Audit of Advances

In the last decade, though traditional banking has undergone a metamorphosis, its two major activities still remain as the acceptance of deposits and the granting of advances. Hence, during the course of audit, especially the statutory branch audit, verification of these two activities form a major component of the audit. In this article, the author has discussed the statutory branch audit with regard to the second component of two aforementioned traditional banking activities, i.e., granting of advances. Read on to understand the concept of this audit, various types of verifications and their extent, and especially to know how to identify irregularities in accounts and frauds...

Introduction

Banking laws, especially the circulars from the RBI (Reserve Bank of India), the apex body governing the Indian banks, have been undergoing a continuous modification. Hence, before commencing the audit, an auditor and her/his staff should acquaint themselves with the contents of all relevant RBI circulars. More than 70 Master Circulars have been issued on 1st July, 2014 and are available on www.rbi.org.in. A Master Circular is a one-point reference of instructions issued by the RBI on a subject between July of a year and June of next year, generally issued on 1st July every year superseding the previous Master Circular on the same subject.

It is necessary that an audit team is well versed with various laws applicable to banks and their customers. While knowledge of the Banking Regulation Act, 1949 and the Reserve Bank of India (RBI) Act, 1934 is vital, the team must not lose sight of various other allied laws such as FEMA,

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Major accounting policies and rules that banks follow are given in the Annual Closing Guidelines and must be understood completely. If some of these guidelines are not in line with the Accounting Standards or other statutory guidelines prescribed, the guidelines as given by the bank should be followed but the fact about its deviation from the statutory guidelines should be given in the report.

taxation laws including the service tax rules and various commercial laws including the Stamp Act. For instance, it should be borne in mind that for the purpose of stamping of documents, the branch has to follow the law of the place where the document is executed and not where the registered office of the bank is situated, implying that different branches of the same bank have to follow different set of rules for stamping, as applicable to the state where document is executed.

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Majority of the bank branches are either fully or partially computerised and the auditor should take full advantage of the same to generate various statements from the system. Some of the statements that could be generated as on 31st March are:

- facility-/party-wise list of accounts outstanding, along with the outstanding balance (aggregate total of these lists should first be tallied with the figure of total advances in the Trial Balance to ensure that none of such statements have been missed out),
- sanctioning powers of the branch officials and the higher authorities,
- list of accounts where regular or ad hoc facility is due for renewal but has not been renewed, where stock/book debt statements are in arrear, where no insurance or inadequate insurance has been taken, where accounts are overdrawn beyond sanction/DP (Drawing Power) limit, where stock audit is due but has not been done, and where inspection has not been carried out in last three or six months,
- for CC (Cash Credit)/OD (Overdraft) accounts, month wise details of debit and credit transactions (turnover),
- NPA (Non-Performing Assets) statements, as prepared by the branch, *etc.*

Type of Facilities

Types of facilities extended by a bank can be divided into the following broad categories:

- **Based on Funds:** *Funded*–where actual money is given by the bank and *Non-Funded*–where only a guarantee or commitment or co-acceptance is given that a certain amount would be paid on the occurrence of a certain unknown event, or an accepted bill would be honoured on presentation (letter of credit)
- **Based on Geography:** *Inland and Export* (Packing/Pre-shipment credit, Post-shipment credit)
- **Based on Security:** *Secured and Unsecured* [Secured is one which is granted against some security, while *unsecured* is one which is given against personal surety only. Secured can be further divided into hypothecation, pledge, mortgage, assignment, *etc.* The security could be tangible (goods) or intangible (bank/government guarantees).]
- **Based on Sector:** *Priority and Non-Priority* sectors [Priority sector is one in which persons with small means are engaged or which needs to be supported/encouraged by the government.]

Type of Advances

Banks extend credit facilities in various forms; major ones are:

- **Demand/Term Loan:** this credit facility, though called *demand loan* is generally repayable in predetermined instalments. If the repayment period exceeds 36 months, it is called *Term Loan.*
- **CC:** this is generally granted against security of stocks/book debts without any stipulation for repayment, but is required to be renewed every year. When a borrower is allowed to draw beyond her/ his sanctioned limit or drawing power limit, the said amount is called *Temporary Over-Limit* (TOL), which is secured by the existing securities against which the CC limit has been sanctioned.
- **OD:** this is similar to CC, except that either no security is taken (termed as *unsecured overdraft*)

or security taken is other than stock and book debts, *e.g.* FD receipts, NSC receipts, shares, LIC policies, etc. When such overdraft is granted to the borrower to tide over temporary financial crisis, it is called *Temporary Overdraft* (TOD), which, unlike TOL, is generally unsecured.

