

Seminar on Concurrent Audit of banks

Income Recognition & Asset Classification (IRAC) Norms- NPAs

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Today's Agenda:

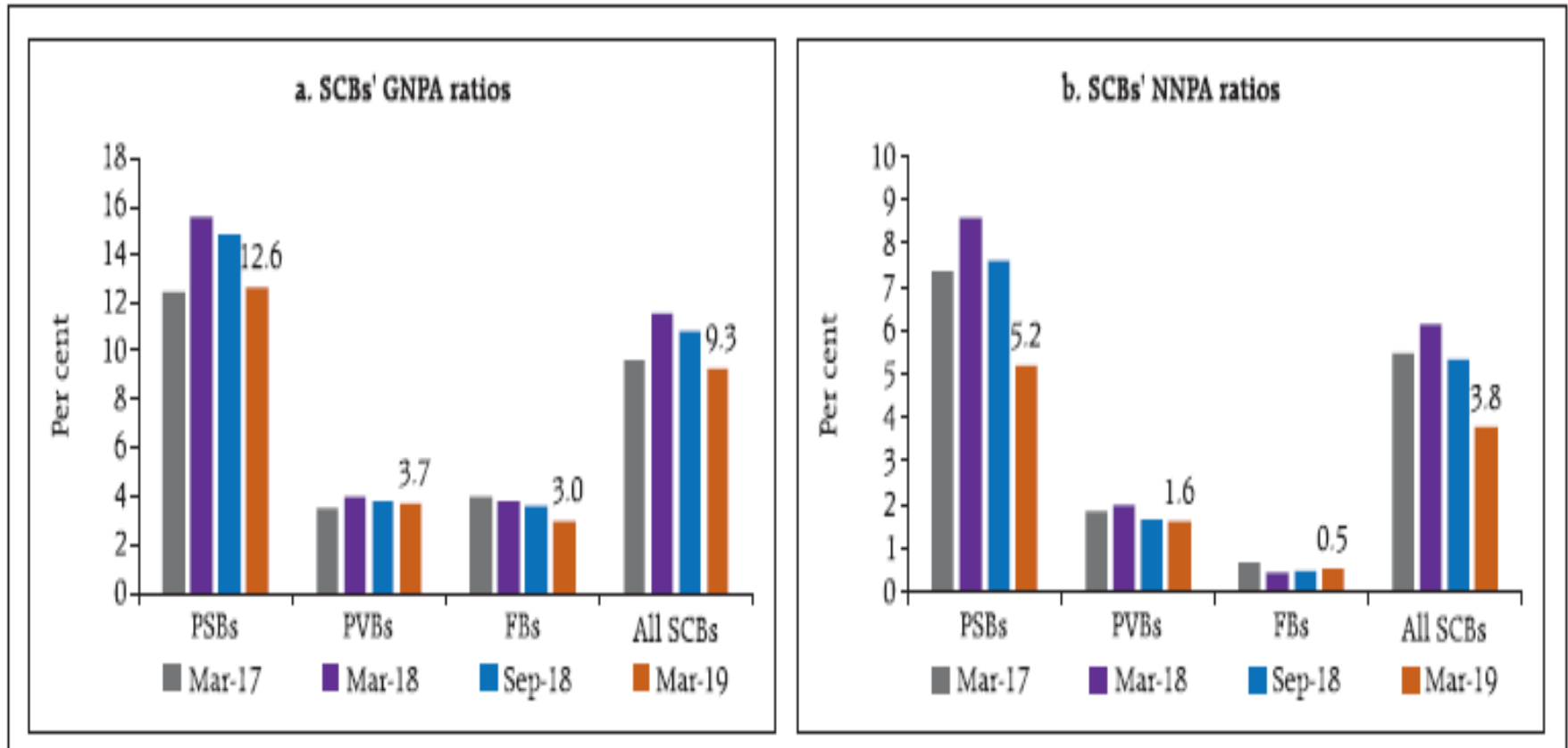
- ❑ Overview of Indian Banking Industry w.r.t. Non-Performing Assets
- ❑ Important Circulars/Notifications issued by Reserve Bank of India
- ❑ Identification of Loan Account as "NPA" as per IRAC Norms
- ❑ Issues in Classification of advances as NPA
- ❑ Income Recognition, Reversal, Upgradation etc.
- ❑ Few Practical issues from audit of NPA perspective
- ❑ Case Studies

