SPECIAL ISSUES CONCERNING BANK AUDIT

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INTRODUCTION

The audit of Banks at the branch level or at Central office level the main thrust areas have been audit of advances, Investments and capital adequacy. Reserve Bank of India has issued prudential guidelines on Income recognition asset classification, Prudential guidelines on Investments and on capital adequacy (BASEL framework)

This paper deals with special issues and case studies in audit of Banks especially at branch level

CASE 1

Para 4.2.4 (i) of IRAC norm states:-

Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

A working capital borrowal account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

FACTS

i. The last stock statement submitted by the borrower was on 30-06-16. The next stock statement was submitted to the bank in the month of February 2017 as on 31-10-16. What is the status of the borrower as on March 31, 2017?

ii. What will be the status of the borrower if he is also having a term loan with 2 instalments and Interest debited on March 31, 2017 is in arrears?

OPINION

The borrower fails to submit the stock statements for more than 3 months, since his last stock statement submitted as on June 30, 2016, the cash credit account will become irregular on completion of three months and become NPA as on 30-12-2016.

View 1:

Since the stock statements are submitted in February relating to October 16 and his account will be upgraded in Feb 17 since the DP is based on stock statements, which is older by more than 3 months, which is irregular and if no further stock statements are provided the borrower account will become NPA in April based 90 days after irregularity.

View 2:

Once the account becomes NPA, it can be upgraded in case of cash credit, if the account is regular, which means the operations are within the DP and DP is arrived based on stock statements which is current. Since the stock submission is older by 3 months the account continues to be irregular and cannot be upgraded in February 2017.

When the above borrower is also having a Term Loan, even when there is no arrears the account will be treated as NPA. Again when the stock statements are submitted, the cash credit account is regularised but the borrower cannot be upgraded unless the arrears of instalment is also paid. This is because once an account has become NPA it can be upgraded only when there are no arrears(no overdue) and not when the arrears are less than 3 instalments.

CASE 2

Para 4.2.7 (ii) of IRAC norm states:-

If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.

FACTS

In some branches of the banks, if the devolved accounts are kept separately under other assets, without treating it as part of operating limit. What will the asset classification status under IRAC norms?

OPINION

If the devolved account is kept in other asset is not in order and it should be treated as part of the operating account. The auditors have to be more vigilant to verify the break up details and analyse the other assets to ensure that the devolvement is part of the operating account and all the provisions of IRAC will apply to the operating account for proper classification.

CASE 3

Para 4.2.7 (iii) of IRAC norm states:-

The bills discounted under LC favouring a borrower may not be classified as a Non-performing asset (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA.

FACTS

The borrower has discounted 2 export bills on 18-01-17 backed by LC which are due for payment on 02-04-2017 and 22-04-2017. The first bill was paid on the due date. The audit of the branch was completed on 09-04-2017. The facilities of the borrower have been classified as NPA on 10-12-16.

What is the asset classification status of the 2 bills discounted by the borrowers? What happens if the bill is not paid on presentation or not made good by the borrower immediately?

OPINION

As per Para 4.2.7(iii) of IRAC norms, the outstanding in both the Bills discounted **will not be treated as NPA,** if the payment on due date namely 02-04-2017 is paid on presentation by the counter party or by the LC issuing bank or immediately by the borrower. However if bill is not paid on the due date, then the first bill alone will be treated as NPA and the date of NPA will be 10-12-16 the same date as applicable to the borrower. The second bill will be classified as Standard.

CASE 4

Para 4.2.8 Advances under consortium arrangements states as under:-

Asset classification of accounts under consortium should be based on the **record of recovery of the individual member banks** and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

FACTS

The branch is a member of the consortium lending and the Lead banker states that the borrower is performing asset and the account is classified as Standard.

OPINION

As per para 4.2.8, the accounts are to be classified as NPA or not, is based on the record of recovery of member banks. Also it states in case the lead banker has received the credit and gives an express consent for transfer of their share of recovery.

AUDITORS PRESPECTIVE:

The branch auditors of member banker can rely on the express consent in deciding the classification of the asset; the branch auditor of lead banker has to ensure that express consent if any given to the member bankers are to be excluded in calculating the record of recovery. The Branch MR should include that no express consent is given to other banks.

CASE 5

The branch has restructured the advance and has sanctioned a Funded Interest Term Loan (FITL) out of unrealised interest which is kept in Interest Suspense account. The provision was calculated by the system as 100% of outstanding FITL.

Is this provision of 100% is in order, if not why?

OPINION

As per para 4.2.15.6 (iii)(a) of IRAC norms is as under:

Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

It clearly shows that only when Interest is recogonised as Income earlier is converted into FITL should be provided for 100% otherwise the provision should be as per IRAC asset classification.

Auditors should also ensure that excess provision is also not provided since it will reduce Net NPA.