- **Bills Purchased/Discounted:** when an advance against a sale bill is granted to a seller with the condition that the same should be repaid before the physical possession of goods passes on to a buyer, it is called *bills purchased* facility; when an advance is granted against a sale bill, wherein a buyer has received the goods and has agreed to pay the amount therein within a stipulated period, such a facility is called *bills discounted*.

Extent of Verification

The sample to be selected for a test check would depend on the existence and efficacy of internal control procedures and the report given by various auditors in this regard, especially the concurrent auditors. However, an auditor has to verify all large advances, which are defined as one that constitutes more than 5% of the aggregate outstanding advance of that branch or ₹ 2 crore, whichever is lower. Nevertheless, if NPAs are high or an extensive problem is identified, percentage of check should be increased.

Stages of Verification

It is suggested that for verification of advances especially the large ones, all stages of verification should be done by the same person to enable him to get a bird's eye view of the account.

The stages are detailed as:

i) **Credit Appraisal and Sanction:** Verification begins with review of documents. Typically the documents relating to the borrower which need to be reviewed would include: the borrowers financial statements, visit report by the branch, valuation report or proforma invoice for plant and machinery, vehicle, *etc.*, credit appraisal report of the bank, papers showing net worth of the borrower and guarantors, confidential report from other banks, ratio analysis, *etc.* Nowadays, banks obtain the CIBIL (Credit Information Bureau (India) Ltd.) report of the borrower and the guarantors to ensure that they have not defaulted in the past. The auditor must review the sanction letter, check its veracity and verify that all terms are complied with. Another important aspect is to ensure that there is no violation of the prudential norms that are set by the RBI for individual and group borrowers (Refer Master Circular on Exposure Norms dated 1st July, 2014). Also, the auditor should verify if there have been any adverse comments on the borrower in previous statutory audit, internal inspection or concurrent audit.

ii) **Disbursement:** At the time of disbursement, the borrower and guarantors have generally to execute the following documents: demand promissory note, necessary documents for hypothecation/ pledge/mortgage of the tangible security, letter of guarantee, *etc.*; similar documents have to be executed for temporary overdrafts and ad hoc limits also; for enhancement of limits, supplementary documents have to be obtained. Further, most of the above documents have to be appropriately stamped. Depending on the type of advance, the borrower also has to provide various documents to the bank such as complete title documents for immovable property, NOC from cooperative housing society, *etc.* All immovable and movable properties given as security to the bank have to be fully insured by the borrower and the policy assigned in the bank's favour. The *terms and conditions of sanction* as indicated in the sanction letter need to be complied with, which the auditor must verify, *e.g.* in case of housing loan, disbursement is to be done directly to the builder and receipts have to be obtained, borrower with previous loan needs to clear his old dues, borrower may have to introduce promoter's capital, branch has to inspect the borrower's unit, *etc.*

iii) **Review of Operations:** It is the most important stage in the verification of an advance. The *RBI has stated that any transaction susceptible to fraudulent transaction should be directly reported to the RBI by the auditors*. In this stage,

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an auditor has to do an intelligent scrutiny of the bank statement-debit/credit entries, cash/cheque transactions, transfer from/ transfer to other accounts, frequent return of cheques, excessive withdrawals/deposits in cash, no/inadequate payments by cheque for purchases, no/ inadequate deposits by cheque for sale proceeds, turnover in the account disproportionate to the sale/turnover of the business, payment to persons or for items which do not concern this business or transfer of funds to personal accounts of the owner or sister concerns (diversion of funds), *etc.*

An auditor should compare the movement of stock/book debts from month to month with the turnover in the account and the purchase and sale declared by the borrower in the stock statements; the stock and book debts declared in the statement for March of the previous year is to be compared with similar figures given in the audited or unaudited financial statements of the concern; many banks insist that the book debts statement should be certified by a chartered accountant on a quarterly basis; for non-submission of these statements, penalty is charged. It is also very necessary to verify whether the stock includes unpaid stock (represented by *sundry creditors*), stock under L/C, stock under Packing Credit, etc., since all these stocks being "unpaid stock" have to be deducted from the total stock considered for DP limit.

