

AUDIT OF LOANS & ADVANCES

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Types of facilities

- Fund based - *Funded - Non-funded (LC Guarantee)*
- Geography based - *Inland - Export (Packing/Pre-shipment - Post-shipment credit)*
- Security based - *Secured - Unsecured Secured- Hypothecation, Pledge, Mortgage, Assignment.*
- Sector based - *Priority - Non-priority*

Types of Advances

- Demand -Term loans- *Demand loans repayable in predetermined installments. If repayment exceeds 36 months, it is term loan.*
- CC- *Granted against security of stock, book debts without any stipulation of repayment but to be renewed every year. If borrower draws beyond Sanction-limit/ Drawing power, it is Temporary Over-limit*
- OD- *Similar to CC but can be unsecured or security is other than stock or book debts (eg- FD receipts, NSC, LIC policies, shares etc.)*

Types of advances (contd.)

- Bills purchased/Discounted-

An advance against a sale bill granted to a seller with condition that it is repaid before physical possession of goods passes to a buyer

Bills purchase.

An advance granted against a sale bill, wherein a buyer has received goods & has agreed to pay amounts within a stipulated period - Bills discounted.

Statements to be obtained

- Accounting policies & Closing Guidelines
- Statements generated on 31st March:
 - Facility - Party wise list of accounts outstanding with overdue over Sanctioned limit / DP
 - Sanctioning powers of branch officials & higher authorities
 - List of accounts where ad hoc or regular facility is due for renewal but not renewed - where stock and book debts statements are in arrears – inadequate insurance – overdue stock audits -
 - For CC and OD A/cs month wise debit and credit transactions (turnover)
 - NPA statements

Extent of verification

- Sample to be selected for test check would depend on existence and efficacy of internal control procedures & Concurrent audit reports
- Auditor has to verify all large advances, - i.e. more than 5% of aggregate outstanding branch advances or 2 crore whichever is lower.

Verification stages

- 1) Credit appraisal & sanction:
 - Review of documents- Borrower's financials, Branch visit report, valuation report, Proforma invoice, bank credit appraisal report, Borrower & Guarantors net worth, Other banks confidential reports, ratio analysis
 - Borrower' CIBIL report & past defaults of guarantors -

Stages of verification (contd.)

1) Credit appraisal & sanction (contd.):

- Auditor to verify:
 - Veracity of Sanction letter & compliance with all its terms -
 - Violation of RBI prudential norms for individual & group borrowers (Master Circular)
 - Adverse comments on borrower in previous statutory audit, internal inspection or concurrent audit reports.

Stages of verification (contd.)

2) Disbursement :

- Borrower to execute- Demand promissory note, documents for hypothecation, pledge/ mortgage, letter of guarantee etc.
- All documents to be appropriately stamped.
- Other documents such as Title document for immovable properties, NOC for society.
- Properties given as security to be fully insured

Stages of verification (contd.)

2) Disbursement (contd.):

- Other points -
 - Housing loan - disbursement to be done directly to builder Obtain receipts
 - Old previous dues to be cleared
 - Inspection of borrowal unit

Stages of verification (contd.)

3) Review of operations:

Any transaction susceptible of fraud to be directly reported to the RBI by auditors

- Auditor to scrutinize bank statements, account transfers, cheque returns, withdrawals/deposits of cash, turnover in account, transfers to sister concerns (diversion of funds) etc.
- Auditor should compare movement of stock and book debts month-on-month with turnover in account. Compare it with audited/unaudited accounts. Book Debt statement should be certified by a CA on quarterly basis.

Stages of verification (contd.)

3) Review of operations (contd.):

- Verify whether stock includes unpaid stock (sundry creditors), stock under LC, stock under Packing credit have been deducted from total stock considered for DP limit.
- In case of Advance against exports, bank to inform ECGC to cover said advance under the insurance scheme
- Compulsory for non-corporate entities having sanction limit above 10 lakhs to get their accounts audited.
- Balance in advance appearing in individual ledgers to be tallied with general ledger balance- unreconciled balances outstanding for a long time could be indicators of probable frauds.

Stages of verification(contd.)

4) Renewal / Enhancement / Re-schedulement / Balance confirmation -

- If limits are re-aligned or enhanced, necessary documents to be executed.
- All rescheduling/restructuring to be done in accordance with RBI norms.
- To avoid documents from getting time-barred, obtain Letter of acknowledgement of debts & securities or balance confirmation certificate.

Stages of verification (contd.)

- 5) Physical Inspection of securities & Valuation -
- Examine stock audit report for any adverse comments with special attention to non-moving/obsolete stock.
 - Demat papers, physical shares, TDR, NSC usually in custody of bank and should be physically verified.
 - Loan against shares- Periodic statement of valuation of shares pledged to ensure margin is maintained.
 - NPA A/cs- Valuation report for all immovable properties mortgaged to the bank at least once in 3 years.

Stages of verification (contd.)

6) Verification of charges on advances -:

Auditor to verify-

- Charges for processing of loans, stamping, insurance etc.
- Interest/charges on advance, temporary over limit etc.
- Charges for late/non-submission of QIS, stock statements, inspection, valuation, non-renewal of limits etc.

Verification – Non funded advances

- Non-funded advances- Off balance sheet items- recorded under contingent liabilities.

1) Co-acceptance of bills-

Seller dispatches goods and raises bill. Buyer accepts the bill which is co-accepted by buyer's bank. Seller's bank then discounts this bill.

