



# **AUDIT OF ADVANCES & MOC**

**Audit of Banks Conclave organized by the Pune Branch of WIRC  
of ICAI,**

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# Disclaimers

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- These views do not and shall not be considered as professional advice.



# **Audit of Advances**

# An Overview – Audit of Advances

- Audit of advances is one of the most important aspect of bank audit.
- Lending represents the largest source of bank's income and the most significant component of bank's assets
- Observations based on audit of advances are to be mentioned in LFAR as well as main audit report, when required

# COVID - 19 Circulars

<b>Date</b>	<b>Circular</b>
Mar 27, 2020	Covid-19 Regulatory Package – Rescheduling of payments
Apr 17, 2020	Covid-19 Regulatory Package – Asset Classification & Provisioning
May 23, 2020	Covid-19 Regulatory Package – Review of Resolution Timelines under Prudential Framework on Resolution of Stressed Assets
Aug 06, 2020	Resolution Framework for Covid-19 related stress
Sep 07, 2020	Resolution Framework for Covid-19 related stress – Financial Parameters
Oct 13, 2020	FAQs (Also revised on Dec 12, 2020)

# Other important Circulars / Orders

Date	RBI Circular
Aug 21, 2020	Ad-hoc / Short Review / Renewal of credit Facilities – <i>Reiteration of earlier guidelines</i>
Aug 21, 2020	New Definition of Micro, Small and Medium Enterprises – <i>Clarifications in line with the modified definition of MSME's</i>
Sep 03, 2020	Supreme Court order: (Gajendra Sharma vs Union Bank of India)  <i>'The accounts which were not declared NPA till 31.08.2020 shall not be declared NPA till further orders' – ICAI guidance to be followed (Guidance Note on audit of banks)</i>
Sep 14, 2020	Automation of Income Recognition, Asset Classification and Provisioning Process in banks  <i>Implementation date: Jun 30, 2021</i>

# Early Identification – Incipient Stress

- Framework of Revitalising Distressed Assets in the Economy (Jan 30, 2014):
  - Setting up of Central Repository of Information on Large Credits database ('CRILC')
  - Banks to submit information on borrowers to CRILC - aggregate fund-based and non-fund based exposure of Rs. 5 Crores and above
- Banks are required to identify incipient stress in the account by creating a sub-asset category i.e Special Mention Accounts ('SMA')
  - SMA-0: Not overdue for more than 30 days, but showing signs of stress
  - SMA-1: Principal / Interest overdue  $\langle \rangle$  30-60 days
  - SMA -2: Principal / Interest overdue  $\langle \rangle$  61-90 days