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Overview of Indian Banking Industry w.r.t. NPA

Indian Banking Industry: Performance

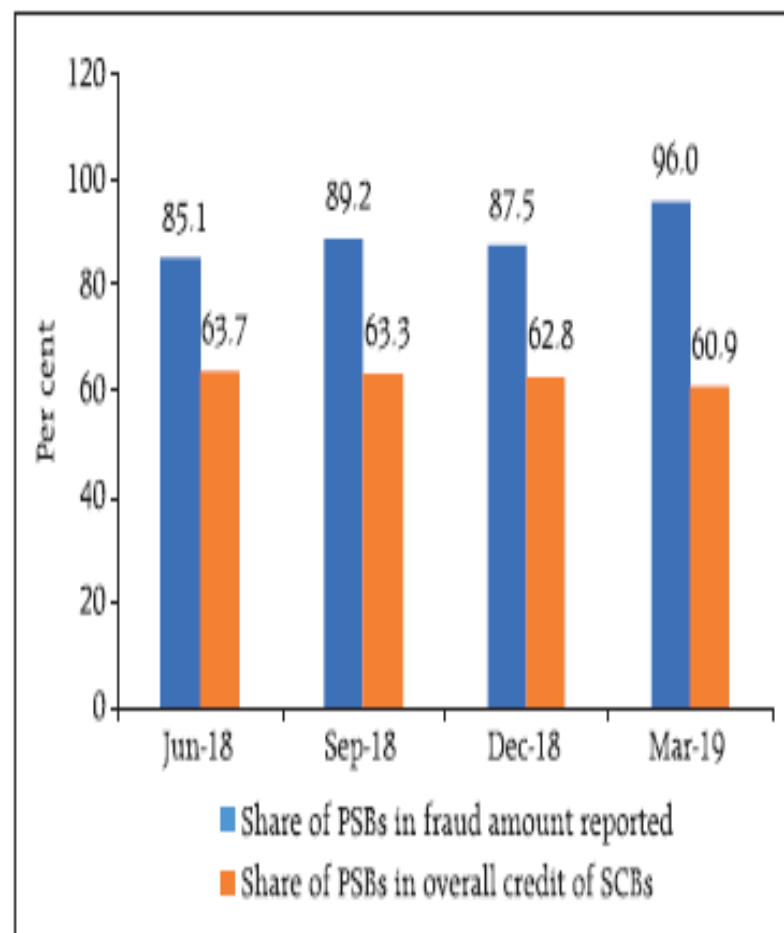


FSR- December 2019

Frauds in Banking Industry:

3.17 As on December 31, 2018, 204 borrowers who had been reported as fraudulent by one or more banks were not classified as such by other banks having exposure to the same borrower. One of the major areas of non-uniformity in processes pertains to identifying Red Flagged Accounts (RFA). The red flagging of accounts based on an indicative list of early warning signals is not uniform across banks. In several cases, banks are unable to confirm RFA tagged accounts as frauds or otherwise within the prescribed period of six months. As per CRILC data, at the end of March 31, 2019, the RFA reported by banks exceeded the stipulated six-month period in 176 cases. The reasons cited for delays in recognising frauds include delays in completing forensic audits or inconclusive findings of forensic audits. It is proposed to revise the Master Direction on Frauds in this regard and issue necessary guidance to banks.

