

The Institute of Chartered Accountants of India

**Pimpri Chinchwad Branch of
Western India Regional Office**

Seminar on Bank Branch Audit

Audit of Loans & Advances

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Verification of Advances

Key Audit aspects for Advances

Application – in the prescribed format with related documents

Credit Appraisal

- Techno-Economic Feasibility / Viability
- Performance of the unit vis-a-vis other similar units.
- Conduct of its accounts with the lenders.
- Experience, competence & profile of the management of the unit.
- Guarantees and collateral securities offered.
- Trend & ratio analysis of unit's growth, sound financials, comfortable liquidity & promoters' stake in the unit.
- Availability of inputs for production, Market condition.
- Technology in use.
- Unit's capability to achieve the projected operating & performance levels and to service the debt.

Key Audit aspects for Advances

- Applicability of norms/benchmarks relating to scale of finance, e.g., Nayak Committee recommendations for SSI units, scale of finance fixed by the bank for agricultural finance to be extended in the local area, etc.
- CIBIL, RBI List of defaulters, Credit and confidential reports from other banks. To be checked from respective websites.
- Latest Govt. policy about particular industry / Locational restriction, etc.
- Verification of detailed appraisal note by Auditors

Sanction

- Sanctioned by officials or Committee having requisite delegated authority as per DoA approved by the Board
- Sanction along with detailed terms and conditions, communicated by the Controlling Office to the Branch.

Key Audit aspects for Advances

Pre-Disbursement formalities

- Consent of the Applicant for terms & conditions – Term Sheet
- Pre-sanction visits by Officers
- Adequate documentation of visit report
- Obtaining documents as prescribed by the Bank
- Search of title deeds & opinion from Advocate on the Bank's approved panel about the title of the borrower
- Valuation of land from a Valuer on the Bank's approved panel.
- Creation of charges & registration with bank's charge the authorities concerned, e.g., Registrar of Companies, Road Transport Authority, Insurance company, land records authority, CERSAI, etc.
- Preparation of documents & consent of bank's legal dept. / Advocates
- Signing of documents by the borrower & guarantor
- ✓ Demand Promissory Note
- ✓ Deed of Hypothecation / Mortgage Deed / Letter of Pledge
- ✓ Letter of Continuing security

Key Audit aspects for Advances

Pre-Disbursement formalities

- Advance to a partnership firm, while the account is opened in the trade name of the firm, the security documents executed from the partners in both their individual capacity (i.e. without mentioning the name of the firm or affixing the stamp of the firm) and in their capacity as Partners of the firm.

Key Audit aspects for Advances

Disbursement – Term Loans

- Term loans (granted generally for acquisition of fixed assets, etc.) disbursed on the basis of quotations/ proforma invoices obtained by the borrower from the vendors.
- Own margin of the borrower credited with the Bank.
- In case of large projects, the schedule & status of completion of projects. Report of the Lenders' Independent Engineer (LIE)
- Utilisation certificate from Chartered Accountants

Key Audit aspects for Advances

Disbursement - Cash Credit

- CC released on the basis of drawing power
- Calculated as per the stock statements (which may be book debts, stock-in-trade, trade creditors, advance received from customers, advance given to trade creditors, Buyer's Credit, etc.) submitted by the borrower as per the periodicity laid down in the terms of sanction.
- Verification of the stock statements (Tangible securities like stock physically verified) & calculate DP.
- Consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (Circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the IBA).

Key Audit aspects for Advances

Monitoring & Supervision

Inspection

- Verification of Primary & Co-lateral securities
- Post-sanction visits by Officers
- Adequate documentation of visit report
- Visit reports by LIE.