Sometimes, for the purpose of convenience or statutory requirements, the borrower is permitted by the bank to open current account near the factory premises to pay certain legal dues or salary or such expenses of the factory. In all such cases, an auditor should insist on verifying the statement of such accounts to ensure that only permissible transactions are routed through these accounts, since the possibility of use of such accounts to divert funds from the business cannot be ruled out.

In case of advance against exports, the bank has to inform to the ECGC (Export Credit Guarantee Corporation) to cover the said advance under its insurance scheme. Further, concessional rate of interest is charged to the borrower, provided certain conditions are fulfilled and the advance is liquidated within a specified time limit out of the export proceeds. If the same does not happen,

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the benefit of concessional rate of interest is withdrawn. The auditor should also note that it is compulsory for non-corporate entities, which have been sanctioned limits above ₹10 lakh, or any higher limit fixed by the bank, to get their accounts audited.

Lastly, in the process of verification, an auditor has to ensure that the balance of advance appearing in the individual ledgers is tallied with the general ledger balance–unreconciled balances outstanding for a long time are indicators of probable frauds.

iv) **Renewal/Enhancement/Reschedulement/ Balance Confirmation:** Generally, the advance is renewed at the end of one year, unless it is an ad hoc advance or it is otherwise specified in the sanction letter; non-renewal can make the account an NPA. If the limits are realigned or enhanced, necessary documents are required to be executed to cover the realigned/enhanced limits sanctioned. Even if the limit is sanctioned for a temporary period, proper stamping and execution of the necessary documents is mandatory. Where a project gets delayed or temporary crisis arise in the business of the borrower, the loan repayment amount and its time is rescheduled. An auditor has to ensure that all reschedulement/restructuring has been done in accordance with the norms prescribed by the RBI. In order to avoid the documents from becoming time-barred, generally banks obtain a document called *letter of acknowledgement of debt and securities* (LAD or ADS) or *balance confirmation certificate.* By virtue of these documents, the borrower and the guarantors confirm their liability, which is then considered as the date of incurring the liability for the purpose of *Law of Limitation.*

v) **Physical Inspection of Securities and Valuation:** An auditor must examine the stock audit report to see if there are any adverse comments and whether they have been

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rectified. Special attention needs to be paid to non-moving stock and obsolete machinery included in the stock statements on the basis of which the DP limit is being determined. Demat papers, physical shares, TDR, NSC, *etc.*, are usually in the custody of the bank and can be physically verified by the auditor. In case of loan against shares, banks have to take out a periodical statement of valuation of shares pledged to check whether margin is still maintained. In case of NPA accounts, it is mandatory for the bank to obtain valuation report for all immovable properties/machinery mortgaged/hypothecated to the bank at least once in three years.

vi) **Verification of Charges Due on Advances:** An auditor must at least test check the recovery of following charges which are recoverable on various advances at the rates prescribed by a bank:
- charges for processing of loan, stamping, insurance, *etc.*;
- interest/charges on the advance, including charges for *withdrawals against effects* (WAE), temporary overlimit, *etc.*; and
- charges for late/non-submission of stock/ QIS statements, non-renewal of limits, inspection, valuation, *etc.*

Certain Indicators which could lead to identify Irregular Accounts/Frauds

While an auditor is a watchdog and not a bloodhound, one needs to take extra care in the course of the audit to rule out any irregularities in the loan and advances portfolio. While verifying loans and advances, the auditor has to take cognisance of certain indicators, which may lead to detection of irregular accounts/frauds.