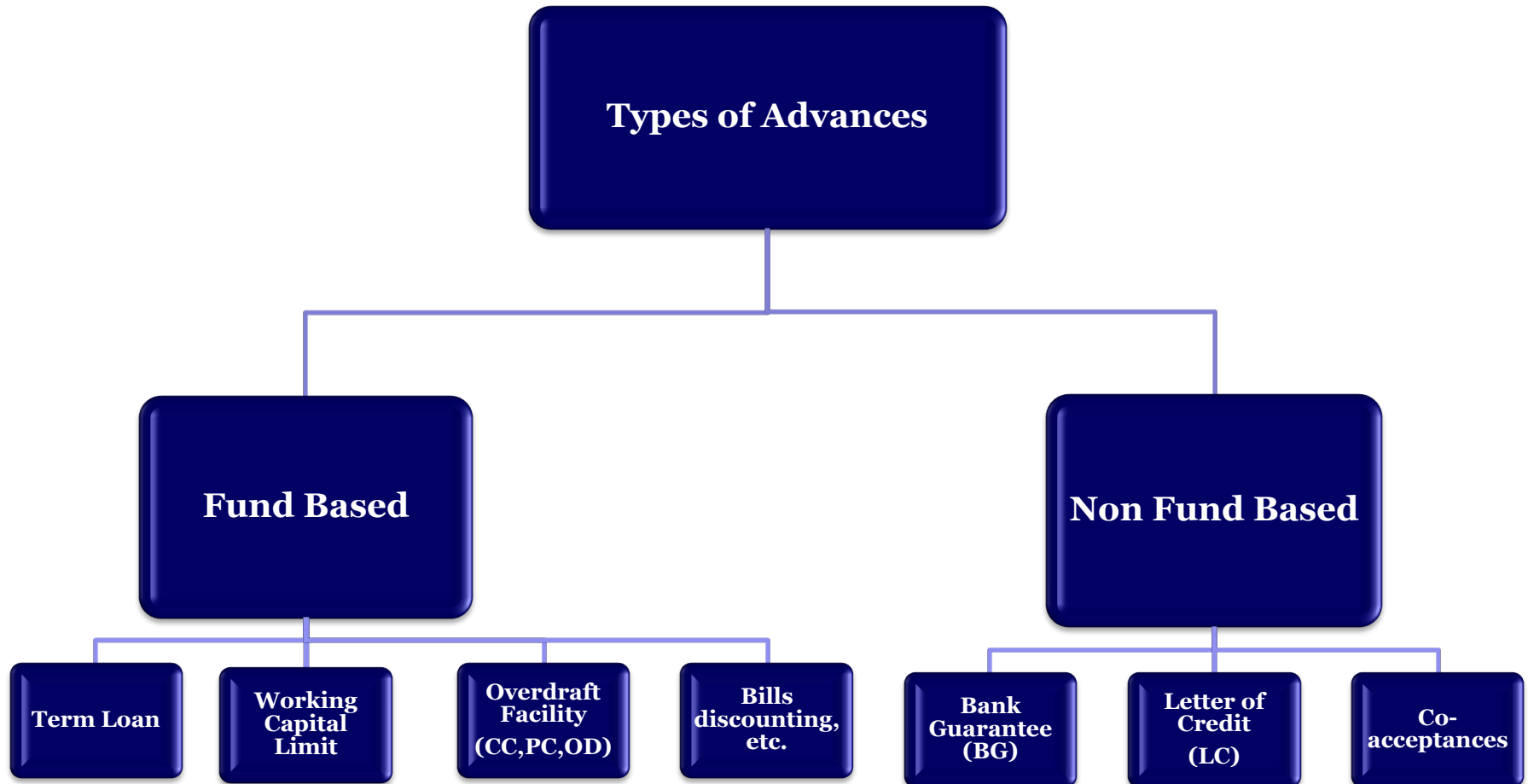
# Early Identification – Incipient Stress

## ■ Examples of incipient Stress: (*illustrative list*)

- The O/S balance remaining continuously in excess of the sanctioned limit or drawing power, whichever is lower, for > 30 days
- Devolvement of LC / invocation of BG and its non-payment beyond 30 days
- Increase in frequent overdrafts (TOD) in Current A/C
- Promoters pledging / selling their shares in the borrower company due to financial stress
- Other lending institutions marking account as SMA -2 / NPA in CRILC database
- Dishonor of cheques / overdue bills in the 30 days span
- Occurrence of a natural calamity in the geographical area where the borrower operates (e.g: Floods, earthquakes, pandemics etc)



# Types of Advances



**Note:** When the BG is invoked or LC is devolved, such facility gets converted into forced loan which is part of funded limits

# Audit of Advances: Branch risk profile

## *Branch Risk Assessment:*

- Internal branch risk rating exercise carried out by the Bank
- Analysis of the mix of advances (e.g. Corporate lending, retail lending)
- Comparison of the Advances portfolio of the branch vis-à-vis last year position.
- Pareto analysis of the Advances further drilled down to the borrowers (e.g. In case of a branch 65% advances were to a single borrower owning different entities)
- Notings of adversely commented in previous reports, concurrent audit, RBI inspection, control returns i.e. accounts overdrawn, adhoc sanctions.

