd condition for quarter ended 31st December 2022:

Months	Interest Debits	Credits (Scenario A)	Credits (Scenario B)
July	15	15	15
August	20	0	0
September	21	0	0
October		10	10
November		10	10
December		10	25

Scenario- A

Total Debits-56

Total Credits-45

Conclusion- **NPA**

Scenario- B

Total Debits-56

Total Credits-60

Conclusion- **STD**

IRAC Norms – Clarifications/changes for Banks

❖ Clarification regarding definition of ‘out of order’:

Clarification –view-1- Daily NPA classification-Previous 90 days period’ :

Testing 3rd condition for quarter ended 31st December 2022:

Dates	Interest Debits	Credits	Previous 90 days
31-07-2022	13		02-05-2022
02-08-2022		13	04-05-2022
31-08-2022	11		02-06-2022
02-09-2022		11	04-06-2022
30-09-2022	12		02-07-2022
02-10-2022		12	04-07-2022
31-10-2022	13		02-08-2022
01-11-2022		0	03-08-2022

On 31-10-2022
 PR 90 days Debits-36
 PR 90 days Credits-36
 Conclusion- **STD**

On 01-11-2022
 PR 90 days Debits-36
 PR 90 days Credits-23
 Conclusion- **NPA**

IRAC Norms – Clarifications/changes for Banks

❖ Clarification regarding definition of 'out of order':- View-1

- ❖ Circular requires that credits in the account should be able to cover the interest debited during the previous 90 days period;
- ❖ Post September 2020 circulars all the banks are required to run the NPA on “**Daily basis**”- therefore each day 3rd condition of the circular will be tested by the bank to classify an account as NPA.

❖ In view-1-

- ❖ 31st October 2022- as part of day end process for 31st October- the system will consider all the credits & debits since 2nd August 2022 i.e., previous 90 days- in example sufficient recovery & **hence it will STD account.**
- ❖ 1st November 2022- here the previous 90 days will start from 3rd August and hence recovery made on 2nd August 2022 will not be covered & therefore it may be NPA account.

IRAC Norms – Clarifications/changes for Banks

❖ Clarification regarding definition of ‘out of order’:

Clarification –view-2- Daily NPA classification-Previous 90 days period’ :

Testing 3rd condition for quarter ended 31st December 2022:

Dates	Interest Debits	Credits	DPD
31-07-2022	15		1
01-08-2022		-	2
02-08-2022		15	0
31-08-2022	11		1
01-09-2022		-	2
02-09-2022		11	0
30-09-2022	12		1
01-10-2022		-	2
02-10-2022		12	0
31-10-2022	13		1
01-11-2022		0	2

IRAC Norms – Clarifications/changes for Banks

Clarification regarding definition of 'out of order':

- ❖ Circular requires that credits in the account should be able to cover the interest debited during the previous 90 days period- which can be interpreted as **interest should not remain overdue for 90 days;**
- ❖ In this view- interest charged in the CC account will be treated as demand created in the account and if there are no credits within 90 days the account will be treated as out of order.
- ❖ The view removes the difference between term loans and CC facility w.r.t. interest recovery- however it still differentiate between the two by **way of credit in the account vs. one way recovery in term loans.**
- ❖ **Different views/approach adopted by different bank in following 3rd condition of out of order.**

CS-1-Quality of Credit in CC accounts :

- ❖ ABC Pvt. Ltd. has availed CC facility from the bank. The bank has closed current account with borrower as per new RBI guidelines. The company has also taken Rupee Term Loan and Capex LC was sanctioned as sub-limit to this facility. The company had taken LC against the capex expenditure and on due date of LC the bank had disbursed RTL to close these LC's.
- ❖ The **disbursement against the capex LC were routed through the CC/OD account** and the payment were made from this account itself. The account is classified as Standard based on out of order criteria [credits are sufficient].
- ❖ On careful verification of the account statement, the auditor has observed that **the business credits in the account were not sufficient to cover the interest debited during the period of previous 90 days**. However, the system had classified the account as STD considering the disbursement credits in the CC/OD account.
- ❖ As an auditor what is your view on such practice and compliance with IRAC norms.

❖ Consolidated Circular on Opening of Current Accounts and CC/OD Accounts by Banks- April 19, 2022

5.3 Banks shall put in place a monitoring mechanism, both at head office and regional/ zonal office levels to monitor non-disruptive implementation of the circular and to ensure that customers are not put to undue inconvenience during the implementation process.