- A branch has one or two major borrowers constituting more than 50% to 75% of the total advances of that branch, for whom the branch goes out of its way to give continuous overlimits or withdrawals against uncleared effects or does not pursue recovery of overdue bills or stock statements are not received in time and yet drawing power limit is continued or account is not renewed on due date or ad hoc limits are not cleared and yet facility is continued, *etc.*
- While verifying CC a/c, OD a/c and bills a/c, following observations are made:
  - account remains continuously overdrawn;
  - a number of cheques are bounced due to insufficient funds;
  - cheques deposited are not honoured and returned unpaid;
  - the account has been granted continuous TOL by the branch–for 20 to 25 days every month; moreover, at times, such TOLs have been granted by the Branch Manager without having the power to do so;
  - the 12 month's turnover in the account does not commensurate with the sale and purchase shown in 12 monthly stock statements or the statement of accounts submitted;
  - the realisation of bills purchased/bills discounted is not received on the due date and subsequently the same is cleared by debit to the borrower's CC/OD a/c;
  - as soon as the above bills are cleared, fresh bills are purchased/discounted;
  - the facility has not been renewed on the due date and the reason given is that the borrower has not submitted the necessary papers;
  - all overdue CC limits, OD limits, unrealised bills, unrealised interest are bundled together and the borrower is granted WCTL (Working Capital Term Loan) to avoid the account becoming NPA. *Generally, such bullet loan is an indicator that the account is having problems;*
  - for certain accounts, when papers are asked for, the branch is unduly slow in producing the same or makes a plea that the same have been sent to some authority and hence is unavailable at the branch or states that the same are not traceable;
  - in case of certain accounts, the Branch Manager pleads not to put any adverse remark in the report and that he shall get it rectified after the audit is over.

- While verifying monthly/quarterly stock statements submitted, following observations are made:
  - generally stock statements are not submitted on time;
  - the itemwise details of stock is not given and instead lumpsum figures are shown without quantitative details;
  - if itemwise details are given, a comparison of statements submitted over a period of time shows that the same stock is repeated over and over again with the same quantity and value;
  - there is heavy "sundry creditors" indicating unpaid stock, but the said amount has not been deducted from the stock value, before determining the DP limit of the borrower;
  - the stock statement includes certain items which have actually been financed by the branch under LC limit or Packing Credit limit or some other limits;
  - there is a huge difference in the closing stock shown in the stock statement of 31st March of previous year and the audited/ unaudited accounts submitted subsequently or better still, the borrower does not submit the stock statement of March or the same is untraceable in the branch;
  - the stock statement reflects an unusually high amount of "stock in transit" every month, which does not commensurate with the monthly purchases or the monthly turnover in the accounts;
  - though mandated, the branch has not obtained the "stock audit report";
  - the stock audit report has adverse comments, but the branch has not taken any corrective steps or the Branch Manager states that subsequently he has visited the unit and everything is rectified and regularised;
  - the stock inspection done by the branch is superfluous and does not record the details of the stock verified–a few direct indepth questions to the branch staff, who went for the concerned stock inspection, would reveal the quality of the inspection done.
- While verifying monthly/quarterly book debts statements submitted, following observations are made:
  - book debts due for more than 90 days are not segregated, though the same is mandated in the Sanction letter;
  - a comparison of last 10-12 month's statement reveals that there are a number of book debts, which probably are being shown for more than 8-10 months and may be bad debts or recovered, but not deducted from the statement;
- A comprehensive 10-12 months' analysis of monthly sales, purchase and stock as shown in the stock statements, the book debts, the turnover in the accounts and the audited financial statements may reveal that the stock statements submitted every month are highly inflated.
- Verification of other records at the branch
  - verification of stamping of the immovable property documents under ultra violet rays can reveal whether the document is genuine or a colour xerox copy;
  - in immovable property loans, the branch has not obtained "search report" of the property from the Registrar's office, or the adverse comments in such report have been ignored;
  - the branch has not obtained NOC from the builder/society or such NOC has been personally brought by the borrower to the branch instead of the same being directly obtained by the branch from the builder/ society;
  - in case of loans to limited companies, details of previous charges have not been obtained or if any adverse observations have been made, the same are ignored, e.g. the report shows that the borrower has borrowed from other banks without the knowledge/ permission of the existing banker, old charges which were supposed to have been cleared have not been done indicating that old loans are still outstanding;
  - there is correspondence on record, which states that on the same immovable property, the borrower has obtained loans from more than one bank; and

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– the branch has filed a suit against the borrower to recover the amount;

Verification of Non-Funded Advances

While the general verification of funded and non-funded advances is done simultaneously, there are certain components of non-funded advances, which need to be looked into. The RBI has issued a Master Circular dated 1st July, 2014 under *Guarantees and Co-acceptances*, which can act as a guiding parameter.

