

Seminar on Bank Branch Audit

Income Recognition & Asset Classification (IRAC) Norms- NPAs

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Today's Agenda:

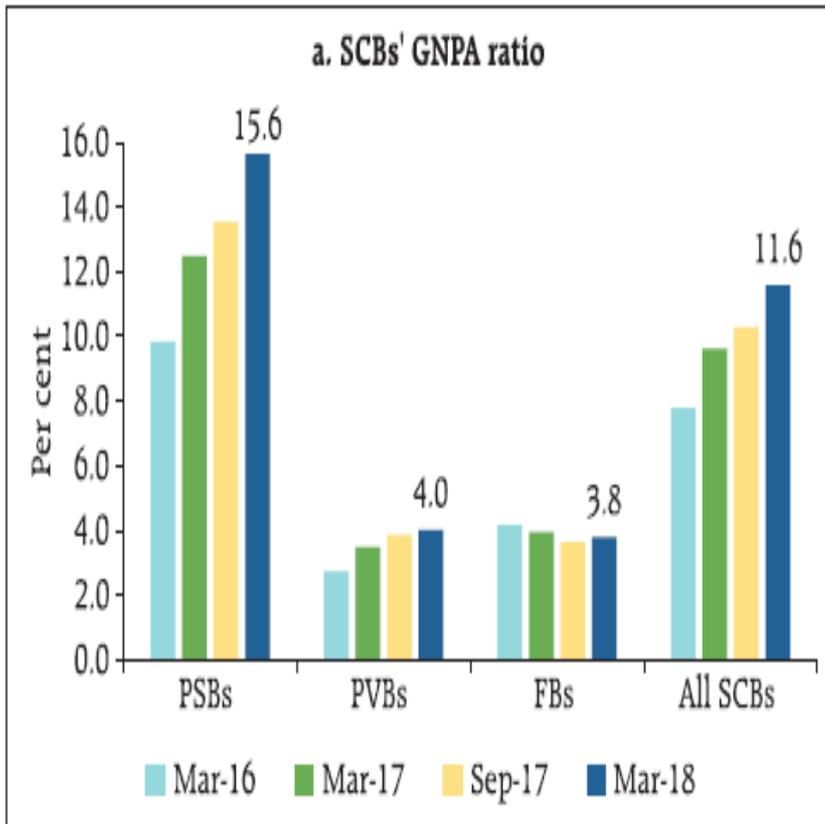
- ❑ Overview of Indian Banking Industry w.r.t. Non-Performing Assets
- ❑ Important Circulars/Notifications issued by Reserve Bank of India
- ❑ Identification of Loan Account as "NPA" as per IRAC Norms
- ❑ Issues in Classification of advances as NPA
- ❑ Income Recognition, Reversal, Upgradation etc.
-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

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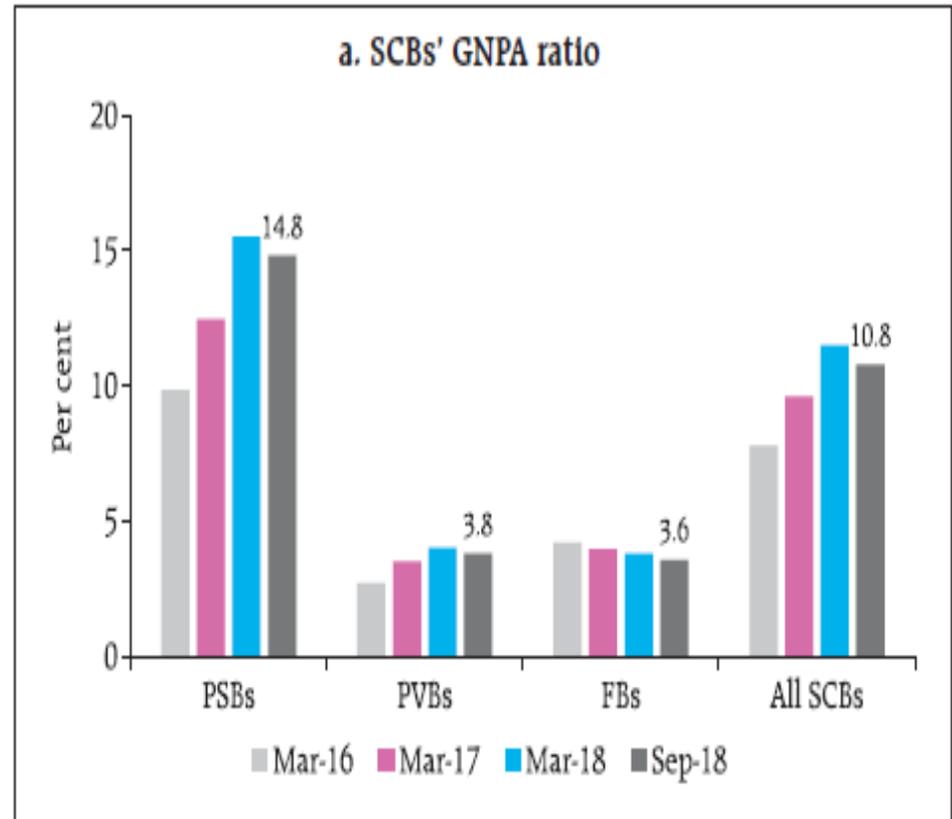
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Overview of Indian Banking Industry w.r.t. NPA