5.4 Banks should not route drawal from term loans through CC/ OD/ Current accounts of the borrower. Since term loans are meant for specific purposes, the funds should be remitted directly to the supplier of goods and services. In cases where term loans are meant for purposes other than for supply of goods and services and where the payment destination is identifiable, banks shall ensure that payment is made directly, without routing it through an account of the borrower. However, where the payment destination is unidentifiable, banks may route such term loans through an account of the borrower opened as per the provisions of the circular. Expenses incurred by the borrower for day-to-day operations may be routed through an account of the borrower.

CS-1-Quality of Credit in CC accounts :

❖ Following is account extract of XYZ Limited CC Account:

31-07-2022		Int. Coll:01-07-2022 to 31-07-2022	INR	1,86,324.00		1,90,73,469.68 Dr.
20-08-2022			INR		3,30,000.00	1,87,43,469.68 Dr.
22-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
22-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
23-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
23-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
24-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
24-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
25-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
25-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
26-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
26-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
29-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
29-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
30-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
30-08-2022	BRN-SI-		INR		1,44,530.32	1,87,43,469.68 Dr.
31-08-2022	BRN-SI-		INR	1,44,530.32		1,88,88,000.00 Dr.
31-08-2022		Int. Coll:01-08-2022 to 31-08-2022	INR	1,85,091.00		1,90,73,091.00 Dr.
31-08-2022	BRN-SI-		INR		1,44,530.32	1,89,28,560.68 Dr.

❖ No credit entry in account post 31st August 2022 & the bank has classified the account as NPA on 29th November 2022 (90 days) due to non-service of interest.

❖ As an auditor what is your view on the above and compliance with IRAC norms.

IRAC Norms – Clarifications/changes for Banks:

Clarification regarding interest during moratorium period:

12. The extant instructions (compiled at paragraph 3.2 of the [Master Circular on IRACP norms dated October 1, 2021](#)) require that once an account is classified as NPA, the entire interest accrued and credited to income account in the past periods, must be reversed to the extent it remains unrealised. It is clarified that if loans with moratorium on payment of interest (permitted at the time of sanction of the loan) become NPA after the moratorium period is over, the capitalized interest corresponding to the interest accrued during such moratorium period need not be reversed.

- ❖ Mainly applicable for Educational loans- where accrued interest during the repayment holiday period is added to the principal and repayment in Equated Monthly Instalments (EMI) fixed.
- ❖ Different views among the auditors/banks on treatment of the above interest once the account is classified as “NPA”.

IRAC Norms – Clarifications, February 15, 2022:

Major points of clarifications – 15th February 2022 circular:

- ❖ Out of order- applicable to all loan products being offered as an overdraft facility
- ❖ Previous 90 days period- inclusive of the day for which the day-end process is being run- **IMP clarification**
- ❖ Upgradation of the facility-only upon repayment of entire arrears of interest and principal pertaining to all the credit facilities- **IMP clarification**

CS-2-Linked account upgradation:

- ❖ Mr. A, customer of ABC Bank Limited is having 3 facility with the bank.

Facility	O/s in Rs.	Status as on 29 th November	Status as on 11 th March 2023
Personal Loans	5,00,000	30 days DPD	81 days DPD
Housing Loan	59,00,000	90 days DPD	Nil DPD
Auto Loan	15,00,000	Nil DPD	30 days DPD

- ❖ The Housing loan account of the customer was overdue and was classified as NPA on 29th November 2022. On 11th March 2023 the customer has paid entire overdues of the housing loan and DPD in other loans are below 90 days.
- ❖ The bank on 11th March 2023 has upgraded the housing loan from NPA to standard and all other account automatically upgraded to standard account.
- ❖ As an auditor what is your view on such practice and compliance with IRAC norms.

Major points of clarifications –Upgradation of loan account: 1st October 2021 IRAC norms:

4.2.5 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 nonperforming and may be classified as 'standard' accounts. With regard to upgradation of accounts classified as NPA due to restructuring, non-achievement of DCCO, etc., the instructions as specified for such cases shall be applicable.