# Audit of Advances: Audit Approach

*Audit of Advances should be divided in 2 parts:*

- Audit of advances sanctioned during the year
  - Credit Appraisal
  - Sanction and disbursements
  - Documentation
  - Review / Monitoring / Supervision
  
- Review of operations in advances sanctioned prior to the current year (Old Advances)
  - Asset classification
  - Operations in account as per the sanctioned terms (Sanc. Letter)
  - Provisioning as per IRAC norms
  - Income is recognized as per the IRAC norms
  - Review / Monitoring / Supervision

# Audit of Advances: Advances sanctioned during the year (New Advances)

- Preliminary requirements:
  - List of Advances sanctioned during the year under review along with account number and CUST ID (UCIC, Borrower wise as well)
  - Auditors to verify all large advances – O/S more than 10% of aggregate outstanding branch advances (FB+NFB) or Rs. 10 crores whichever is lower
  - Select samples from the above mentioned list by taking into account key parameters:
    - Total exposure to the branch in respect of the sanctioned loan
    - Credit rating of the borrower
    - Cases where the loan has been taken over from other bank/FIs
    - Advances pertaining to current stress sectors (E.g. Real estate, NBFCs, Aviation, MSMEs, Travel agencies etc)
    - Accounts of high value borrowers and high risk segment as may be identified by the bank
    - Advances lent to group Companies / related parties
    - Exposure to PEPs (Politically exposed persons)

# Audit of New Advances: Credit Appraisal

## *Key verification points:*

- Fresh or renewal proposal submitted by the borrower is in bank's prescribed forms
- Borrower has submitted relevant documents (viz. Financial Statements, Project Report, Cash Flow, etc.)
- Counter party risk i.e. Industry Risk, Group Risk & Individual Risk has been properly assessed and appraised in appraisal report
- Credit worthiness, means, net worth & other financial indicators of the borrower has been properly appraised and are satisfactory
- Nature of securities (prime /collateral) offered and to confirm the adequacy of security cover

# **Audit of New Advances: Credit Appraisal**

## ***Key verification points:***

- Title clearance report and valuation report of the security has been obtained. Check for any adverse remarks.
- In case where borrower is enjoying facilities with other banks, no objection certificate/ confidential report has been obtained
- Debt-equity Ratio, Debt Service Coverage Ratio (DSCR) and other financial ratios are satisfactory
- The factors such as, prospects of the business, the sources & period of repayment, evaluation of financial statement, projections, project report etc. has been evaluated
- Memorandum and Articles of Association or proof of constitution of the borrower is obtained

# **Audit of New Advances: Credit Appraisal**

## ***Key verification points:***

- Latest income tax records of the borrower & guarantors are obtained

# Audit of New Advances: Sanction & Disbursement

## *Key verification points:*

- Compare the sanction letter with the appraisal note prepared by concerned authority
- Proposal has been routed through appropriate authorization levels and recommendations are properly documented
- Limits sanctioned are within the discretionary powers of the sanctioning authority (verify delegation of authority matrix)
- In case where the sanctions are beyond the discretionary powers, the same has been reported to appropriate higher authorities and ratified
- Sanction letter/ limit approval letter stating the terms and conditions of sanction is available
- Acceptance of the borrower confirming the terms & conditions of sanction is obtained
- Terms & conditions of the sanction have been complied with



# Audit of New Advances: Sanction & Disbursement

## *Key verification points:*

- Any change in the terms of sanction is ratified by appropriate authority
- Fund disbursed has been utilized towards the object for which limit was sanctioned i.e. funds were not diverted to associates / subsidiaries
- Board Resolution for availment of the facility was obtained
- Facilities sanctioned to the borrower or its associated concern were not utilised to clear off existing overdues in the accounts
- Pre-disbursement inspection has been carried out & report held on record
- Confirm whether all the documents are executed as mentioned in the sanction letter before disbursement has been made
- Check the method of calculating drawing power on the basis of stock and book debts statement – whether same is in line with terms of sanction and also whether stock levels are in line with those mentioned in the appraisal note

# Audit of New Advances: Sanction & Disbursement

## *Key verification points:*

- Confirm whether the facilities sanctioned are within prescribed exposure limits. For calculating the exposure limits, both fund based and non-fund based limits should be considered together
- In case of credit facilities taken over from other institutions confirm whether takeover norms of the bank have been followed.
- Confirm whether the financial parameters given in the terms of sanction letter are properly fed in CBS. Such parameters include: *(more diligently in case of consortium loans)*
  - Amount of loan sanctioned
  - Amount of security
  - Rate of interest
  - Moratorium period, if any
  - Tenure of loan
  - 'D' indicator or 'E' indicator in case of Cash Credit (Finacle ERP)