Stock & Book Debts Audit

Verification of financials & Corporate Actions

Reports submitted by the borrowers

- FFR
- QIS, MSOD

Key Audit aspects for Advances

Monitoring & Supervision

- To ensure utilisation of amounts disbursed for right purpose
- Borrower has not acquired / disposed of any assets without Bank's consent
- Diversion of funds - Acquisition of fixed assets – either for business or personal assets - from working capital funds
- Investments in or advances to its associates without the bank's approval
- To cross-check data in the stock statements with the books maintained by the borrower (including excise and other statutory records, as applicable)
- Physically verification of stock
- Performance as per projected levels particularly Sales, Production & general working.
- Unauthorised finance from any other lenders, without permission– Multiple lending arrangements

Key Audit aspects for Advances

Monitoring & Supervision

- Finance against unpaid stocks ???
- Regular turnover of stocks, obsolete, unusable stocks.
- Book debts outstanding beyond a specified period (normally 90 / 120 days) not eligible for bank finance.
- Trade creditors irrespective of age required to be netted off against the stock to calculate the amount of 'paid stock'
- To ensure borrower continues to be engaged in the activity for which the loan has been granted.
- Observing the operations – debits & credits to the account.
- RBI circular no. DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11 dated January 14, 2011 on "End Use of Funds - Monitoring"
- To evaluate & strengthen the efficacy of the existing machinery in the banks for post- sanction inspection, supervision & follow-up of advances.

Key Audit aspects for Advances

Framework for revitalisation of distressed assets

- Early Recognition of financial distress, Prompt Steps for Resolution & recovery
- RBI guidelines for classification of standard assets into three sub-categories, viz., SMA-0, SMA-1 and SMA2 in order to recognise the financial distress
- ✓ SMA-0: Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress as given in appendix to Part C of Master Circular on Advances
- ✓ SMA-1: Principal or interest payment overdue between 31-60 days.
- ✓ SMA-2: Principal or interest payment overdue between 61-90 days.
- ✓ Reporting to CRILC (Central Repository of Information on Large Credits)

Regulatory Aspects

Statutory Restrictions on Advances

- Advances against Bank's own Shares
- Advances to Bank's Directors
- Restrictions on Power to remit Debts
- Restriction on holding shares in Companies
- ✓ Section 19(2) of the Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 % of the paid-up share capital of that company or 30 % of its own paid-up share capital and reserves, whichever is less.
- Granting loans & advances against shares, statutory provisions contained in Sections 19(2) and 19(3) to be strictly observed.
- Restrictions on Credit to Companies for Buy-back of their Securities

Regulatory Restrictions on Advances

- Granting Loans to relatives of Directors
- ✓ Banks not to grant loans, without the approval of Board of Directors/Management Committee aggregating Rs. 25 lakhs
- Restrictions on grant of Loans to Officers & Relatives of Senior Officers of Banks
- Restrictions on loans to Industries Producing / Consuming Ozone Depleting Substances (ODS)
- Restriction on payment of commission to staff members including officers
- Restrictions on offering incentives on any banking products

Regulatory Restrictions on Advances

- Restriction on Advances against Sensitive Commodities under Selective Credit Control (SCC)
 - ✓ Food grains i.e. cereals and pulses,
 - ✓ Selected major oil seeds indigenously grown, viz. groundnut, rapeseed / mustard, cottonseed, linseed / castor seed, oils thereof, vanaspati and all imported oils / vegetable oils
 - ✓ Raw cotton / Kapas
 - ✓ Sugar, Gur, Khandsari
 - ✓ Cotton textiles, cotton yarn, man-made fibres, yarn / fabrics made out of cotton / man-made fibres.

Other Restrictions on Advances

- Loans against Shares, Debentures & Bonds
 - ✓ No loans to be granted against partly paid shares.
 - ✓ No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.
- Advances to Share & Stock Brokers / Commodity Brokers
 - ✓ Not permitted to undertake financing of 'Badla' transactions.
 - ✓ Advances only to share / stock brokers registered with SEBI and who comply with capital adequacy norms prescribed by SEBI / Stock Exchanges.
- Bank Finance for Market Makers
- Bank Finance for Margin Trading
- Bank Finance to assist employees to buy shares of their own companies
- Bank Loans for financing Promoters' Contribution
- Advances against units of Mutual Funds
- Financing for acquisition of Equity in Overseas Companies