1st April 2022- IRAC Norms: (added by 15/02 clarification)

4.2.5 Upgradation of loan accounts classified as NPAs

The loan accounts classified as NPAs may be upgraded as 'standard' asset only if entire arrears of interest and principal are paid by the borrower. In case of borrowers having more than one credit facility from a bank, loan accounts shall be upgraded from NPA to standard asset category only upon repayment of entire arrears of interest and principal pertaining to all the credit facilities. With regard to upgradation of accounts classified as NPA due to

Recent RBI Divergence/observations:

- ❖ Non-implementation of RP-7th June 2019:
 - Defaults not rectified within the review period of 30 days or viable RP not implemented within 180 days
 - **Additional provision made only on FB exposure portion and not on total o/s amount (FB+NFB)**
- ❖ DP computed based on the expired stock statements- to be classified as NPA
- ❖ Wrongful upgradation of NPA accounts before implementation of restructuring plan
- ❖ Wrongful reversal of provision on change in ownership before expiry of monitoring period
- ❖ Realisable value of security less than 10% of o/s- not classified as Loss assets – **only in NPA cases**
- ❖ **Rollover of Working Capital Demand Loan (WCDL) of a borrower under financial difficulty tantamount to restructuring – Cash Credit**
- ❖ **Wrongful upgradation of investment exposure without ensuring satisfactory performance after writing off advances**

Probable Expectation of RBI from Bank Auditor :

- ❖ Identification of **probable evergreening of accounts** by the banks
- ❖ Reporting on **non-compliance of IRAC norms**- identification of account (e.g. restructured a/c) and provisioning (e.g. no security)
- ❖ Extra care or **additional audit procedure on restructured accounts**- MSME + Non-MSME
- ❖ **Basis compliance of IRAC norms** – upgradation of accounts from NPA to Standard
- ❖ **Assess increase in credit risk**- pervasive in nature- identify through QMR reports etc.
- ❖ Highlighting the areas of two different view/interpretation issues through LFAR

Standard Assets:

- ❖ The account/borrower is regular in paying the interest and the principal as and when due/demanded by the Bank.
- ❖ Normal risk and the provisioning on these advances depends on the category of the loans

Non-Performing Assets:

- ❖ Para 2.1.1. “An asset, including a leased asset, becomes non performing when **it ceases to generate income** for the bank”
- ❖ Only recovery need to be seen to classify an account as NPA
- ❖ No distinction between Secured and Unsecured assets for the purpose of the classification of account

Criteria for classification- NPA

Sr. No.	Type of Facility	Criteria –Para 2.1.2
(A)	Term Loans	<p>“interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan”</p>
(B)	Overdraft/Cash Credit	<p>“the account remains ‘out of order as indicated in the IRAC <i>Out of Order- para 2.2</i></p> <ul style="list-style-type: none"> ▪ Outstanding Balance > SL or DP continuously for 90 days ▪ No credits in accounts continuously for 90 days as on B/s date ▪ Credits in the accounts are not sufficient to cover interest debited during the same period the previous 90 days period

Criteria for classification- NPA

Sr. No.	Type of Facility	Criteria –Para 2.1.2 & 4.2.21
(C)	Bills Purchased & Discounted	“the bills remain overdue for a period of more than 90 days “ Overdue – any credit facility is overdue if it is not paid on the due date fixed by the bank (para 2.3)
(D)	Credit Cards	“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”
(E)	Derivative Transactions	“overdue receivable representing positive M-t-M value of derivative contract remains unpaid for more than 90 days”

Criteria for classification- NPA

Sr. No.	Type of Facility	Criteria –Para 2.1.2 & 4.2.21
(F)	Agricultural Advances	<ul style="list-style-type: none">▪ Short duration crop- if the instalment of principal or interest thereon remains overdue for two crop season;▪ Long duration crop- if the instalment of principal or interest thereon remains overdue for one crop season;▪ Crop season is decided by State Level Banker’s committee

Classification of NPA: Asset Classification

Sub-Standard Assets: (SSA)

- ✓ Account has remained **NPA** for a period less than or equal to 12 months

Doubtful Assets:

- ✓ Account has remained **SSA** category for a period of 12 months- **DB-1**
- ✓ Account has remained in **DB-1** for 1-3 years –**DB-2**
- ✓ Account has remained in **DB-2** for more than 3 years-**DB-3**

Loss Assets:

- ✓ Identified by the bank or internal or external auditor or the RBI inspection

SA-SSA-DB1-DB2-DB-3



CS-3-Evergreening through group co's:

- ❖ ABC Pvt. Ltd. is a company registered under CA, 2013. The company is 100% subsidiary of XYZ Ltd. ABC Pvt. Ltd. has taken Rs. 20 cr. Loan from KNK Bank and is serving interest on regular basis. These funds have been utilised to construct a factory which has started its commercial production, however the market for the product has declined considerably. The principal amount for November 2022 and December 2022 is due. During the current year, KNK bank has sanctioned a loan facility to XYZ Ltd. for cash flow mismatch .
- ❖ Post granting of such facility XYZ Ltd. has made inter-corporate deposit to ABC Pvt. Ltd @ 12%. The overdue in the account has been fully paid by the ABC Pvt. Ltd.
- ❖ Both the account has been classified as Standard as on 31st March 2023. Comment on appropriateness of the classification of advances.

- ❖ The bank has sanctioned ECLGS facility to **ABC co. under ECLGS 1.0 extension scheme**. The sanction was as per the limit prescribed under the scheme and after complying with the eligibility criteria. Another group entity of the borrower **XYZ Co.** had also applied for the ECLGS facility but the same was rejected by the bank since the customer was ineligible as per the scheme.
- ❖ On verification, the auditor observed that after the disbursement of ECLGS facility to the borrower **the amount disbursed in the account has been transferred to CC a/c of XYZ co.** and the bank has utilised the same to recover its pending overdues.
- ❖ Post cleaning of dues, the CC facility of **the borrower was renewed with enhancement**. The enhanced amount was transferred from CC to ABC co. CC account. **The ECLGS facility was closed through such disbursement.**
- ❖ As an auditor what is your view on such practice and appropriate reporting in Advance section of LFAR?

CS-5-Evergreening-additional funding:

M/s K.C. & Co. has two facilities with XYZ Bank Ltd. CC/OD facility of INR 5 cr. and General Business Purpose Term Loan of INR 10 cr. (disbursed to the extent of INR 8 cr.).

As on February 2023, the CC/OD facility is out of order and will be classified this account as NPA as on March 31, 2023. During the month of March-2022, M/s K.C. & Co. **requested for additional disbursement of the loan to the extent of INR 2cr.**

On 28th March 2023 the firm repaid the overdue amount in the CC/OD facility and the account is regular as on 31st March 2023.

During statutory audit, the auditor raised an objection stating that the account has been regularised by sanctioning an additional facility to the borrower and this account should be classified as NPA as on 31st March 2023

CS-6-Negative amortisation:

Mr. A has taken housing loan from ABC Bank Ltd. and has been servicing EMI regularly on monthly basis. Due to increase in the repo rate, the interest rate of the loan has increased significantly as compared to earlier. The extract of the HL-statement is as follows:

Date	Particulars	Dr.	Cr.	Closing Amt.
01/01/2023	Opening Balance			11,00,000
31/01/2023	Interest for January	10,000		11,00,000
31/01/2023	Recovery		9,500	11,00,500
28/02/2023	Interest for February	9,800		11,10,300
28/02/2023	Recovery		9,500	11,00,800

In the above example, the recovery is not sufficient to cover the interest portion as well the principal o/s is increasing on monthly basis. The bank has not rescheduled the EMI and therefore Rs.800 interest demand is unserved. Should the account of Mr. A be classified as NPA on expiry of 90 days?

CS-7-Form over Substance:

M/s XYZ & Co. (Mr. X & Mr. Y only partners of the firm are brothers) has following facility with ABC Bank Ltd. **Term Loans- INR 5 Cr, CC/OD facility- INR 3 cr.** Both the partners are also having housing loan with the bank. The cumulative o/s of such loans are INR 2 cr. The **CC/OD facility of the firm has been classified as out of order due to continuously overdrawn for more than 90 days.** There is no other business activity carried out by the partners of the firm.

The statutory auditor is of the view that the **housing loan of partners of the firms should be classified as NPA** and the bank should make provision on such loans as well. Whether the auditor is justified in classifying these advances as NPA?

Will your answer differ if this is the case of proprietor firm- where CC facility is given in the name of proprietor firm and housing loan in individual capacity. Cust-ID of both these loan accounts are different in system?

Classification of Co-borrower: [Industry Issue]

Assessment of Joint Loans:

- ❖ Loans given after assessing and considering income of primary and co-borrower;
- ❖ Eligibility criteria tested considering the profile of both the borrowers;
- ❖ Borrower and Co-borrower – equal responsibility in regular service of EMI;
- ❖ Default in repayment by both would lead to account getting classified as overdue and then NPA.