CASE 6

The recovery in NPA accounts was received on by which all the arrears in the account were settled and the branch has upgraded the account as standard. As auditors can we accept the same on the face of it?

OPINION

As per Para 4.2.6 of IRAC norms as stated below:

The asset classification of borrowal accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors/Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

As per the above unless there are genuine credits with revival of business it would be deemed to be NPA

CASE 7

The facilities of the borrower has been restructured under CDR mechanism applying special regulatory treatment for restructuring. The Basic data are as under:

1. Date of reference to CDR & IRAC status on that date	19-Mar-12 Standard
3. Date of CDR order & IRAC status on that date	19-Oct-12 Substandard
4. Roll back due to special regulatory treatment of IRAC norms	Standard on 14-Feb-13
5. Specified period ends on	31-Dec-15
6. Current date of default Date of NPA	31-Dec-13 31-May-12

PRESENT IRAC STATUS

The advances were rolled back to standard based on the special regulatory treatment as per para 15 of IRAC norms. Due to non-payment of dues the account has become NPA on 31-Dec-13

According to the Bank, the date of NPA is only Dec'13 and need not be rolled back to pre-restructuring terms as they are covered by para 12.2.4 of IRAC which reads as follows:-

"In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule"

As per this para, the bank argues that since the specified period is not yet complete, the date of NPA need not be worked out based on pre-restructuring terms.

CORRECT POSITION AS PER IRAC

Para 17 deals with "General Principles and Prudential Norms for Restructured Advances". Para 20 deals with "Special Regulatory Treatment for Asset Classification" for restructured assets.

The opening paragraph of Para 17 clearly states that it is applicable to all advances, including the borrowers who are eligible for special regulatory treatment for asset classification as specified in Para 20.

While Para 17 gives the restructuring guidelines applicable to all restructured advances, Para 20 only provides an exception to this process. If certain conditions as per Para 17.2 are fulfilled a standard asset will retain the same category and will not get downgraded. Para 20.1 clearly states that it only modifies para 17 to this extent and para 20 has to be complied in addition to adherence to prudential framework given in para 17 (Para 20.2.2)

In case of a default only para 17 has to be referred for consequences. Para 17.2.4 is clearly not applicable and quoted out of context as it applies only in cases where an account which is upgraded after the specified period is again downgraded after default. In our case the account is upgraded ab-initio and not after the end of specified period.

Under the framework for restructuring given in para 17, an account asset status undergoes the following changes

Stage 1: Immediately on restructuring, all standard advances are treated as sub-standard (17.2.1). All non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule (17.2.2)

Stage 2: If satisfactory performance is evidenced during “Specified period”, Standard accounts downgraded as NPA and NPA accounts retained in the same category on restructuring can be upgraded to standard category (17.2.3)

Stage 3: However, after the specified period, if satisfactory performance is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule. (17.2.4)

So a standard account gets downgraded immediately on restructuring and continues to slip further to D-1/ D-2 / D-3 till the end of specified period. If repayment is on schedule based on restructured terms, it will get upgraded to standard. Even after such upgradation, if satisfactory performance is not evidenced after the specified period, it will get downgraded based on pre-restructuring terms.

Normally, where an account which is standard, it would have been classified as sub-standard immediately on restructuring. Then it deteriorates till completion of specified period. If it defaults during specified period, it would continue to deteriorate and will not be upgraded on completion of specified period. If it upgraded after specified period based on satisfactory performance and defaults after the specified period it will be downgraded based on pre-restructuring terms (17.2.4). In either case the account follows only the pre-restructuring schedule for classification and not the restructured terms.

The rationale is that if the account is unable to comply with restructuring terms it reverts back to the original terms for classification. In our case, the account did not go through stage 1 and 2 before up-gradation. It was classified as standard immediately on compliance of conditions given in Para 20. Effectively it has defaulted on restructured terms and stands on the same position of a defaulted account as provided in Para 12 and explained in earlier paragraph.

Hence, the restructuring terms have not been complied with and have to be dealt with as per pre-restructuring terms. The date of NPA will be 31st May 2012 which is the original date of NPA. If current date (31.12.13) is taken as the date of NPA, it will create an advantageous position compared to a similar account which was downgraded immediately upon restructuring. Default at any point of time in such a case will entail slippage based on pre-restructuring terms while a similar default will only make it into a sub-standard asset based on post-restructuring terms. Such an interpretation will lead to differential treatment for similar advances.

OTHER ISSUES

APPROPRIATION POLICY FOR RECOVERY

The Banks adopts a system of recovery in Standard assets to appropriation of Interest first and Principal next. However this system is not consistently followed whenever the arrears are more than 2 months. This methodology leads to postponing identification of NPA.

In respect of NPA CC/OD Accounts the interest recovery is not made and the credits are adjusted against the irregularities. This is against revenue recognition policy and also non recognition of Interest.