Other Restrictions on Advances

- Advances against Fixed Deposit Receipts issued by Other Banks
- Advances to Agents/Intermediaries based on consideration of Deposit mobilisation
- Loans against Certificate of Deposits (CDs)
- Finance for and Loans/Advances against Indian Depository Receipts (IDRs)
- Bank Finance to Non-Banking Financial Companies (NBFCs)
- Advances against NR(E) & FCNR(B) Deposits
- Advances against Bullion/Primary Gold
- Advances against Gold Ornaments & Jewellery
- ✓ Loan to Value Ratio (LTV) for loans against Gold Ornaments & Jewellery
- Loans to Micro and Small Enterprises (MSEs)
- Working Capital Finance to Information Technology & Software Industry

Other Restrictions on Advances

- Financing Housing Projects
 - ✓ Direct Finance.
 - ✓ Indirect Finance.
 - ✓ Investment in Bonds of NHB/HUDCO, or combination thereof.
- Banks not permitted to extend fund-based or non-fund-based facilities to private builders for acquisition of land even as part of a housing project.
- In terms of the orders of the Delhi High Court, banks can not grant loans in respect of:
 - ✓ Properties which fall in the category of unauthorised colonies, unless and until they have been regularised and development and other charges paid.
 - ✓ Properties which are meant for residential use but which the applicant intends to use for commercial purposes and declares so while applying for the loan.
- Loan to Value (LTV) ratio
- Innovative Housing Loan Products – Upfront Disbursal of Housing Loans

Other Restrictions on Advances

- Financing of Infrastructure Projects
- ✓ Circular No. RBI/2012 13/297/DBOD.BP.BC.No 58/08.12.014/2012-13 dated 20/11/2012 on "Second Quarter Review of Monetary Policy 2012-13 - Definition of 'Infrastructure Lending'".

Non-Fund Business

Peculiarities

- Bank Guarantees/ Letters of Credits/ Buyer's Credits
- Assessment of combined overall limits for Fund Based and Non Fund Based
- Non Fund Based not to be sanctioned unless funded limits are available to absorb irregularities due to invocation/devolvement (interchangeability options)
- Invocation/Devolvement to be treated as a part of Operative Limit for IRAC

Letters of Credit

- Whether in favour of regular supplier – Status report from suppliers' bank
- For genuine trade transactions, movement of goods to be ensured
- Confirmation from the issuing bank, while discounting the bills

Finance for Imports / Exports

Peculiarities

- Pre-shipment Finance
- Packing Credit (PCFC or EPC)
 - ✓ Running Account / Against specific orders
 - ✓ Copy of order from overseas customer
 - ✓ Status report of overseas customer
 - ✓ Monitoring of execution of Export Order, supporting documents
 - ✓ ECGC cover –blanket or orderwise
 - ✓ Realisation through export proceeds
- Post-shipment Finance
 - ✓ FBP / FBD
 - ✓ RBI FEMA guidelines – XOS statement
 - ✓ BEF Statement

Restructuring of Advances

Restructuring of Advances

- RBI Guidelines
 - ✓ Guidelines on restructuring of advances extended to industrial units.
 - ✓ Industrial units under the Corporate Debt Restructuring (CDR) Mechanism.
 - ✓ Small and Medium Enterprises (SME).
 - ✓ All other advances.
- Guidelines on Joint Lenders Forum (JLF)
 - ✓ Aggregate exposure (AE) [fund based and non-fund based taken together] of lenders in that account Rs. 1000 million and above
 - ✓ Account is reported by any of the lenders to CRILC as SMA- 2.
 - ✓ Optional for other borrower accounts

Restructuring of Advances

- Corrective Action Plan (CAP)
 - ✓ Rectification
 - ✓ Restructuring
 - ✓ Recovery
- No account classified as doubtful considered for restructuring
- In cases where a small portion of debt is doubtful i.e. the account is standard/sub- standard in the books of at least 90% of creditors (by value), the account may then be considered for restructuring.

SDR

- Possibility of transferring equity of the company by promoters to the lenders to compensate for their sacrifices
- Promoters infusing more equity into their companies
- Transfer of the promoters' holdings to a security trustee or an escrow arrangement till turnaround of company. This will enable a change in management control, should lenders favour it.