Current Industry practice:

- ❖ In absence of clear guidance- only Cust ID of primary borrower is classified/tagged as NPA- Co-borrower only CIBIL

Borrower	Housing Loan	Auto Loan	Credit Card
Primary	Rs.10 crore (Joint Loan)	Rs. 50 lakhs	
Co-borrower		-	Rs.5 lakhs
NPA Classification	Yes	Yes	???

Classification of Co-borrower:

IRAC norm- 1st April 2022:

- ❖ No specific guidance on classification of co-borrower in case joint facility becomes an NPA;
- ❖ Joint responsibility of repayment - Default by one to be constituted as default by other;
- ❖ Term 'borrower' in IRAC norms would mean to include 'co-borrower' as there is no visible distinction between the two;
- ❖ Both the borrowers to be classified as NPA.

Current Practice in some banks:

❖ **ICICI Bank-**

If a loan account of a borrower is classified as NPA, all other accounts of the same borrower/co-borrower are also classified as NPA, irrespective of overdue status in other accounts.

❖ **Axis Bank-**

Further, in case of NPA, if a loan account of a borrower is classified as NPA, all other accounts of the same borrower/ co – borrower(s) are also classified as NPA, irrespective of overdue status in other accounts.

Approach for classification of Co-borrower:

- ❖ Co – applicant(s) will be classified as NPA, if any of the facilities of the primary applicant have been classified as NPA; [**any** vs. **joint facility could be debated**]
- ❖ All the other **Linked facilities** of the co- applicant where he/she is the primary/sole applicant will also be classified as NPA
- ❖ Percolation impact on co - applicant(s) being classified as NPA shall **trigger only when the primary applicant** identify as NPA and/or Upon Fraud classification of primary applicant
- ❖ Percolation impact to co – applicant(s) shall be restricted **up to one level only**
- ❖ If the co - applicants have been identified as NPA, it will not trigger NPA Classification of the primary applicant(s) [**reverse way**]

CS-8- Classification of Co-borrower:

Loan	A	B	C	D
Housing Loan - NPA	Primary	Co-Applicant	-	-
Auto Loan	Primary	-	Co-Applicant	-
Credit Card	-	Sole	-	-
Personal Loan	-	-	Sole	
Mortgage Loan	-	-	Primary	Co-Applicant
Personal Loan	-	-	-	Sole
NPA Classification	??	??	??	??

Exemption from NPA Classification

Para 4.2.11 of IRAC Norms:

- ❖ Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

Para 4.2.14 of IRAC Norms:

- ❖ 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.

Provisioning Norms:

Sr. No.	Asset class (NPA)	Provisioning %
(A)	<p>Normal Category: Sub-Standard Assets (Fully Secured) Sub-Standard Assets (Unsecured)</p> <p>Unsecured exposure: <i>“Realisable value of security is not more than 10% of the outstanding exposure”</i></p> <p>Infrastructure Category: Sub-Standard Assets (Fully Secured) Sub-Standard Assets (Unsecured)</p>	<p>15% 25%</p> <p>15% 20%</p>
(B)	<p>Doubtful Assets: DB-1 (Upto 1 Year) DB-2 (1 to 3 Year) DB-3 (More than 3 Year)</p>	<p>25% 40% 100%</p>

Provisioning Norms:

Sr. No.	Asset class (NPA)	Provisioning %
(C)	Loss Assets	100%
(D)	Standard Assets: <ul style="list-style-type: none"> ▪ Direct Advances to Agriculture and SME Sector ▪ Advances to Commercial Real Estate (CRE) ▪ Advances to CRE- Residential Housing (CRE-RH) ▪ Housing Loan at Teaser rates (+ 1 Year) ▪ Restructure Advances (Other than Provision for Dim. In Value) ▪ All other loans not included in above 	0.25% 1.00% 0.75% 2.00% 5.00% 0.40%

Accelerated provisioning:

SMA status of accounts need to be reported to CRISIL-fails to report such status the bank will be subjected to accelerated provisioning (SSA- to the extent of 40% and DB to the extent of 100% in DB-2 category)

Issues in Classification of advances as NPA:

Erosion in value of security/Frauds by borrower:

- ❖ In Certain circumstances the NPA are classified directly to Doubtful/Loss assets
- ❖ Potential threat of recovery due to erosion in value of security or non availability of security and existence of other factors (e.g. Frauds)
- ❖ Following classification policy should be adopted:

Case	Situation – <i>Realisable value of Security</i>	Classification
(A)	Less than 50% (last assessed)	DB
(B)	Less than 10% (of balance o/s)	Loss

- ❖ **New LFAR Clause- Substantial deterioration in Security Value**

Para 4.2.9 of IRAC Norms:

- ❖ In respect of accounts 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 it will not be prudent that such accounts should go through various stages of asset classification.