Indian Banking Industry: Performance

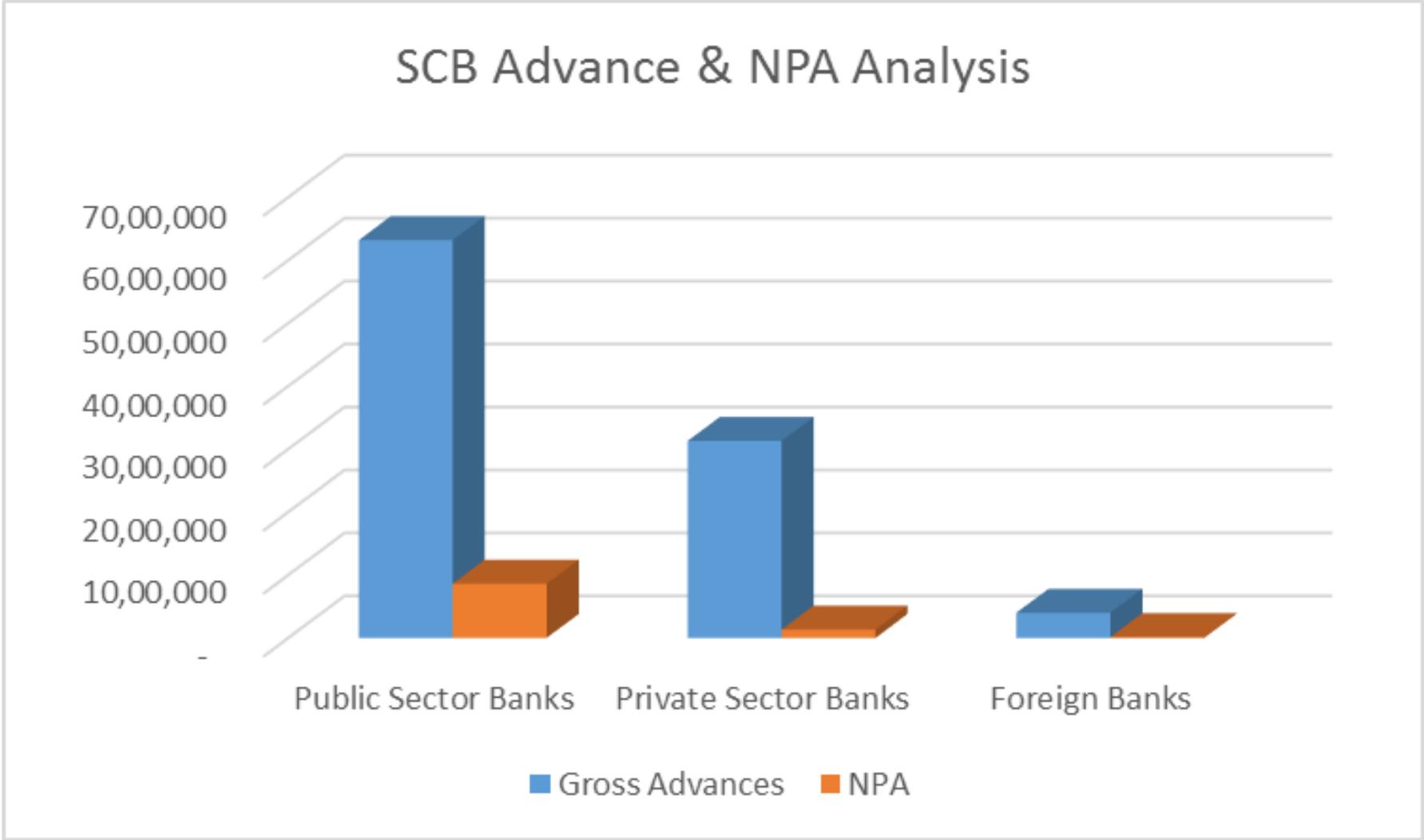


FSR- June 2018



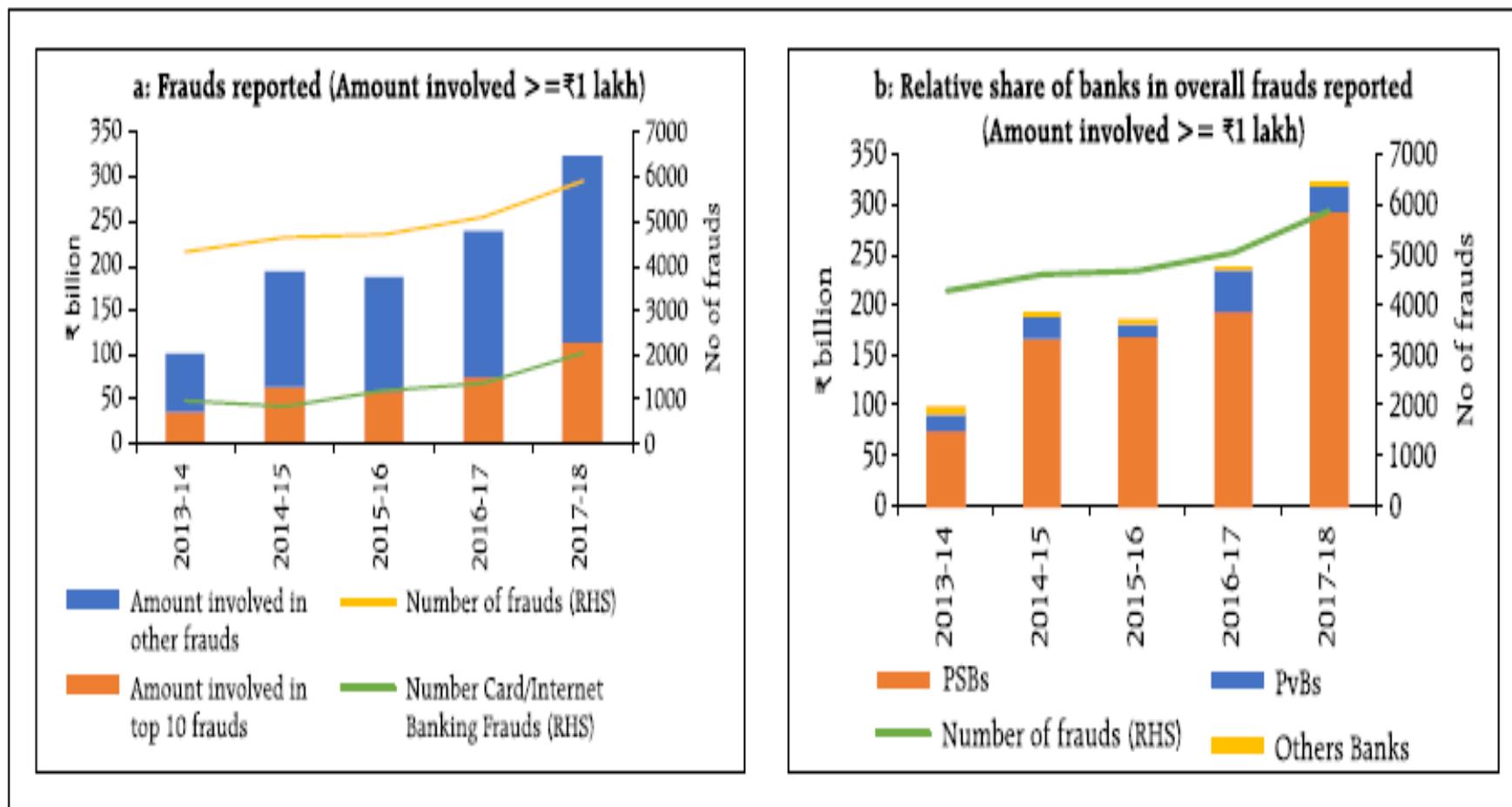
FSR- December 2018

Performance: PSB vs. PVB vs. FB- 31.12.2018



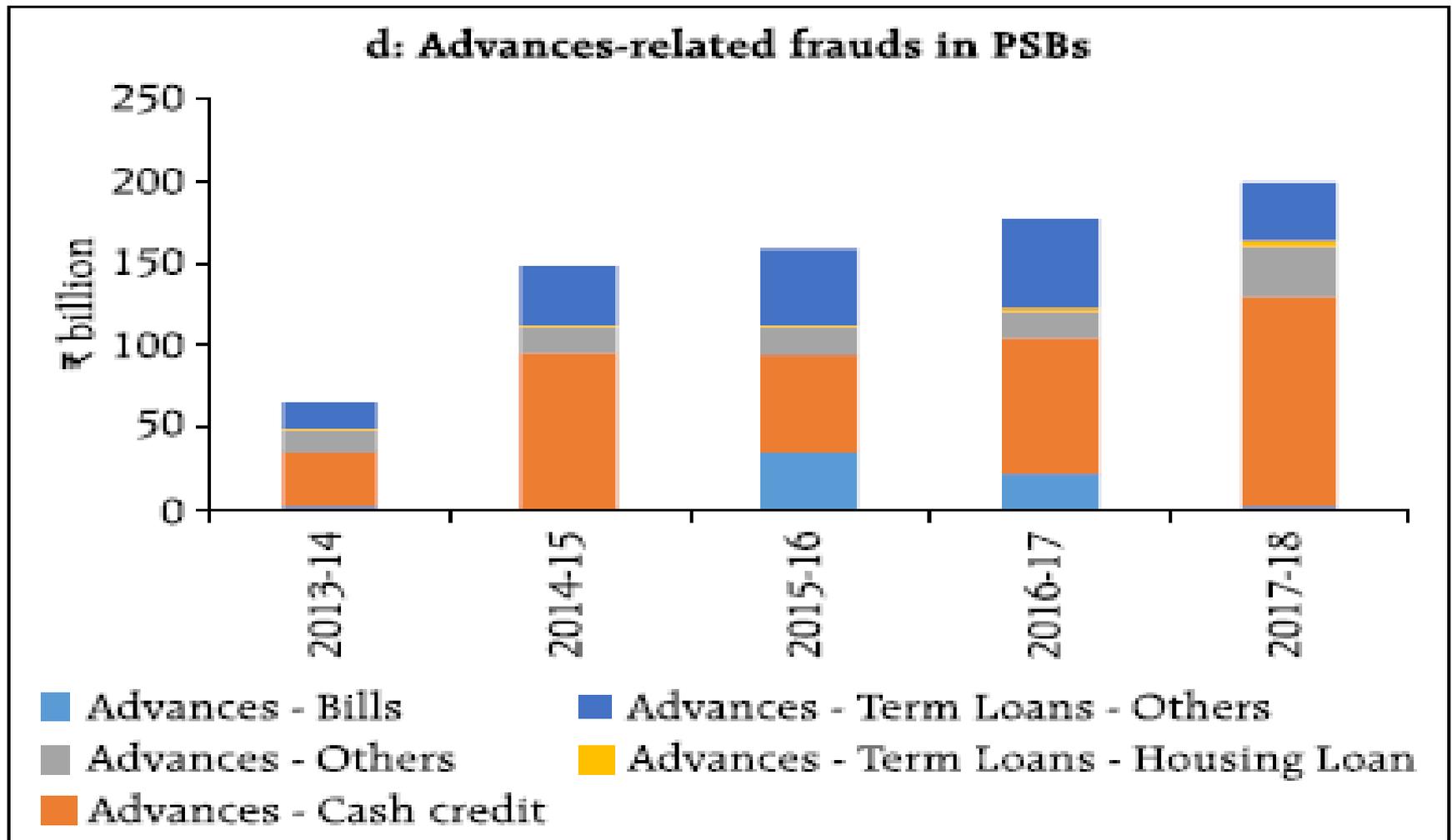
Frauds in Banking Industry:

Chart 3.1: Frauds in the banking sector



Source: RBI.

Frauds in Banking Industry:



Important Circulars issued by RBI

Relevant Circulars applicable for FY 2018-19:

❑ 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:

❑ Other Circular/Notifications:

- **Enforcement action framework in respect of statutory auditors for the lapses in the statutory audit of commercial banks dated June 29, 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

Enforcement action framework for SA:

□ Types of lapses to be considered: (Illustrative List)

- Lapses in **carrying out audit assignments** resulting in misstatement of a bank's financial statements
- **Wrong certifications** given by the auditors with respect to list of certifications as advised by the RBI to banks;
- **Wrong information** given in the Long Form Audit Report (LFAR);
- Issues related to **misconduct by auditors** in respect of their bank audit assignments; and
- **Any other violations/lapses** vis-à-vis the RBI's directions/guidelines regarding the role and responsibilities of the SAs in relation to banks.