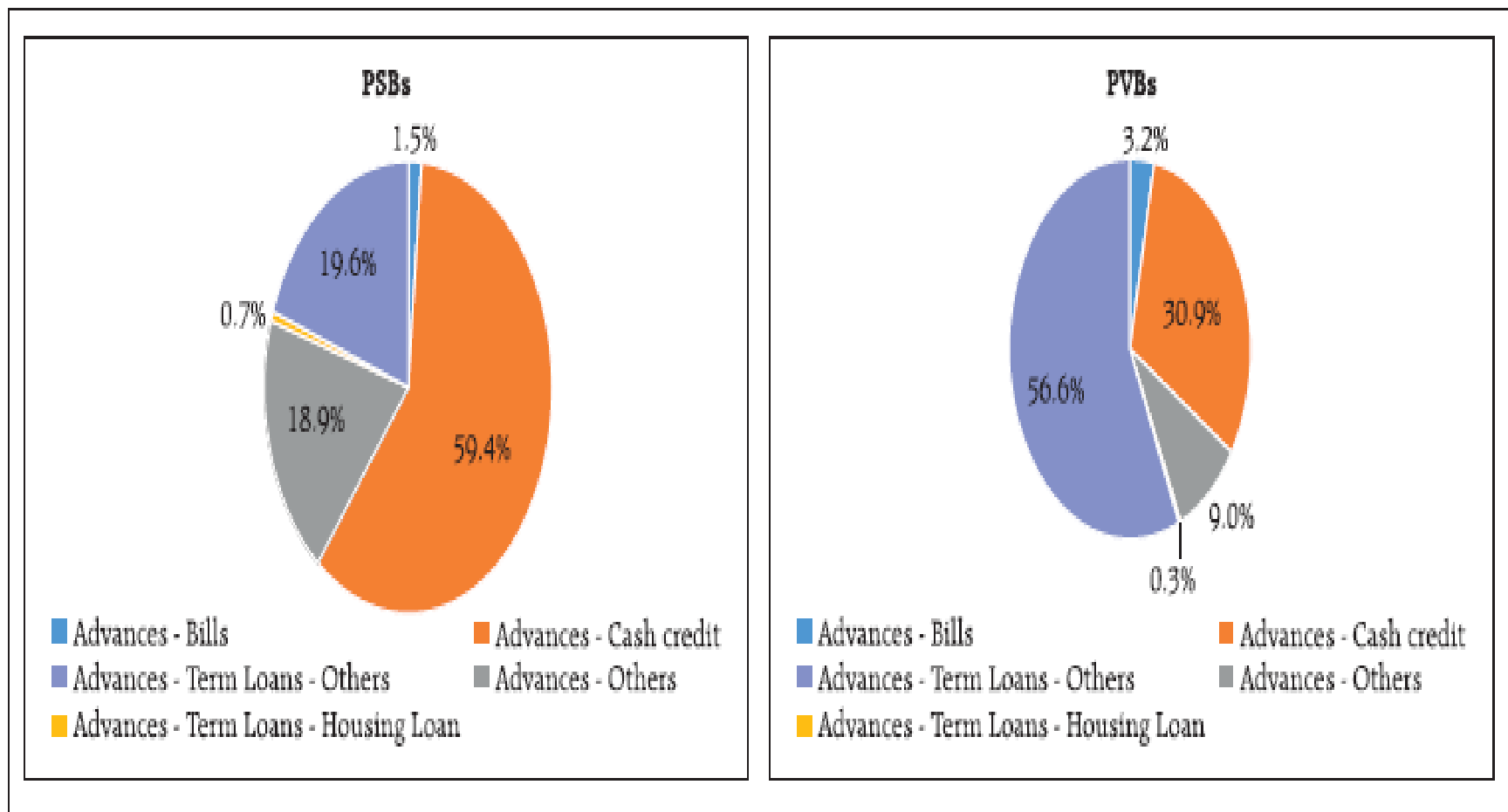
Chart 3.6: Relative share of PSBs in overall fraud amounts reported



Source: The Reserve Bank's Supervisory Returns and staff calculations.

Frauds in Banking Industry:

Chart 3.7: Advance related frauds reported in 2018-19



Source: The Reserve Bank's Supervisory Returns and staff calculations.

