

# *Seminar on Bank Branch Audit*

## *Income Recognition & Asset Classification (IRAC) Norms- NPAs*

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# Today's Agenda:

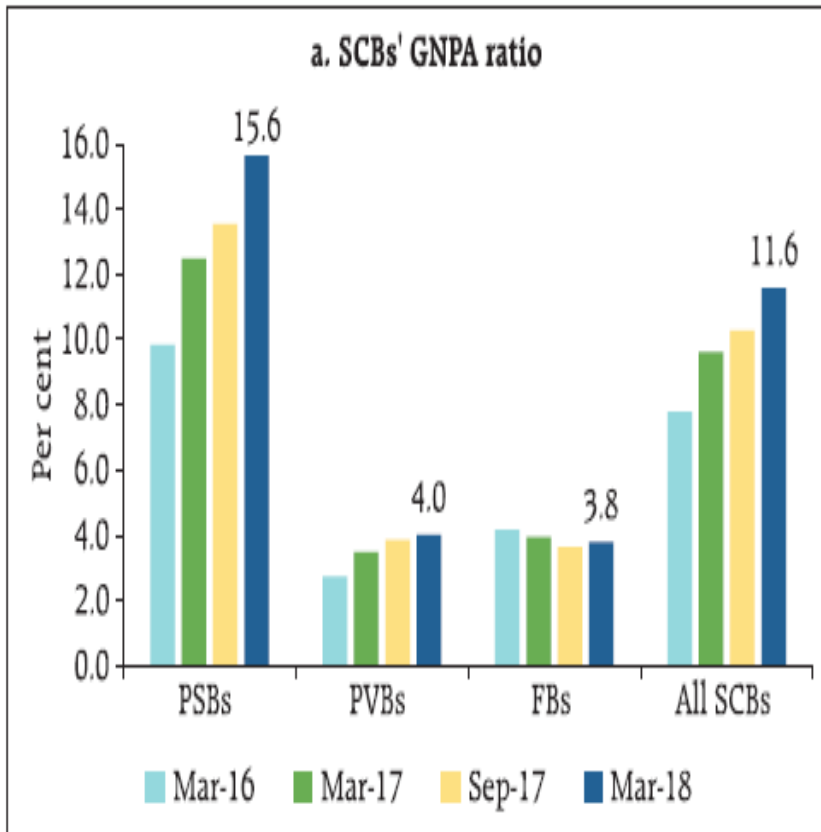
- ❑ Overview of Indian Banking Industry w.r.t. Non-Performing Assets
- ❑ Important Circulars/Notifications issued by Reserve Bank of India
- ❑ Identification of Loan Account as "NPA" as per IRAC Norms
- ❑ Issues in Classification of advances as NPA
- ❑ Income Recognition, Reversal, Upgradation etc.
-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

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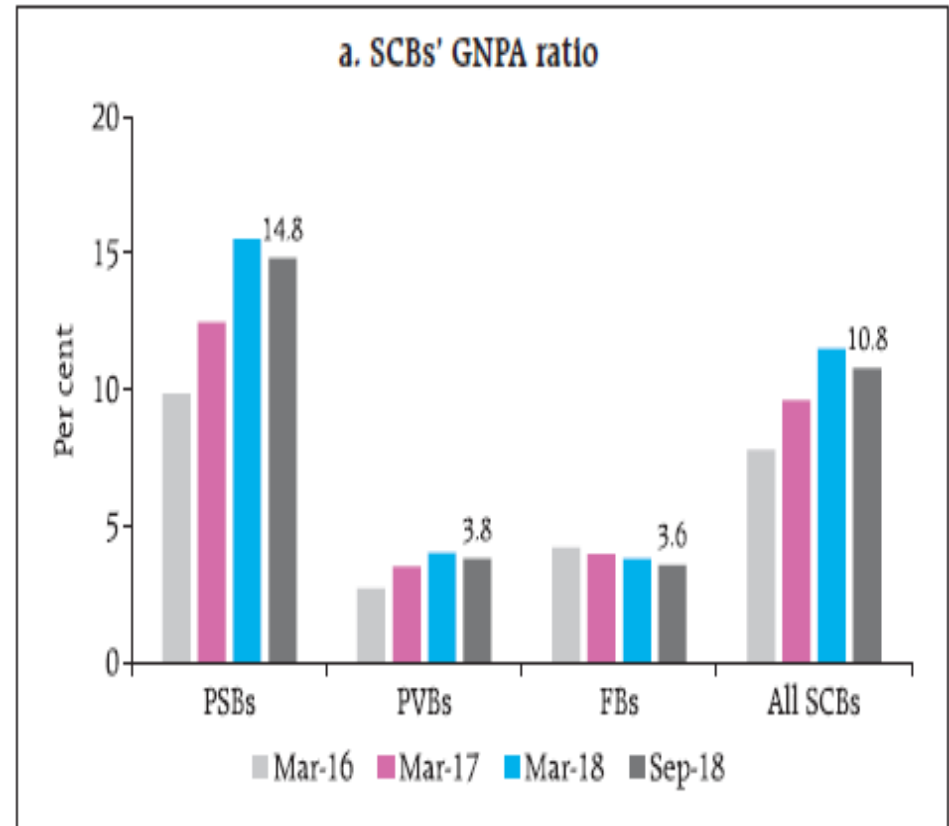
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# Overview of Indian Banking Industry w.r.t. NPA