S4A Scheme

- S4A Scheme – Scheme of Sustainable Structuring of Stressed Assets
 - Only after commencement of operations
 - Existing promoters can continue or new can be introduced
 - Aggregate Exposure above Rs. 500 Crores
 - Without change in the repayment schedule, O/s Debt segregated into “Sustainable” (Part A) and “Unsustainable” (Part B)
 - Unsustainable portion to be converted into equity/OCRPS/OCD
 - Status Quo in Asset Classification

Interest Application

Features of Interest on Loans

- Base Rate
 - ✓ There can be only one Base Rate for each bank. Banks may choose any benchmark to arrive at the Base Rate that may be disclosed transparently.
- Prime Lending Rate
 - ✓ Minimum rate for the credit limits of over Rs 2 lakhs.
- Spread
 - ✓ Board approved policy delineating the components of spread charged to a customer.
 - ✓ Any price differentiation is consistent with bank's credit pricing policy.
 - ✓ Based on credit rating of each borrower
- DBR.No.Dir.BC.67/13.03.00/2015-16 dated December 17, 2015 on "Interest Rates on Advances"

Audit Procedures

Auditors to ensure

- Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- Advances represent amount due to the bank.
- Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- There are no unrecorded advances.
- The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- The advances are disclosed, classified & described in accordance with recognised accounting policies & practices, relevant statutory & regulatory requirements.
- Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

Audit evidence to be obtained for

- Examining the validity of the recorded amounts;
- Examining loan documentation;
- Reviewing the operation of the accounts;
- Examining the existence, enforceability and valuation of the security;
- Checking compliance with RBI norms including appropriate classification & provisioning; and
- Carrying out appropriate analytical procedures.

Audit evidence to be obtained for

Obtain information about:

- ✓ Top 10 exposure accounts
- ✓ Stressed accounts (SMA2)
- ✓ Restructured accounts
- ✓ CDR accounts
- ✓ Unsecured exposures above Rs. 1 Cr.
- ✓ Quick mortality cases
- ✓ Status of accounts with other banks (CRILC)
- ✓ Exchange of information with other banks, for accounts under multiple banking

LFAR Requirements

Comments on Borrowers' A/cs

- Name of the Borrower.
- Constitution.
- Sanctioned limits & Outstanding as on Balance Sheet date.
- Any change in limit during the year.
- Details of fulfilment of terms of sanction.
- Details of Loan documents and observations on the same.
- Classification as per bank.
- Whether classification requires a change?
- If so the reasons for the differing view and the impact of the same.
- Whether necessary changes made in Memorandum of Changes?

Comments on Borrowers' A/cs

- Observations on the conduct of the account.
- Deficiencies noted in the account.
- Availability of security & adequacy of its insurance cover along with Bank's clause.
- Timely submission of stock statement and other statements.
- Analysis of stock statements vis a vis financial statements.

Relaxation of NPA norms upon Demonetisation of HD Notes

Relaxation on De-monetisation

RBI Circulars

Circular No. DBR.No.BP.BC.37/21.04.048/2016-17 dated 21.11.2016

- Relaxation in respect of running loans / term loans up to Rs. 1 Crore for agricultural purpose
- Additional time limit of 60 days granted to various institutions for identification of a loan account as NPA, beyond the extant limit applicable

Circular No. : DBR.No.BP.BC.49 /21.04.048/2016-17 dated 28.12.2016

- Relaxation in limit of 60 days increased by a further period of 30 days.
- To defer the downgrade of standard loans which as at 01.11.2016 but becoming NPA between 01.11. to 31.12.2016, for any reason.
- Dues earlier/later to that period governed by the extant RBI norms on IRAC.
- These relaxations not applicable to further down-gradation of existing NPA accounts due to ageing.

Agricultural Advances

Credit Needs of Agriculture

Crop Loan or Short Term Loan

- For financing revenue expenditure of raising the crops.
- Repayable after crop season.

Medium Term Loan

- Outlay of the replacement & maintenance of assets and for capital investment designed to increase the output from land.
- Purpose: deepening of wells, sinking of new wells, installation of pump sets, purchase of agricultural machinery or a pair of bullocks, etc.
- Repayable in 3 to 5 years.

Long Term Loans

- Capital investment in agriculture.

Credit Needs of Agriculture

Long Term Loans

- Sinking of new wells, construction of tube wells, land levelling, bunding, terracing, purchase of tractors, power tillers & other costly machinery, electrical motors, purchase of land, etc.
- Repayable over a period of 5 to 15 years and in exceptional cases in 20 years.