# Audit of New Advances: Documentation

## *Key verification points:*

- All loan documents, as required by the sanction letter and loan policy have been executed (e.g. DP Note, Loan Agreement, Letter of Guarantee, Hypothecation Agreement, etc.)
- Loan documents are properly executed / filled up.
- Loan documents are approved by the legal expert, wherever required
- Fresh Loan documents are obtained on change in limit, change in the constitution of the borrower
- The letter of acknowledgement of debts/balance confirmation is obtained from the borrower
- Documents are kept in safe custody
- Charge on securities offered have been registered with Registrar of Companies / CERSAI (Central Registry of Securitisation Asset Reconstruction and Security Interest of India)
- Equitable mortgages have been created or documentary evidence for creation of charge are available

# Audit of New Advances: Documentation

## *Key verification points:*

- Original agreement, share certificate, title deeds, title clearance certificate, valuation report are held on record
- Invoice for the assets financed is available
- Fixed deposits receipts, offered as security, are available on record, verify whether lien marking is properly done in the system
- Fixed deposit receipts pledged as security have been properly discharged
- Letter of pledge and letter of appropriation and set off for deposits are obtained
- Insurance policies in respect of prime/collateral security are assigned in the favor of bank
- Insurance policy for entire value of security is obtained and has not expired

# Audit of New Advances: Review / Monitoring / Supervision

## *Key verification points:*

- Review of facilities has been carried out as per the policy of the bank
- Exception report, of the accounts where limit has expired, has been periodically generated and is informed to appropriate authority
- Fixed deposit receipts pledged as security have been properly discharged
- Securities charged to the bank have been periodically inspected
- Inspection report stating existence of security, valuation thereof, etc. is available
- Discrepancies observed on inspection has been rectified in time
- Periodical Stock/Book-debts statements are received regularly and scrutinized by the bank
- Limit sanctioned to the borrower has been reviewed and restricted to the drawing limit i.e. arrived at after deducting margin

# Audit of New Advances: Review / Monitoring / Supervision

## *Key verification points:*

- Periodical MIS reports as required are obtained from the borrower
- Audited financial statement are obtained and reviewed to ascertain overall financial health of the borrower
- Follow up of unrenewed accounts has been done
- Operations in the account of borrower are satisfactory
- The balance does not exceed the sanctioned limit and any excess drawing allowed have been intimated to and ratified by appropriate authority
- Sales / turnover / gross profit / net profit / capital of the borrower is not showing drastic declining trend as compared to previous year

# Audit of Old Advances: Verification of operations

## *Key verification points:*

- Select samples from the total list by taking into account key parameters:
  - Advances having high risk and large exposure to the branch (Top 10 standard accounts post pareto analysis)
  - Current accounts having debit balances
  - Special Mention Accounts 2 (SMA 2) accounts (60 days and above)
  - Quick mortality accounts (NPAs within 12 months)
  - List of LCs devolved and BGs revoked; Packing credit above 90 days
  - Accounts rolled over in case of short term reviews
  - List of restructured accounts
  - Cases which have been upgraded from NPA to standard
  - Special dispensation cases – GST dispensation to MSME sector, one time restructuring (MSME) loans, Project loans (DCCO dates); In all these cases NPAs may have to be identified on a manual basis

# Audit of Old Advances: Verification of operations

- **Loans with a fixed repayment period - Term Loans, other loans:**
  - Scan the SMA 2 list (Use CRILC database)
  - Verify the source of the payment made for outstanding dues specially at the end of the reporting period (fresh loan, TODs, debit to office account, reversal of credits)
  - Compute the estimated balance as on March 31 based on the repayment schedule of the borrower
  - If the approximate balance is substantially more than the computed balance - dig deeper;
  - Check fresh disbursements vis-à-vis sanction letter
  - Verify for 'minor changes' of the repayment terms which may be disguised as CAP (Corrective action plan) without calling it as restructuring



# Audit of Old Advances: Verification of operations

## ■ Cash Credits / Overdrafts:

- Verify the SMA 2 list with CRILC database
- Verify debit & credit summations / credit adequacy of interest debits
- Look for solitary credits especially at the end of the reporting period – Check for its source through the IT system
- Check where LC devolvement(s) have been parked – should be debited to the operating account
- Check for TODs / Adhoc sanctions near to the reporting period, un-regularised TODs (Running TODs)
- Check if limits have been recently altered (Ad-hoc fresh sanction)
- Verify for fresh interchangeability of limits (NFB -> FB)
- Verify for DP computations
- Frequent / Short / Ad-hoc renewals may lead to masking of NPAs