Generally used by customer's to float accommodation bills (i.e not supported by genuine purchase or sale of goods). Auditors to be extra careful.

Verification of non funded advances (contd.)

2) Guarantees-

- Guarantees can be financial or performance. It can be transaction specific or continuing guarantee.
- Auditor to ensure:
 - Unsecured guarantees to a particular borrower not to exceed 10% of the total exposure.
 - Recommendations of Ghosh committee to be complied
 - For guarantees issued on behalf of stock brokers, banks to take minimum 50% margin (with 25% being cash margin)

Verification of non funded advances (contd.)

3) Letter of credit-

Banks not to discount bills drawn under LCs or otherwise for beneficiaries who are not regular clients.

Reporting / Rectification

- Auditors to report discrepancies noted in advances in - Statutory Audit Major/Critical discrepancies report & Long Form Audit Report (LFAR)
- If the discrepancy has to be rectified, it has to be through Memorandum of Changes (MOC)

Classification of Advances- Prudential Norms on Income Recognition & Asset Classification and Provisioning- IRAC Norms

| Sr. No. | Type of Advance | Identification as NPA |
|---------|-----------------------------|--|
| 1. | Term loan | Interest and /or Installment of principal remains overdue for more than 90 days |
| 2. | OD/CC | <ul style="list-style-type: none"> • Outstanding balance remains continuously in excess of sanction limit/ Drawing power* for more than 90 days • No credits in the account for 90 days as on balance sheet date • Credits are not sufficient to cover interest debited during the same period. |
| 3. | Bills purchased/ discounted | •Remains overdue for a period over 90 days |

* Auditor to verify stock statements to verify correctness of drawing power

Provisioning norms

| Sr. No. | Type of NPA | Asset Classification | Required Provision |
|---------|---------------------|--|--|
| 1. | Sub-standard Assets | Advance classified as NPA for the first time for 12 months from date of advance becoming NPA | <ul style="list-style-type: none">• 15% on Total Outstanding• Unsecured exposures- 10% additional i.e. 25% on total outstanding |
| 2. | Doubtful-1 | If account has remained in Sub-standard for 12 months | 25% |
| 3. | Doubtful- 2 | | 40% |
| 4. | Doubtful- 3 | | 100% |
| 5. | Loss Assets | <ul style="list-style-type: none">• Loss has been identified by internal/ external auditor but amount not wholly written off.• Considered uncollectible | 100% |

Other Issues

- Unbiased objective credit assessment & evaluation by independent team having no profits or volume targets –
- Deadlines for sanction of proposals –
- Account specific resolution strategies for NPA's
- Emphasis on borrower's cash flows, financial soundness, liquidity profile & repayment capacity & not on property mortgaged -

Other Issues

- Probability of default to be calculated on guarantors as well – Guarantors risk limits to be calculated –
- Forecasting Credit quality –
- Stress testing –
- Close out procedures where collateral value falls below a predefined trigger level –
- Assessment of the borrower ability to service a proposed level of borrowing without distress
- Churning of accounts year on year

Other Issues -

- Ministry of Finance has said 3 agencies responsible for frauds in Banks – CA – Lawyer – Valuer
- Credit processing is a core activity & cannot be outsourced –
- NPA + Restructured accounts more than 10% of the total lending by Banks – could be 13% by March 2016 –
- Fraudulent removal of pledged stocks – disposal of hypothecated stocks without bank's knowledge – inflating the value of stocks
- In the stock statements & drawing excess bank finance –
- Diversion of funds outside the borrowing units –
- Lack of interest – criminal neglect on the part of the borrowers – Managerial failure leading to the unit becoming sick & due to laxity in effective supervision over operations in borrower account on part of bank functionaries making the advance difficult to recover -

Documentation as per Guidance note

- Critical review of large advances –
- Classification of advances –
- Latest valuation of securities –
- Provision on NPA's –
- Credit card over dues –
- Review of advances lower of 5 % - 2 Crores –
- Test check of other accounts –
- Adverse comments by audits / inspections –
- Review of suit filed / decreed accounts –
- Review of accounts upgraded from substandard – standard –
- Review of accounts frequently exceeding limits / DP -

Documentation as per Guidance Note

- Pre-Sanction – System of credit appraisal & review – Renewal -
- Post Sanction – compliance with terms of sanction / end use of funds – documentation –
- Monitoring – stock & book debts statements, Insurance, Inspection of stock –security, operations in the account –
- Whether system facilitates a proper evaluation of credit risk – Adequacy of information –ie financial statements, Costing analysis – Market information – Tax status – Project Reports etc -

Ghosh – Jilani recommendations

- Pre sanction visit to borrowers Premises – Godown –
- Not allowing large transfers to sister concerns –
- Monthly certificate to RO that periodical stock statements are being received –
- Ensure that Bills represent genuine Trade transactions – insistence of all related documents to ascertain credit worthiness of Borrowers / Drawees – Lorry receipts of approved transporters –
- 1 of the 2 authorized signatories to the LC to be from the RO-
- Bills discounting under LC to be extended to clients with regular sanctioned limits

Ghosh – Jilani (contd..)

- Check list of guidelines to avoid misuse of hypothecation / pledge facilities – safety of goods hypothecated – pledged –
- Monitoring of end use of funds by allowing payments to parties connected with the borrowers line of business –
- Looking into the staff side in case of shift of health code status of account -

THANK YOU