Important Circulars issued by RBI

Relevant Circulars applicable for Concurrent Audit:

□ September 18, 2019 Circular:

- Amendment to the guidelines issued on 16th July 2015 w.r.t. Concurrent Audit System;
- Review of effectiveness of concurrent Audit- evaluation of performance of concurrent auditor by Audit Committee;
- Minimum Areas covered under Concurrent Audit- specifically identified and listed; (13 areas identified by RBI)
- ***Loans & Advances including physical verification of securities, delegation of Powers for sanction, Security Charge Creation, end use verification of funds, monitoring of accounts with excess drawings, monitoring of projects, etc.***

Relevant Circulars applicable for FY 2018-19: (NPA)

❑ Master Circular/Master Directions:

- Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning (IRAC) dated July 1,2015
- Master Directions on Frauds – Classification and Reporting by commercial banks and select FI
- Master Direction-Priority Sector Lending-Targets and Classification (updated as on December 04, 2018)
- Master Direction - Know Your Customer (KYC) Direction, 2016 (Updated as on July 12, 2018)
- Master Direction - Lending to Micro, Small & Medium Enterprises (MSME) Sector (Updated as on April 25, 2018)

Relevant Circulars applicable for FY 2018-19: (NPA)

❑ Other Circular/Notifications:

- **Guidelines on Loan System for Delivery of Bank Credit-conversion of working capital into Term Loan- December 5, 2018**
- Priority Sector Lending – Targets and Classification dated March 1, 2018- Foreign Bank & Services Sector
- Relaxation to MSME borrower- Encouraging formalisation of MSME sector June 6,2018
- Priority Sector Lending – Targets and Classification June 19,2018- Housing Loan
- Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances dated January 1,2019 & February 22, 2019
- Intérêts Subvention Schème for MSMEs dated February 2,2019

Identification of Account as “NPA”

What is NPA?



Etc...

Role of Concurrent Auditor in NPA:

□ Account/Borrower Master Creation:

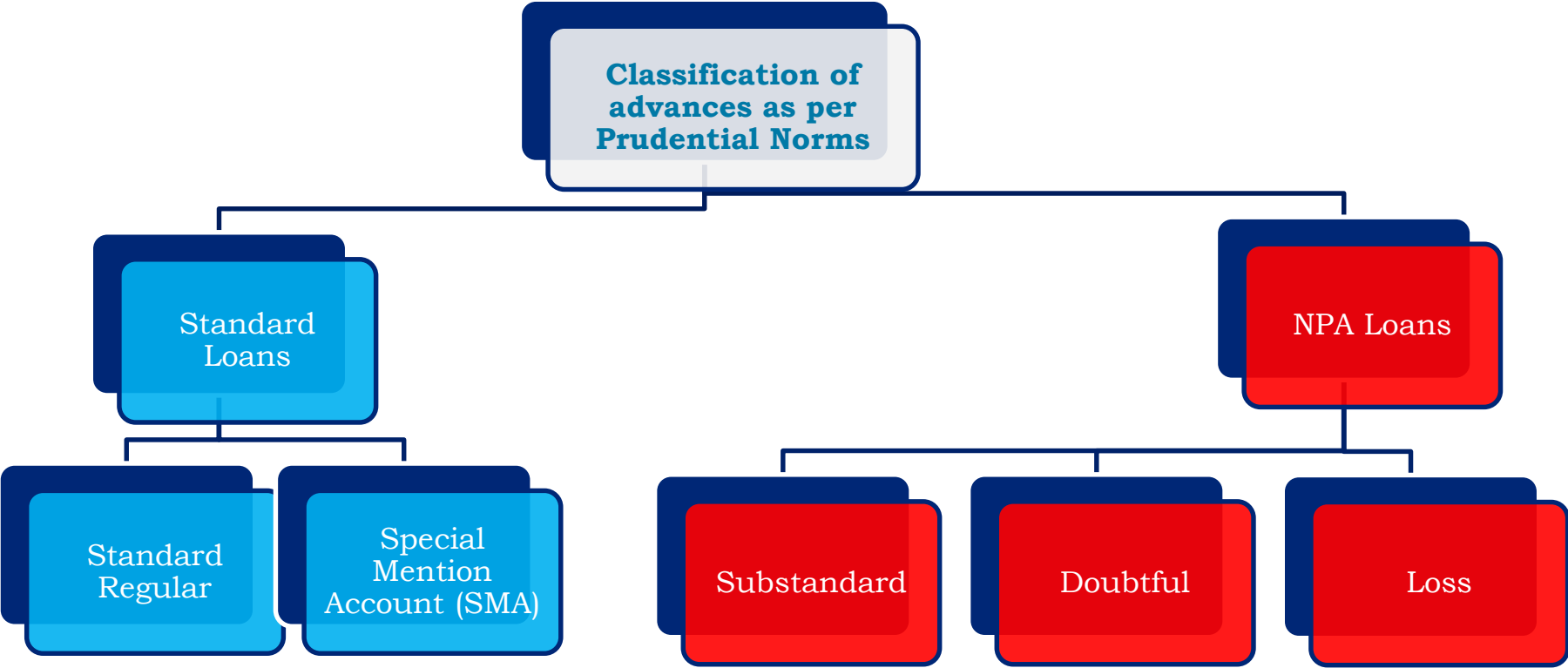
- Repayment schedule of borrower for demand of principal and interest is one of the important area for classification of account as NPA;
- Classification of the borrower into different category like MSME sector to identify the eligible borrower for any exemptions or benefits;
- Classification/tagging of the borrower under special category for lower/higher provision –Standard Asset provision;
- Updation/granting of drawing power based on stock statements-implication on NPA identification;
- Tagging of priority/Non-priority accounts in the systems