Classification of Agricultural Advances

- **Till 31st March 2015**

- ✓ Direct & Indirect Agricultural Advances

- **From 1st April 2015**

- ✓ Farm Credit

- ✓ Agri. Infrastructure

- ✓ Ancillary Activities

(Ref.: RBI-2014-15/573 FIDD.CO.Plan.BC.54/04.09.01/2014- 15 dated April 23, 2015)

Production Loans / Farm Credit

Component in Kind

- Based on the cost of inputs - fertilizers, seeds, pesticides etc. - essential for cultivation of crops.
- Amount disbursed directly to the supplier of inputs to ensure end use of funds.

Cash Component

- Mainly for expenses - hired labourers, hire charges for tractors, machinery, electricity charges etc.

Disbursement

- Meeting the current expenditure in connection with raising of crops.
- In stages linked up with inspection to ensure ultimate use of funds.

Agriculture Infrastructure

- Loans for construction of storage facilities (warehouses, market yards, godowns & silos) including cold storage units / chains designed to store agriculture produce/ products, irrespective of their location.
- Soil conservation & watershed development.
- Plant tissue culture & agri-biotechnology, seed production, production of bio-pesticides, bio-fertilizer, & vermi composting.
- For the above loans, an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system, will apply.

Ancillary activities

- Loans up to Rs. 5 crore to co-operative societies of farmers for disposing of the produce of members.
- Loans for setting up of Agriclincs and Agribusiness Centers.
- Loans for Food & Agro-processing up to an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system.
- Loans to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on contract basis.
- Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi-Purpose Societies (LAMPS) for on-lending to agriculture.
- Loans sanctioned by banks to MFIs for on-lending to agriculture sector as per the conditions specified in paragraph 19 of these Master Directions.
- Outstanding deposits under RIDF and other eligible funds with NABARD on account of priority sector shortfall.

Kisan Credit Cards

- Scheme for providing adequate & timely credit support, under single window, to the farmers for their cultivation & other needs
- **Short term credit limits**
 - ✓ To meet the short term credit requirement for cultivation of crops
 - ✓ Post harvest expenses
 - ✓ Produce marketing loan
 - ✓ Consumption requirement of farmer household
 - ✓ Working capital for maintenance of farm assets & activities allied to agriculture like dairy, inland fishery etc.
- **Long term Credit Limits**
 - ✓ Investment credit requirement for agriculture & allied activities like pump sets, sprayers, dairy animals etc.
- KCC is not a type of loan, but is a channel for granting either short term or long term agricultural finance.

Key Concepts

“Long duration” Crops

- Crops with season longer than one year.

“Short duration” Crops

- Crops which are not “long duration” crops.

Crop season

- The period up to harvesting of the crops raised, includes period required for sale of crops as well.
- Based on the sowing, harvesting period prevailing in the State, crop pattern, agro climatic condition.
- determined by the State Level Bankers’ Committee (SLBC) in each State depending upon the duration of crops raised by an agriculturist.
- same crop may have different harvesting season in different states as decided by the respective SLBC of those states.

Auditors’ Role

- Whether crop seasons as defined by the SLBC mapped properly in CBS?
- Any discrepancies may have a direct impact on identification of NPAs.

Agri. Loans against Gold: RBI guidelines

- Constitute a major portion of agricultural finance.
- Certain relaxations from normal gold loans
 - Maximum LTV Ratio of 25% is not required to be maintained
 - Interest on half yearly basis as against monthly
 - Repayment linked to crop season as against maximum tenor of 12 months
- Banks to ensure genuineness of Agricultural Operations (through documentary proofs and pre & post disbursement visits)
- Instances of normal loans being reflected as agri. loans are evident.

Restructuring of Loans

NPA norms upon restructuring

- Additional finance granted due to natural calamities treated as a standard assets, and will be governed by the terms & conditions of its sanction.
- Different dues from the borrower (e.g. current dues, dues which are not restructured etc.) will be classified under different asset classification norms.
- Accepted departure from the basic principle of IRAC norms, i.e. NPA should be borrower-wise and not facility-wise.

Questions ???

Thanks !!!