Identification of NPA in Bank Audit

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'System driven identification of bad loans has not been found robust enough in certain banks', a top RBI official once said. This concern of RBI itself , imposes additional responsibility on all the Statutory Auditors of Bank.

Statutory Auditors cannot just depend on the accounts identified by the system. The auditor needs to go extra mile to identify the hidden NPA accounts.

NPA DEFINED

The asset classification is broadly guided by the RBI's Master Circular dated July 1st,2015 which deals with 'Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.'

Accordingly a non performing asset (NPA) is a loan or an advance where;

i. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii. the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC),

iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,

vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006.

vii. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

In case of interest payments, banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

Broadly speaking, classification of assets into above categories should be done taking into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for realization of dues.

RBI has constantly asked the Banks to establish appropriate internal systems (including technology enabled processes) for proper and timely identification of NPAs, especially in respect of high value accounts. The banks may fix a minimum cut off point to decide what would constitute a high value account depending upon their respective business levels. The cutoff point should be valid for the entire accounting year. Responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines

Inspite of these well placed RBI guidelines and setting up of the required parameters in the core banking solutions, there remain many accounts which though required to be classified as NPAs but on account of reasons best known to the Management of the Branch, are shown as Standard. Hence all the Statutory Auditors are required to be diligent while certifying the asset classification of the Branch.

IDENTIFICATION EXERCISE FOR BANK NPA

The Statutory Auditors may consider the following exercise to dig out the hidden accounts which are shown as Standard but are required to be classified as NPAs.

1. Verification of Concurrent Audit / Internal Audit Report

The first thing an auditor should do is to go through the Concurrent Audit/ Internal Audit reports. These reports will give the real insight of the functioning of the Branch. This will also give a fair idea of those loan accounts which are chronic, frequently irregular, overdrawn and where terms and condition of sanction are not complied with. From the list of such accounts an exercise can be made to ascertain new NPAs accounts.

2. Screening of accounts

Screening of accounts can give a fair idea of correct classification of advances of a Branch. Payment of interest at the end of each month may prevent a cash credit account from being classified as NPA account, but if the credits in the account are not commensurate with the limits sanctioned, then this may indicate diversion of funds , closure of business or a considerable fall in the business activity of the borrower entity. For e.g. if a borrower firm is enjoying a c.c. limit of Rs.100 lacs, then the credits in the accounts through sale proceeds should ideally be near to Rs.500 lacs (Working Capital limit being 20% of the turnover). If the credits are low then it could be a sign of stress and in that case an auditor should thoroughly look into the account and other details.

In respect of irregular term loan accounts, the source of credit at the end of the month should be verified to ascertain that the credits are coming out of genuine sources.

Similarly high value debit & credit transactions are also required to be seen as suspicious as the transactions may not reflect the correct value of sale & purchase.

3. Coding of accounts

Identification of NPAs by the system itself solely depends on the parameters set in the system. In respect of agriculture advances the account is classified as NPA if the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops. But housing loans sanctioned for rural houses cannot be treated as agriculture loans. But while opening the loan accounts in the computer system , if coding of such housing loans is erroneously done as the agriculture loans then the system can never identify such loans as NPAs on three continuous defaults in repayment of interest/ installments. It will wait for a default of 12 months to recognize these accounts as NPAs.

4. Restructuring of accounts

Restructuring of accounts with out obtaining application from the borrower entity, without executing additional loan documents and with out ascertaining the future viability and cash generating capability of business may lead to classification of these accounts as NPAs. Accounts where restructuring is frequently done are also required to be classified as NPAs.

Special care is to be taken in those accounts where change in repayment schedule in the computer system is done without actually restructuring the account . Core banking solution will never identify such accounts as NPAs.

5.Non achievement of DCCO

For all projects financed by the banks , the 'Date of Completion' and the 'Date of Commencement of Commercial Operations' (DCCO), of the project is clearly spelt out at the time of financial closure of the project and the same is formally documented. These is also documented in the appraisal note by the bank during sanction of the loan.