Para 5.3 of IRAC Norms:

- ❖ **100 percent** 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.

CS-10-Realisable value:

Mr. XYZ has taken housing loan from the bank for an aggregate amount of INR 5 cr. He has not paid the installment and was classified as NPA, since year 1. The **loan account is in DB-1 category** with an outstanding amount of INR 4.3 cr. The bank currently has done the valuation of the property and the details of the same are as follows:

Date of Valuation	Market Value	Realisable Value	Distress Value
21-02-2021	INR 4.5 cr.	INR 4.2 cr.	INR 4 cr.

In January 2023, the bank has carried out the auction of the property at Base price of Rs.4.2 crore. However, **no bid was received** towards the auction.

The **bank has made provision @25%** on the total outstanding balance **considering the value of INR 4.5 cr.** as on 31st March 2023.

Comment on the adequacy of the provision on the above case.

CS-11-Realisable value:

ABC Pvt. Ltd. has been classified as Non-Performing Asset in the earlier year. During the current year, the security valuation considered for making provision has been arrived at valuation report which is 2-year-old.

However, the auditor observed that latest audited financial statement of the **borrower includes impairment loss against such assets**. These impairment losses have been arrived at on the basis of the independent valuation obtained by the company.

The **provision for the NPA has been considering the old report** since the same not more than 3 years old.

Further, the bank has also considered **claim of ECGC** as security on the application made to the department. The **approval of such claim is still awaited** from the department.

Comment on the adequacy of the provision in the above case.

CS-12-Existence of security:

AZB Bank has sanctioned a facility in FY 2020-21 of Rs. 5 crore to Mr. B for the purpose of buying a flat in an **under-construction property** in Noida (20th Floor). The value of the property at the time of sanctioning of Loan is Rs. 8 cr.

The bank has disbursed Rs.3 crore up to 31st July 2022 based upon the completion of the construction of the building on overall basis. However, the **civil structure of the building has been completed up to 18th floor and the construction work has been stopped by the local authorities**. The builder is also having a financial difficulty for commencing the construction and completing the same.

The account has become **NPA as on 31st March 2023** and the has been classified as SSA. The bank has made **15% provision** on the same.

Whether in your view such classification and provisioning are as per IRAC norms.

CS-13-Existence of security:

XYZ Bank has classified Q-real estate Pvt. Ltd. as NPA and the account is in DB-2 category. The total exposure is Rs.15 crore and the same is considered as fully secured against the residential units.

However, based on review of the valuation reports the auditor noted following comments in the same:

04. Few of them have been sold by the Builders But we have considered the Full Mortgage units for calculation as per the advise from [REDACTED], as their is no official information to bank due NOC's from bank has not been taken , however as per information gathered from site 88 units out of them have been sold by the Builder without obtaining NOC from Bank , so legal aspect of this has to be adjudged by the banker itself. (Facts to be Validated by Legal Team and Corrective course of action to be taken by Bank on Urgent

The bank has considered all the units including the above units sold without obtaining NOC as security for the purpose of provision.

Whether in your view such provisioning are as per IRAC norms.

XYZ Pvt. Ltd. is classified as NPA and is currently under DB-2 category. The lenders have filed case under IBC and the resolution plan-liquidation has been accepted by the NCLT and the court has passed the order on 3rd March 2023. Based on the same, the bank is expected to receive only 10% against its exposure.

However, on verification of NPA the auditor has observed that the bank has continued to consider value as per latest available valuation report for making provision as per IRAC norms. On discussion, the branch manager is of the view that these reports are system generated and value has been arrived based on CBS system.

Whether in your view such provisioning are as per IRAC norms.

CS-15- P&M based on valuation reports:

ABC Pvt. Ltd. has been classified as NPA and is currently under DB-1 category as on 31st March 2023. The bank has charge on P&M and Land & Building of the company. The bank has obtained separate valuation reports for P&M and Land & Building in February 2021.

Based on the above, the bank has considered the realisable value of the security for the purpose of provision as on 31st March 2023.