Role of Concurrent Auditor in NPA:

❑ Security details:

- Security details as per the sanction note and updating the same on frequent basis;
- Computation of bank's share in security in case of consortium advances;
- Consideration of correct value ("realisable value") as per the valuation report obtained by the branches;
- 100% verification of valuation for the Borrower in doubtful category

Types of Assets:



Types of Assets:

□ 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><i>“interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan”</i> (para 2.1.3 of IRAC Norms)- except MSME</p>
(B)	Overdraft/Cash Credit	<p><i>“the account remains ‘out of order as indicated in the IRAC Norms”-except MSME</i></p> <p><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

Criteria for classification- NPA

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

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

MCQ:

□ Mr. X has taken housing loan from ABC Bank of Rs. 50 Lakhs. Mr. X is required to serve the principal and interest on monthly basis. Mr. X monthly EMI is due on 28th of each month. Mr. X has paid the EMI upto June 2019 and has not paid any EMI after the said date. What will be the date of NPA for classification of Mr. X as NPA?

□ Ans:

- 29th October 2019;
- 29th July 2019;
- None of the above



MCQ:

- ❑ ABC Ltd. has taken a term loan facility with a moratorium of principal for 12 months, however interest need to be served monthly basis. On 30th of each month the due for the payment of interest is created in the system. The company has not paid the interest since month of October 2019.
- ❑ As a concurrent auditor as on 31st March 2019, whether the account of ABC Ltd. will be classified as NPA? If yes, please identify the date.



MCQ:



- XYZ LLP has a Cash credit with DBI Bank with a sanction limit of Rs. 1 crores and drawing power is computed based on the stock and book debt statements submitted by the borrower. The relevant details of XYZ LLP is as follows:

Months	Sept-19	Oct-19	Nov-19
DP	85	87	90
O/s Balance as on month end	84	87	89
Interest charged on 30 th of month	15	18	20
Amount received from the customer	14	17	-

- Whether XYZ LLP will be classified as NPA as on 31st December 2019?