The statutory auditors should examine the DCCO in respect of term loan accounts . Non achievement of DCCO may lead to classification of the account as NPA.

6.Pending Review/Renewals

Statutory Auditors should generate the date of renewals from the core banking software. Where limit sanctioned is over Rs. 25.00 lacs , in such cases audited financials are required. A list of those borrower accounts should be prepared where audited balance sheet is not furnished. Renewal of limit without obtaining audited financials is not desirable.

Regular and ad hoc credit limits need to be reviewed/ regularized not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA.

7. Loss of Primary Security

In respect of cash credit accounts it is stipulated to submit stock and book debts statement monthly/ quarterly. These statements are required to ascertain the availability of primary security at all the times. The drawing power is drawn based on the availability of these securities. Therefore in respect of cc accounts drawing limits are set to the extent of limit sanctioned or drawing power available, which ever is less. Hence the sanction limit can never be treated as drawing power.

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.

8.Debit & Credit Entries of same value

In respect of Cash Credit / Overdraft accounts, if the account remains "out of order" it is to be classified as NPA. As per RBI guidelines, the account should be treated as "out of order" if the outstanding balance remains continuously in excess of sanctioned limit / drawing power for 90 days. In cases where outstanding balance 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 credits are not enough to cover the interest debited during the same period, these accounts should be treated as NPA.

It is observed that taking advantage of the above provisions, few superfluous Credit entries are passed in Cash Credit / Overdrafts accounts and the same are reversed within next 3-4 days. On passing such entry, the system appropriates the amount towards interest debited, showing no arrears of interest as per system and while reversing that entry it becomes part of the principal, showing the account as temporarily overdrawn, on the basis of which the account is not shown as NPA.

To locate such entries, it is necessary to view the statement of account and see whether there are any Debit and Credit entries of the same amount within a period of 3-4 days, and if so, the vouchers pertaining to such transactions can be verified to find the genuineness of the entries.

9.TOD in current and saving account

Granting of TODs in current / saving account at the end of the month and then transferring funds from there to the overdue loan accounts is a very prevalent practice amongst the bankers. So any debit balance in current / saving account and TODs granted at the end of the month may be treated with extra care. If the funds are transferred from these accounts to overdue loan accounts , then such loan accounts are required to be classified as NPAs.

10.EDUCATION LOANS/ HOME LOANS

The recovery trend in education loans is not very encouraging. There is steep rise of NPA accounts in this segment. There is common practice of restructuring these accounts to save their slippage to NPA category. Quite often restructuring is done without ascertaining the employment particulars of the borrower. Any restructuring done without appropriate justification and without documentation should not stop the auditor in classifying these accounts as NPAs.

Similarly home loans accounts, which are over 10 years old & where principal outstanding is still over 50% of the loan amount sanctioned, such accounts may be screened carefully.

OTHER POINTS FOR CONSIDERATION IN ASSET CLASSIFICATION BY BANKS :

Following points can also be useful to a Statutory Auditor while certifying the assets classification :

♣ Availability of security / net worth of borrower/ guarantor

The availability of security or net worth of borrower/ guarantor should not be taken into account for the purpose of treating an advance as NPA .

♣ Accounts with temporary deficiencies

The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc.

♣ Accounts regularized near about the balance sheet date

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 regularization of the account to eliminate doubts on their performing status.

♣ Asset Classification to be borrower-wise and not facility-wise

Where a borrower entity is enjoying different kind of credit facilities, then asset classification is to be done borrower wise and not facility wise. Therefore, if one account of the borrower is classified as NPA, all the facilities granted by a bank to a borrower will have to be treated as NPA and not the particular facility or part thereof which has become irregular.

♣ Advances under consortium arrangements

Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks. 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.

♣ Advances against Term Deposits, NSCs, KVPs/IVPs, etc.

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. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

Reserve Bank of India & SEBI have issued various directions for correct asset classification and compliance of provisioning norms from time to time. Hence the responsibility of Auditors has increased manifold as the system driven identification of NPA accounts is not full proof. Attempt should be made that no deviations are observed in asset classification, post completion of Statutory Audit.

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