Additional Certifications for FY 2018-19:

□ Additional Certification requirements from Statutory Auditors from FY 2018-19

- SCAs may be advised to verify and certify, at the corporate level, the bank's computation of ANBC – **SCA**
- SCAs may be advised to verify and certify that at the banks' branches, the loans are classified under Priority Sector across various categories strictly as per their eligibility- **SCA/SBA**
- SCAs may be advised to verify and certify whether calculation of Marginal Cost of Funds based Lending Rate (MCLR)- **SCA**
- SCAs may be advised to verify and certify whether the penalty levied by banks for non-maintenance of minimum balance in savings accounts is in accordance with RBI instructions- **SCA/SBA**

Additional Certifications for FY 2018-19:

□ Additional Certification requirements from Statutory Auditors from FY 2018-19

- SCAs to certify that the bank is in compliance with the Cyber Security Framework and the circulars issued by RBI and the bank has attended to all the advisories/alerts issued by the RBI effectively and the bank has attended to all the advisories/alerts effectively – **SCA**
- Whether the bank is using the Central Fraud Registry (CFR) while preparing the credit appraisal in respect of a prospective customer for granting new facilities and at the time of renewal of facilities? **SCA/SBA**
- Whether Red Flagged Account (RFAs) are being monitored and investigated by the bank? Whether the RFA status is changed, within six months, to fraud or otherwise?– **SCA**

MSME Borrower for FY 2018-19:

Type of Borrower	Relaxation/Benefit available
a) GST Registered MSME Borrower	<ul style="list-style-type: none">➤ Relaxation for 180 days up to 1st May 2019;➤ One Time Restructuring of Loans w/o classifying the same as NPA;➤ Interest Subvention @ 2% on additional loan facility after 2nd November 2018
b) Non-GST Registered MSME borrower	<ul style="list-style-type: none">➤ Relaxation for 180 days up to 1st January 2019;➤ No Restructuring of loans- if restructured will be classified as NPA➤ No Interest subvention for these borrowers

Identification of Account as “NPA”

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

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



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~~

Special Relaxation due to GST Implementation:

- ❑ RBI Circular dated **February 07,2018** provides relaxation to borrowers classified as Micro, Small and Medium enterprises subject to following condition:
 - Borrower registered under the GST regime as on January 31,2018
 - Aggregate exposure (including Non-Fund) of banks and NBFC not exceeding INR 25 cr.
 - Borrowers account was standard as on August 31,2017.
 - Amount overdue as on September 1,2017 and payments due between September 1,2017 and January 31,2018 are paid within 180 days from the due date.

- ❑ Provision of 5% shall be made by Banks against these exposure not classified as NPA

- ❑ Additional time is only for the classification only and not for income recognition.

MSME Relaxation June 6, 2018:

- ❑ As per February 7, 2018 circular the RBI gave certain relaxation to the bank to classify their exposure to GST-registered MSME borrowers.
- ❑ The circular revises the position of RBI and extend the relaxation given by the above circular to the Non GST- registered MSME borrowers as well.
- ❑ Non-GST registered MSME borrower- from January 1, 2019 onwards shall immediately revert to the extant IRAC norms.
- ❑ GST-registered MSMEs from January 1, 2019 onwards, the 180 days past due criterion is aligned to the extant IRAC norms in a phased manner as specified in the above circular.
- ❑ Other terms and condition of the circular remains the same- income reversal and provision of 5% on outstanding advances

MSME –One time Restructuring :

- RBI Circular dated **January 1, 2019** provides relaxation for one-time restructuring to borrowers classified as Micro, Small and Medium enterprises subject to following condition:
 - Aggregate exposure (including Non-Fund) of banks and NBFC not exceeding INR 25 cr. as on January 1, 2019.
 - Borrower is in default but is a standard as on January 1, 2019 and standard till implementation of restructuring.
 - The restructuring of the borrower account is implemented on or before March 31, 2020.
 - GST-registered on the date of implementation of the restructuring. this condition will not apply to MSMEs that are exempt from GST-registration

- Provision of 5% in addition to the provision already held shall be made by Banks.

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.

□ *Recoveries after Balance Sheet date:*

- No clear guidelines by the regulator- no objections as well in any 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

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

Happy Season of Branch Auditing

Thank You

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