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



MCQ:

- Mr. X has taken housing loan from ABC Bank of Rs. 50 Lakhs. Mr. X is required to serve the principal and interest on monthly basis. Mr. X monthly EMI is due on 28th of each month. Mr. X has paid the EMI upto June 2019 and has not paid any EMI after the said date. The NPA Date will be 29th October 2019. Prepare a full NPA life-cycle schedule for Mr. X



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

Issues in Classification of advances as NPA:

□ Borrower Account with temporary deficiencies:

- Classification on the basis of record of recovery and not due to existence of deficiencies temporary in nature
 - *DP computed on basis of old Stock statement (3 months)*
 - *Balance in account exceeds temporarily*
 - *Non-renewal of limit on the due date (within 180 days)*

□ Borrower wise Vs. Facility wise

- All the facility granted by a bank to a borrower will be classified as NPA and not particular facility which has become irregular
- All facilities should be linked to single unique code (Cust_ID) for each borrower and the classification should be done on the basis of such ID.

How to ensure the correctness of DP computation and Borrower wise classification of NPA?

Issues in Classification of advances as NPA:

□ Advances under consortium arrangement:

- Classification of accounts under these arrangements on the basis of record of recovery of the individual member bank
- Amount recovered by Lead banker not shared with other member is treated as “not serviced”

□ Accounts regularised near Balance Sheet date:

- Irregular accounts- certain credits/recovery before the balance sheet date

□ Advances against TD, NSC, KVP etc.

- Advances against these are not considered as NPA provided adequate margin is available with the Bank

~~▪ Gold ornaments, G-Sec~~

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)

Provisioning Norms: Valuation of Security

- ❑ **NPA with balance of INR 5 cr. & above**
 - Stock audit at annual interval by external agencies to enhance reliability on the stock valuations

- ❑ **NPA cases secured against immovable property:**
 - Valuation of such security once in 3 year by an independent valuer

- ❑ **Infrastructure Projects (PPP Model):**
 - Detailed guidance & conditions in the para 5.4(iii)(c) 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.**

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 in NPA Account:

□ *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.

Provision on Fraud Accounts:

- ❑ **Circular No. DBR.No.BP.BC.92/21.04.048/2015-16 dated April 18, 2016.**

- ❑ The bank have the option to make the provision over a period, **not exceeding four quarters**. The provision should start from the quarter in which the fraud has been detected.

- ❑ In case the above results in the full provisioning being made in **more than one financial year**, banks should debit 'other reserves' and credit the provision.

Practical Issues/Challenges:

- ❑ Divergence in NPA observed by RBI during the Inspections
- ❑ NPA classification in Nationalised Bank and Private Sector Bank
- ❑ Verification of parameters set in the system for classification of account as NPA (e.g. Repayment Schedule)
- ❑ Non reversal of **total** interest in account classified as NPA (Realised + Unrealised)
- ❑ Recognition of interest income in NPA A/c's
- ❑ Non availability of value of securities in case of NPA below Rs.5 Cr.
- ❑ Non submission of Stock Statement by small borrowers.

Practical Issues/Challenges:

- ❑ 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
- ❑ The Detailed Advances statement be tallied with GL, and individual accounts be checked for balances, security value, date of NPA, etc.
- ❑ 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

Audit Approach:

- ❑ 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

Disclosures from Balance Sheet:

❖ Movement of NPA:

Particulars	2016-17	2015-16
Balance at the beginning of Year	XXXX	XXXX
(+) Additions during the year/Transfer	XXXX	XXXX
(-) Reduction during the year		
- Upgradation	XXXX	XXXX
- Recoveries	XXXX	XXXX
- Write-off	XXXX	XXXX
Closing at the end of Year	XXXX	XXXX



Microsoft Excel
97-2003 Worksheet

Revenue Leakage:

❑ Processing Fees/Renewal Fees:

- Non charging of Processing fee;
- Non Charging of Processing fee for broken period;
- Non Charging of Processing fee on non fund based limits

❑ Commitment Fees/Other Charges:

- Non charging of commitment charges;
- Non Charging of annual lead bank charges

❑ Interest:

- Non Charging of interest in the account
- Reversal of penal interest for non renewal due to back dated history change
- Non Charging of interest in the account
- Reversal of penal interest for non renewal due to back dated history change

Thank You

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