Non-funded advances are called *off balance sheet* items, as their value is not reflected in the balance sheet. They form the *contingent liability* items of the bank. However, for the purpose of keeping a control over these items, banks have a system of passing contra entries in its books of accounts at the branch level and hence these items get reflected on the liability as well as asset side of the trial balance. However, while preparing the balance sheet of the bank as a whole, the value of these items are reflected in the *notes to accounts*.

(i) Guarantees

a. Guarantees are of two types—*financial* guarantee, wherein the guarantor (the bank) promises to pay the stated amount to the beneficiary, if the person for whom the guarantee is given, fails to pay the same (also referred to as invoking the guarantee); *performance* guarantee, wherein the guarantor promises to pay the beneficiary a stated sum of amount, if the person for whom the guarantee is given, fails to perform, as expected, in a given period of time. Banks are generally discouraged from issuing performance guarantees.
b. A guarantee transaction usually comprises two independent but related components—one is the guarantee issued by the banker (of the buyer) to the beneficiary (*i.e.,* seller) and the other is a counter guarantee given by the buyer to his banker, who has issued the guarantee.
c. Generally, guarantees should not be issued on behalf of customers, who do not enjoy credit facilities with the bank.
d. Since guarantees invoked could get converted into funded advance to a borrower, banks should not encourage borrowers to over extend their commitments solely on the basis of guarantees.
e. Guarantees could be for specific transaction (called *specific* guarantee) or it could be for multiple transactions within a specific time frame (called *continuing* guarantees). Guarantees should generally be for short durations; in any case, is should not have a maturity period of more than 10 years.
f. Unsecured Guarantees to a particular borrower should generally not exceed 10% of the total exposure.
g. Banks should also not concentrate its unsecured Guarantees to a particular borrower or a group.
h. Ghosh Committee has recommended certain precautions to be taken by banks while issuing guarantees.
i. Guarantees are generally issued by keeping margins, either in the form of cash/term deposit or some other security.
j. In case of guarantees issued on behalf of share and stock brokers, the RBI has advised that banks should obtain a minimum margin of 50% (with 25% being cash margin).
k. RBI has laid restrictions on guarantees of inter-company deposits/loans and inter-institutional guarantees.
l. In the above mentioned circular, the RBI has also given extensive guidelines on issue of guarantees on behalf of exporters and importers.

(ii) Co-Acceptance of Bills

a. In this type of facility, the seller despatches the goods and raises the bill on the buyer. The buyer accepts the bill and then it is co-accepted by buyer's banker. The seller's banker then discounts this bill.
b. This type of facility is often used by customers to float accommodation bills (*i.e.,* bills which are not supported by genuine sale and purchase of goods) and hence auditors should be careful while examining such bills.

(iii) Letter of Credit

a. A Letter of Credit (LC) is a promise by a banker to honour the payments to be made by its customer (the buyer or importer) to the seller or exporter. This type of payment facility is generally used in international trade. In this type of facility, at the request of the buyer, his banker opens an LC, which is sent to the seller. Based on such LC, the seller despatches the goods and then sends the bills and other documents through his banker to the buyer's banker, which has opened the LC, to make payment of the bill.

b. The buyer then makes the payment and routes it through his banker to the seller's banker. In case the buyer fails to make the payment (also known as *devolvement of LC*), the buyer's banker, which has opened the LC, is liable to make the payment to the seller.

c. RBI has mandated banks not to discount bills drawn under LCs or otherwise for beneficiaries, who are not their regular clients.

Reporting of Verification and Rectification

Statutory auditors have to report about discrepancies noted in the advances in two separate reports—one is the Statutory Audit Report for Major/Critical Discrepancies and the other is a detailed report in the Long-Form Audit Report (LFAR) under para I-5–Advances. If any financial adjustment has to be done (short/excess debit of interest, other charges, *etc.*), the same should be done through the Memorandum of Change (MOC).

Classification of Advances—Prudential Norms on Income Recognition & Asset Classification and Provisioning–IRAC Norms or also called NPA Norms

This is one of the most important aspects of *verification of advances*, details of which have been provided in a separate article in this issue of the Journal.

Conclusion

Advances bring income to the bank, but carelessness in sanction of the same may also lead the bank to lose the money advanced. The auditor has therefore to ensure that advances are granted after due diligence, are within the norms prescribed by the RBI and others, are good of recovery and are adequately provided for, if doubtful of recovery. ■