# Audit of Old Advances: Verification of operations

- **Bills Purchased / Bills discounted:**
  - Look for due dates and date of payments - in some banks it may not be automated
  - Overdue bills - Auditor should ascertain reasons for the delay and the action taken by the bank
  - Certain eligible cases – bills discounted may be rediscounted with RBI / SIDBI such bills would constitute contingent liability.
  - Total of outstanding bills of each party is not in excess of the sanctioned limit

# Audit of Old Advances: Verification of operations

## ■ **Project Loans - Area of Focus:**

- Project loan means any term loan which has been extended for the purpose of setting up of an economic venture:
  - Infrastructure
  - Non-infrastructure
- Verify for eligibility of project loans – ineligible project loans like retail loans and projects not undertaken for economic venture
- Need to verify ‘Actual Date of Completion’ (DC) vis-à-vis ‘ original Date of Commencement of Commercial Operations’ (DCCO) / extended DCCO

# Audit of Old Advances: Verification of operations

## ■ Non Fund Based Facilities: LCs/ BGs

- Proper procedure for sanctioning non fund based facilities; NFB facilities are duly monitored and are within the sanctioned limit
- In general, banks do not issue these facilities especially Guarantees for walk-in customers even with 100% cash margin
- Necessary margins as prescribed in the sanction letter have been duly collected and lien marked
- If these facilities are devolved / invoked, then they would be funded advance
- Banks to discontinue the practice of issuance of LoUs / LoCs for Trade Credits for imports into India with immediate effect (RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018)

# Audit of Old Advances: Verification of operations

- *Instances of Evergreening / Round tripping*
  - Sanction/extension of Additional facility /Adhoc facility.
  - Enhancement of Limit
  - Conversion of Overdue Limits
  - Conversion of NFB to FB
  - Frequent re-schedulement of Term Loans
  - Adjusting Loan of one borrower against other borrower
  - Appropriate technical reports on DCCO should be on record
  - Single or random credits in accounts.



# **Classic Cases – Evergreening / Round tripping**

# Audit of Advances: Evergreening

**Six (6) New Agri Loans sanctioned to employees of S education institute**

**A**  
13 L + 7 L

**B**  
15.20 L + 4.8 L

**C**  
15 L + 5 L

**Total Recovery: Rs. 59,60,000**

**7.60 L**

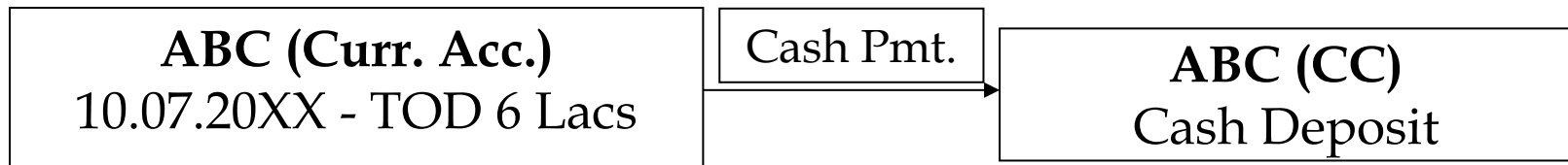
**52 L**

**S education institute  
(3620)  
Loan A/c in Overdue**

**S education institute  
(3638)  
Loan A/c in Overdue**

# Audit of Advances: Evergreening

Month	Intt Amt	Recovery	Date	Mode
Dec-20XX	1,22,621.00	45,000.00	22-Feb-XX	Cash
Jan-20XX	1,51,949.00	50,000.00	29-Mar-XX	Cash
Feb-20XX	1,54,613.00	90.00	29-Mar-XX	
Mar-20XX	1,60,140.00	<b>5,00,000.00</b>	<b>30-Mar-XX</b>	<b>Cash / NOTE</b>