The auditor is of the view that the practice of considering the value of P&M based on two-year-old valuation report is not correct. These P&M are depreciable assets and therefore the value as on 31st March 2023 will be lower as compared to value as per valuation report of February 2021.

Do you agree with the view of the auditor? If yes, what will be the alternate way to arrive at the value for the provision purpose?

S N	Types of Advances	Types of Security available	Impact
1	Standard Advances	<ul style="list-style-type: none"> ▪ Immovable and Movable Assets (P & M, Inventories etc.); ▪ Shares and Securities; ▪ Fixed Deposits and other liquid security (LIC, KVP, NSC etc.) ▪ Guarantee by Govt./Promoter/Corporate 	<ul style="list-style-type: none"> ▪ Schedule-9- Secured and Unsecured Loans; ▪ Para 4.2.9 of IRAC Norms; ▪ Para 4.2.11 of IRAC Norms; ▪ Para 4.2.14 of IRAC Norms
2	Non-performing Assets (NPA)	<ul style="list-style-type: none"> ▪ Immovable and Movable Assets (P & M, Inventories etc.); ▪ Shares and Securities; ▪ Fixed Deposits and other liquid security (LIC, KVP, NSC etc.) ▪ Guarantee by Govt./Promoter/Corporate 	<ul style="list-style-type: none"> ▪ Para 4.2.9 of IRAC Norms; ▪ Para 5.3 of IRAC Norms

Income Recognition & Reversal on NPA:

- ❖ Interest income on NPA **not** recognised on **accrual basis**- against the principal of certainty of collection as AS-9- Revenue Recognition
- ❖ Interest income on such accounts should be recognised on “Cash basis ”or “Actual receipt” basis
- ❖ Exceptions:- Interest on advances against TD/KVP/NSC etc. subject to availability of Margin
- ❖ Advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income in past period should be reversed if the same is **NOT REALISED.**
- ❖ Fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if **UNCOLLECTED.**

- ❖ During the year, PQR Pvt. Ltd. has been classified as NPA since the credits in the account were not able to cover the interest debited in the accounts.
- ❖ On verification of the account statement the auditor observed that the bank has charged **Rs.20,00,000 as Bank Guarantee commission in the account, however the same has not been recovered by the bank but recovered through unutilised limit in the account.**
- ❖ The account is classified as Sub-Standard Account as on 31st March 2023.
- ❖ The auditor insisted on reversal of such fee's income; however, the bank is of the view that the said **commission have been realised through unutilised limit in the CC account and hence should not be reversed.**
- ❖ Comment on the compliance of IRAC norms w.r.t. accuracy of such commission income.

Upgradation of NPA Account:

- ❖ If arrears of **interest and principal** are paid by the borrower in case of loan accounts classified as NPA, the account should no longer be treated as non-performing and may be classified as “Standard” accounts.
- ❖ Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the bank should be upgraded only when **ALL the outstanding loan/facilities in the account perform satisfactorily** during the specified period i.e. principal and interest on all facilities in the account are serviced as per terms of payment during that period.
- ❖ Comparison of NPA accounts/ critical accounts over a period- may highlight some serious concern over Upgradation of NPA account during a particular period

❖ Recoveries before Balance Sheet date:

- **Interest realised on NPA's** may be taken to income account provided credits in the accounts towards interest are **not out of fresh/additional credit facilities sanctioned to borrower by the bank.**
- No formal guidelines/agreement between bank and borrower w.r.t. apportionment of recoveries made- bank should adopt an accounting principle and exercise the right of appropriation of recoveries in uniform and consistent manner.

❖ Recoveries after Balance Sheet date:

- No clear guidelines by the regulator- no adverse remarks on diverse practices followed by the Bank
- AS-4 Events occurring after the Balance Sheet date- Non adjusting event
- Temporary vs. Permanent deficiencies/weakness
- Best Judgement after review of facts and circumstances of each case

CS-17- Appropriation policy:

XYZ Bank Limited has adopted following policy for the purpose of appropriation of recovery:

Standard a/c	NPA a/c
Charges	Principal
Penal Interest	Interest
Interest	Penal Interest
Principal	Charges

The policy further states that the above policy should be followed uniformly across all the loan products.

The auditor is of the view that the above policy is practically not implemented at the ground in case of one of the product.

In your view, if there any product & if yes please identify the same. Further How you will report in LFAR on the same?