# Indian Banking Industry: Performance

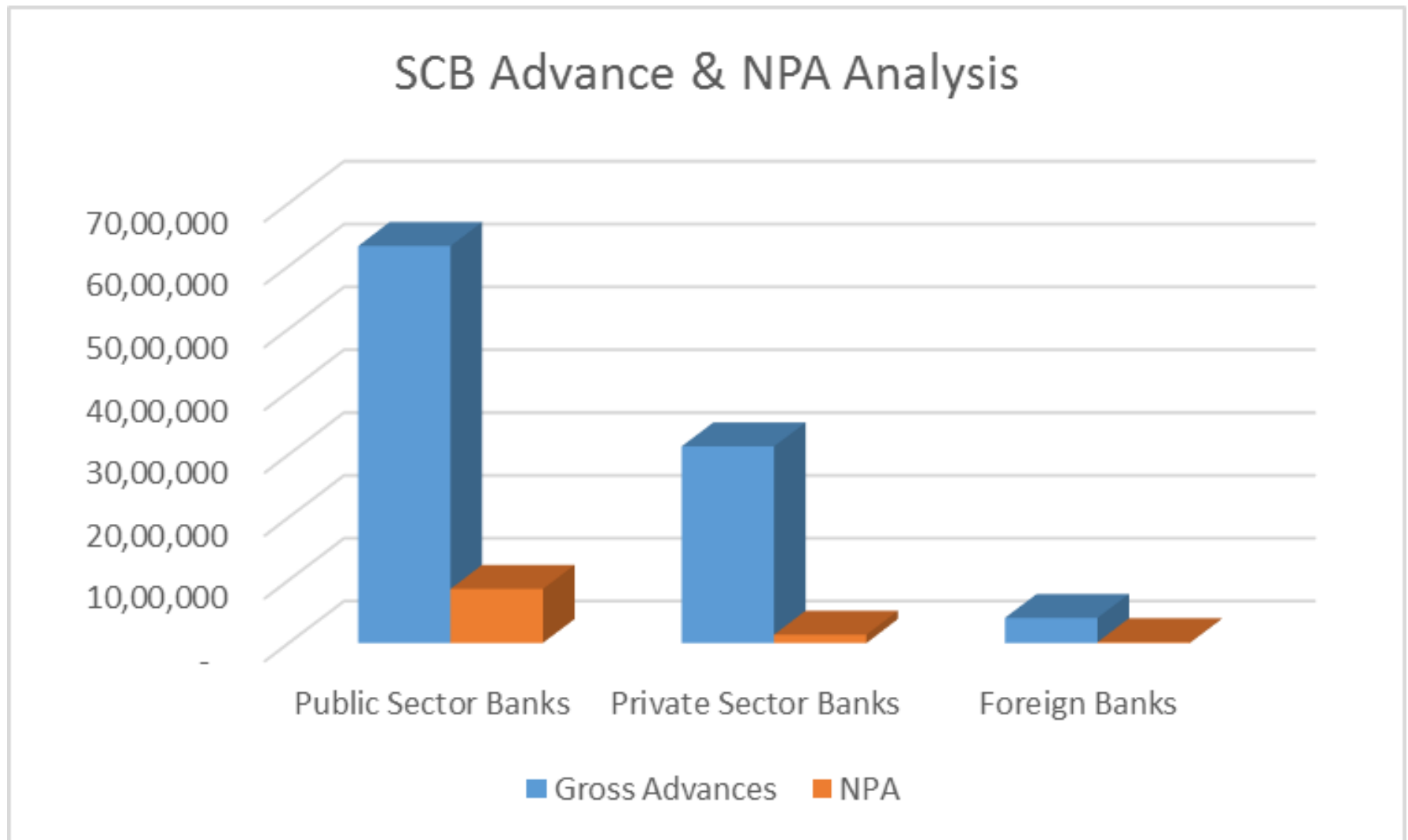


FSR- June 2018



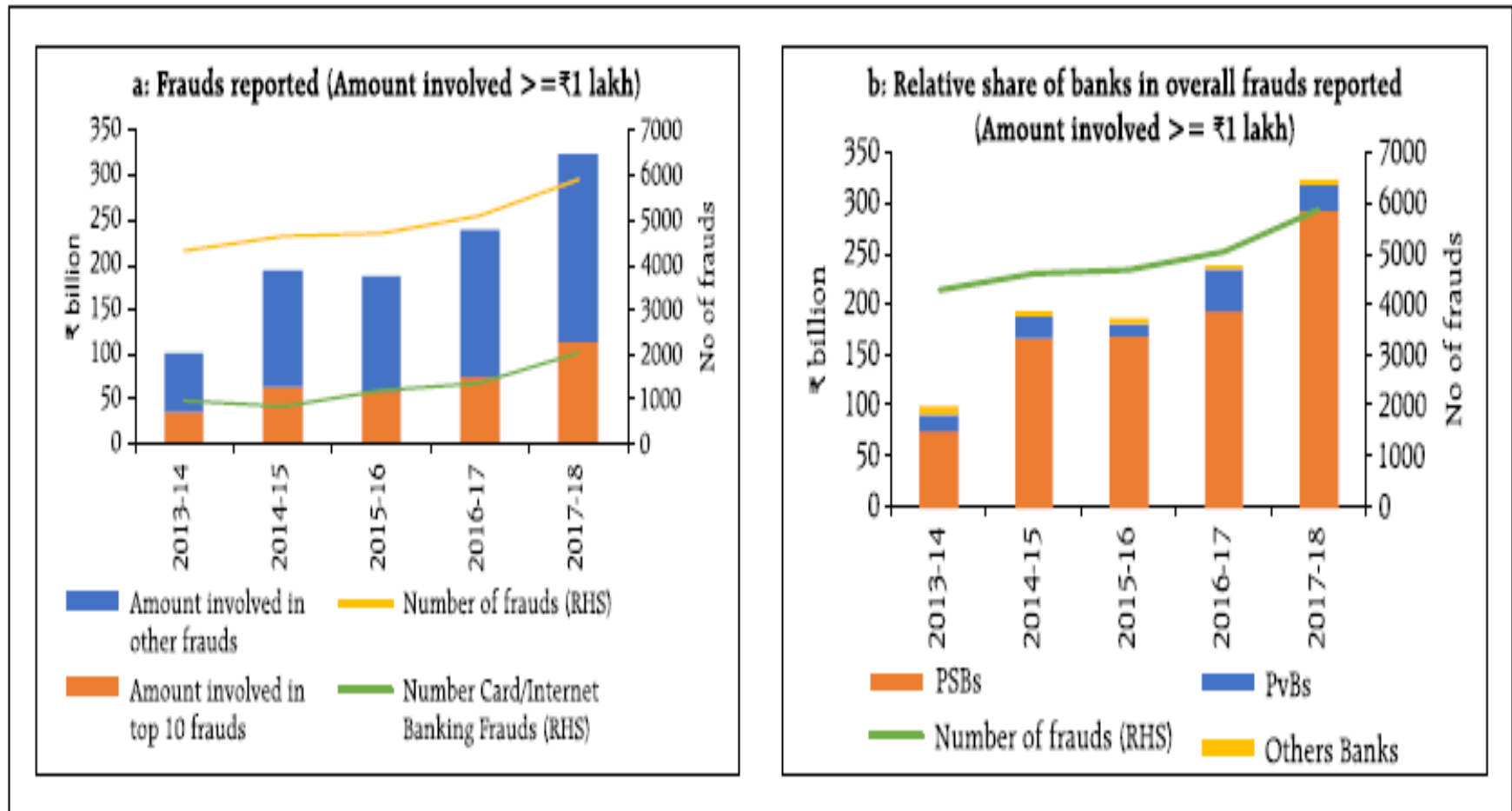
FSR- December 2018

## Performance: PSB vs. PVB vs. FB- 31.12.2018



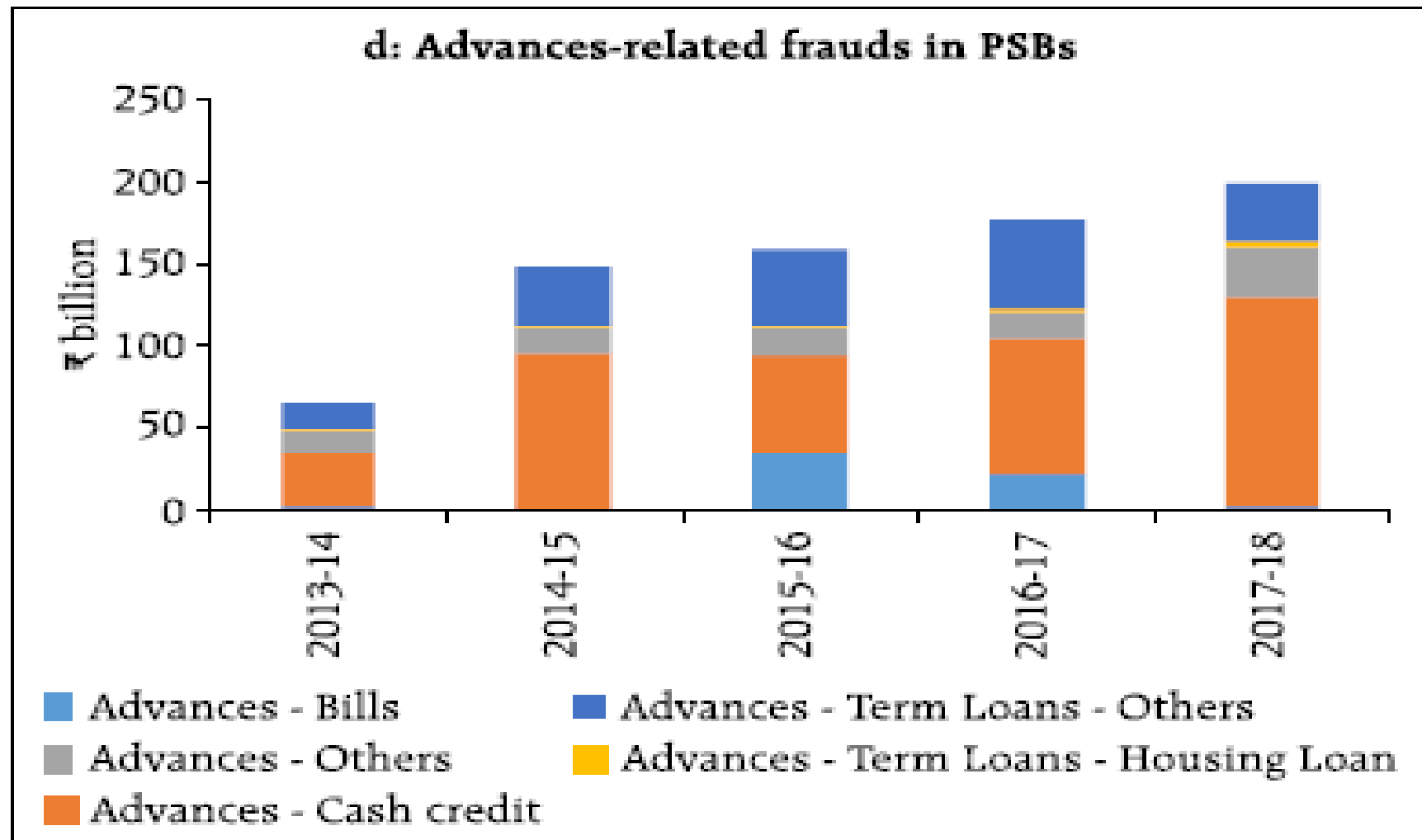
# Frauds in Banking Industry:

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

# 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><b><i>“interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan”</i></b>            (para 2.1.3 of IRAC Norms)- <b>except MSME</b></p>
(B)	Overdraft/Cash Credit	<p><b><i>“the account remains ‘out of order as indicated in the IRAC Norms”-except MSME</i></b></p> <p><b><i>Out of Order- para 2.2</i></b></p> <ul style="list-style-type: none"> <li>▪ Outstanding Balance &gt; SL or DP continuously for 90 days</li> <li>▪ No credits in accounts continuously for 90 days as on B/s date</li> <li>▪ Credits in the accounts are not sufficient to cover interest debited during the same period</li> </ul>

## 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><b>Overdue</b> – 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"><li>▪ <b>Short duration crop-</b> if the instalment of principal or interest thereon remains overdue for two crop season;</li><li>▪ Long duration crop- if the instalment of principal or interest thereon remains overdue for one crop season;</li><li>▪ Crop season is decided by State Level Banker's committee</li></ul>

# 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)	<b>Normal Category:</b> Sub-Standard Assets (Fully Secured) Sub-Standard Assets (Unsecured)  Unsecured exposure: <i>“Realisable value of security is not more than 10% of the outstanding exposure”</i>  <b>Infrastructure Category:</b> Sub-Standard Assets (Fully Secured) Sub-Standard Assets (Unsecured)	15% 25%        15% 20%
(B)	<b>Doubtful Assets:</b> DB-1 (Upto 1 Year) DB-2 (1 to 3 Year) DB-3 (More than 3 Year)	25% 40% 100%

## Provisioning Norms:

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