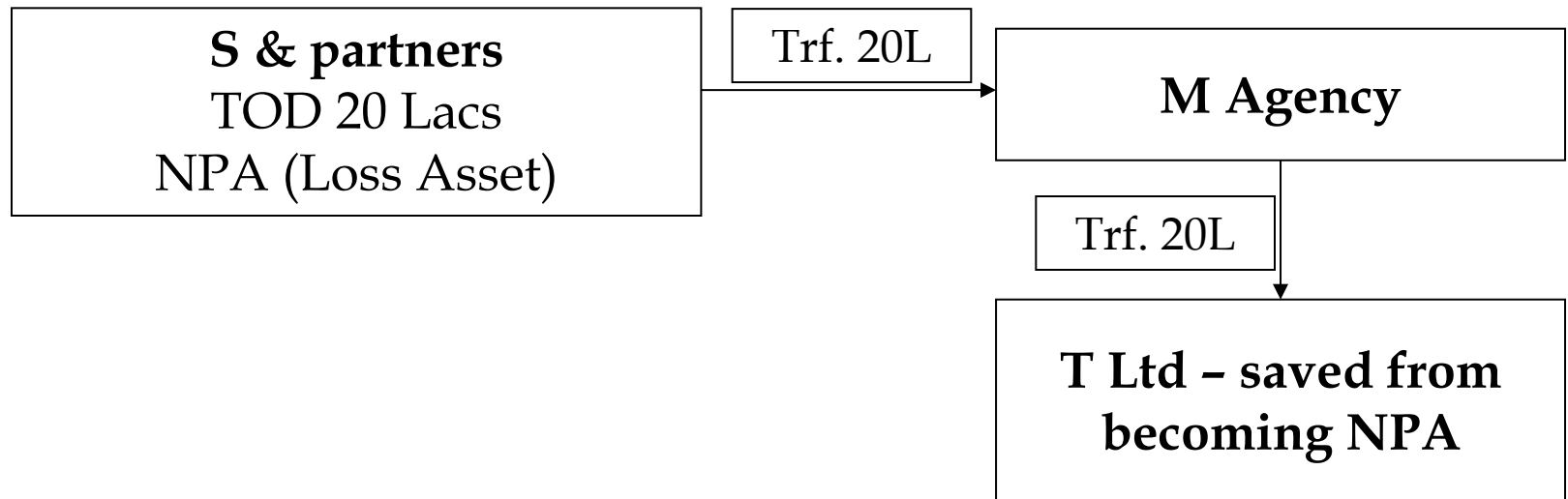




# Audit of Advances: Evergreening

## ■ Background:

Funds by virtue of TOD in a loss account transferred to M Agency (A/c 9888) for final credit to T Ltd (A/c 3632)



# Audit of Advances: Evergreening

(Credit Summation Analysis)

- A/c No. 3681 – CC Account (ABC Constructions)
- Limit – Rs. 7,00,00,000
- Balance as on 31.03.20XX – Rs. 7,44,79,224 (Dr.)
- Total Credits in FY XX: Rs. 1,57,80,641

Credit Source Analysis	Amount	% to Total
Cash	12,68,500	8.04%
<b>XYZ Construction (Current Account – Related Party)</b>	<b>1,26,00,000</b>	<b>79.84%</b>
<b>XYZ IT Co. (Current Account- Related party)</b>	<b>10,10,000</b>	<b>6.40%</b>
Reversal of Penal Int.	8,99,120	5.70%
Misc. recovery	3,022	0.02%
	<b>1,57,80,642</b>	<b>100%</b>

# Audit of Advances – Case Studies

## *Case Studies – Instances observed*

### **Case - 1**

- Large group account with consortium banking
- 2 Term Loans sanctioned in a span of 6 months with significant deviations (CAP) and dilution of security position of the bank
- Purpose in the sanctioned letter:
  - Normal and maintenance capex
  - Funding of subsidiary projects
- Actual Utilization made for:
  - To repay other banks debts
  - Service interest for earlier dues, ECB dues and derivative dues
  - Round tripping of funds
  - **Classic Case** - of disguised restructuring and evergreening.