- ❖ Divergence in NPA observed by RBI during the Inspections
- ❖ System based classified – sometime leads to incorrect classification (GIGO rule)
- ❖ Verification of parameters set in the system for classification of account as NPA (e.g. Repayment Schedule)
- ❖ Co-borrower classification – not implemented by the banks in system
- ❖ Non reversal of **total** interest in account classified as NPA (CY + PY unrealised)
- ❖ Recognition of interest income in NPA A/c's
- ❖ Non submission of Stock Statement by small borrowers.

- ❖ Carry forward of date of NPA (from earlier year to current year)
- ❖ Classification of accounts qua borrower would apply for agricultural and non agricultural loans?
- ❖ Classification of accounts transferred from other branches
- ❖ NPA regularised after balance sheet date but before signing the accounts
- ❖ Income Leakage- Rate of Interest fed in system is incorrect, DP is wrongly calculated, penal interest not recovered on late submission of Stock statements and Financials etc

- ❖ **Automated classification of NPA**- verify system, parameters, controls on modification of parameters, control on categorisation of NPA
- ❖ **CC/OD/WC facility**- verify the computation of drawing power, fresh sanction to escape the NPA classification, stock statement submission with the latest Balance Sheet.
- ❖ **Reversal of unrealised interest** on first time classification and subsequent transfer to memorandum account
- ❖ **Borrower wise classification**, Upgradation, and subsequent down gradation of NPA accounts are as per IRAC Norms
- ❖ **Valuation of Security** of main NPA cases- above a certain threshold determined by the Bank.
- ❖ No debits allowed in the NPA Accounts (e.g. Legal Charges debit separately)

Minimum Audit Procedures on NPA:

- ❖ **Comparison of NPA of current year vs. Previous year** [Name of Customer, Date of NPA, O/s Balance etc.]
- ❖ Verification of the any changes in the above and reasons for the same along with relevant supporting documents
- ❖ Increase in the O/s Balances- due to recovery charges etc. should be debited to P & L A/c- CRIP Cost in case of IBC cases
- ❖ **Verification of the recovery in the NPA accounts- apportionment as per the recovery policy of the bank- adjustment of recoveries done through suspense a/c rather than direct NEFT/RTGS**
- ❖ Verification of the **security valuation for the cases shifted to Doubtful category in the current year** from the date of NPA
- ❖ Verification of Fraud accounts – comparison of the same with the last year and new accounts identified in the CY

Key areas in NPA during Bank Audit-2022-23:

- ❖ **Linked account upgradation** from NPA to standard category
- ❖ **Quality of credits in CC account** considered for testing 2nd /3rd condition
- ❖ **Possible evergreening** through new facility to clear overdues in existing stress account
- ❖ **Form over substance-** classification of account under different legal entity
- ❖ **Co-Borrower classification** post classification of joint loan as NPA
- ❖ **Security** – existence of security & valuation for provision purpose
- ❖ **Downgrade of Restructured account** – Post COVID era- backdated NPA
- ❖ Revised EMI/**Negative amortization** due to increase in the interest rates in retail loans

Practical Issues in verification of advances:

- ❖ Classification and updation of security details in the system – **impact on secured and unsecured classification**
- ❖ End- use certificates- **not in compliance with the sanction terms** or means of utilisation
- ❖ Disbursement made on the basis of **Performa invoice/quotation** without obtaining the tax invoice – diversion of funds
- ❖ Continuous monitoring of **promoter margin** vs. margin at the end of the disbursement
- ❖ Classification of **PSL and Non-PSL** advances in system- impact & penalty by RBI
- ❖ Long pending **perfection of security** by the branch – legal issue vs. procedural matters
- ❖ Risk of **double funding** based on copy of Performa invoices/quotations
- ❖ Non-recognition of **penal income** in case of non-compliance of sanction terms

Recent RBI development - Ind AS Regime:

- ❖ RBI directions with respect to banks leading towards Ind AS regime
 - Report of RBI working group on Implementation of Ind AS by banks (September 8, 2015)
 - Discussion paper on review of Prudential norms for Classification, Valuation and Operations of Investment Portfolio of Commercial Banks (January 14, 2022)
 - Discussion paper on Expected Credit Loss Framework for Provisioning by Banks (January 16, 2023)
- ❖ Employee benefits – ESOPs accounting as per Black Scholes model (FY 2021-22)



THANK YOU



suresh@cnkindia.com