# Audit of Advances – Case Studies

## Case - 2

- The account became ‘out of order’ with a BG invocation on July 7, 20XX.
- The amount was parked in a separate account and paid off on Sep 27, 20XX from the CC account wherein interchangeability from NFB to FB facility was allowed.
- Rectification under CAP sanctioned, with a sanction of WCTL – amount matching the BG invocation.
- The account had already turned NPA in Oct 15, if interchangeability was not sanctioned by the bank.

# Audit of Advances – Case Studies

## Case – 3

- CC account on the verge of becoming NPA, limit / DP was overdrawn for a period of more than 90 days.
- However, without performing a credit appraisal, the bank sanctioned an ad-hoc increase in the DP and also increased the limit of the account so that the system does not identify the account as NPA.

## Case – 4

- A TL account on verge of becoming NPA, overdues not serviced for 90 days.
- An account of the borrower of the same branch used to finance the overdues on the 90th day and the funds again transferred to the borrower after a period of 4 days post closure of accounts.



# **Memorandum Of Changes (MOC)**

# MOC – When & How to issue MOC

- **Memorandum of Changes (MOC) – When to issue**
  - MOC in effect is a rectification entry that needs to be passed in the books of branch accounts to rectify errors / omissions / classifications / provisions etc.
  - MOCs can be categorized into following heads:
    - Relating to modifications in Balance Sheet
    - Relating to modifications in Profit and Loss Account
    - Modifications to advances portfolio (Re-classifications)
    - Relating to outstanding balances of the advances
    - Revision in provisions (NPA or other)
    - Reversal of income on newly recognized NPAs.
    - Rectification required in relation to fixed assets

# MOC – When & How to issue MOC

## ▪ Memorandum of Changes (MOC) – How to Issue

- The branch auditor should read the closing circular issued by the banks to branches, wherein the detailed methodology to be followed for preparing the MOC is elucidated.
- The branch auditor is expected to acquaint himself with the methodology of preparing MOC and particularly the correct account codes, corresponding effect of the debits and credits.
- Wherever the interest or other incomes are reversed on Non performing advances the MOC for provisioning should be net of such reversals
- The MOCs should be backed up by adequate documentation and should be correctly reflected in the statement of MOC with reasons provided thereof.
- Even in case there are no such issues observed by the Auditor, NIL MOC is required to be enclosed with the report. All the facts and figures given in the MOC are also given a reference in the Main Audit Report.



# MOC – When & How to issue MOC

To  
Finance & Accounts Department

Branch :  
Br. Code :  
Region :  
Date :

## Memorandum of changes - Journal Entries to be passed

Sl. No.	Particulars *	Code No.	Debit Rs.	Credit Rs.

\* Full details along with code number in Balance Sheet / P & L Statement shall be furnished along with each entry.

Principal Officer  
Name

**Auditors' signature with seal**

# MOC – When & How to issue MOC

<b>Memorandum of Changes (summary) – Audit Report</b>				
	Increase		Decrease	
	(No. of items)	(Rs.)	(No. of items)	(Rs.)
<b>In respect of :</b>				
<b>a. Income</b>				
<b>b. Expenditure</b>				
<b>c. Assets</b>				
<b>d. Liabilities</b>				
<b>e. Gross NPAs</b>				
<b>f. Classification of Advances</b>				
<b>g. Risk Weighted Assets</b>				
<b>f. Other items (if any)</b>				

# MOC – When & How to issue MOC

## ▪ Memorandum of Changes (MOC) – Precautions

- Justification for modifications suggested by auditor i.e. the nature of change as well as the quantification of suggested change and its impact.
- The format of MOC in most banks will have both sides like a trial balance. It should be ensured that total of changes suggested in balance sheet and profit and loss account is tallied on both accounts
- The total of reclassification of the advances suggested in secured, unsecured, guaranteed advance and sector wise advance should be correctly brought out in the MOC and total of both sides should tie up
- In case of change suggested as per prudential norms on income recognition, the impact, if any on the provisioning of the assets is also to be looked into
- It is to be ensured that a NIL MOC is invariably forwarded, even if there are no change in the report.
- MOC also to be signed by the branch in charge
- Disagreement between branch manager and auditor – Scenario
- If branch is not agreeable then it should say so, at least the impact is quantified in case CSA has to uphold the MOC



**Questions ?**



**Thanks!!!**

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