

AUDIT OF BANK BRANCH ACCOUNTS FOR 2007-08

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NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION AND PROVISIONING**I. ADVANCES ACCOUNTS NEED TO BE EXAMINED TO DETERMINE THEIR STATUS AS TO WHETHER:**

- i) **Provision** is made to the satisfaction of the auditors, as per the legal requirements in respect of accounts of borrowers for which Guidelines of the Regulator (RBI), based on categorisation of the borrowers into "Standard", "Sub Standard", "Doubtful" or "Loss".
- ii) **Income** is recognized only on accrual basis:
 - a. as contractually due in respect of Performing Advances, i.e., Standard Assets; and
 - b. on actual realization/recoveries in case of Non Performing Assets, being Sub standard, Doubtful and Loss Assets).

The determination of the realistic status of the Borrowal accounts has direct impact on the net operating results of the bank, based on the effect of the sum total of provisions for advances (*including standard assets, where the same is required at higher levels*) and income recognition and disclosure of Advances appropriately.

While provisions are generally centralised and not considered at the Branch level, is imperative to determine, at the Branch, the correct classification status of the borrowal accounts, based on documentation, operations, security/guarantee and other relevant factors.

Based on the Audit exercise and the Memorandum of Changes forming part of the Branch Audit Report, remedial action is taken at the centralized level with regard to provisions (including where the classification status is changed); and income recognition/derecognition is considered on behalf of the branch, beyond revenue recognized by the Branch, based on consideration of the Branch Audit Report.

Verification of Advances is a critical part of the scope of the work and responsibilities of the Branch Auditor and he needs to be equipped with the requisite and updated knowledge of the latest applicable legal, regulatory and accounting requirements and corresponding skills to execute the assignment.

- A. **Provision** needs to be made based on categorization of Assets (including leased assets), as under; and would include advances sanctioned against Central Govt. guarantee, if the same is invoked and State Govt. Guarantee irrespective of invocation, and where the advance remains in default for 90 days:

Reference may be made to the Chart in **Section E II**

Provisions in special circumstances:

- a. In Advances where rehabilitation is considered, provisions should continue in respect of the existing credit facilities as per their classification as "Sub standard" or "Doubtful" except that **in respect of additional facilities granted:**
 - no provision is to be made for one year *from the date of disbursement*, for rehabilitation packages approved by BIFR/term lending institutions(TLIs); and
 - no provision need be made for one year for SSI Units identified as sick and where the rehabilitation packages/nursing programmes are drawn up by the Bank under consortium arrangements with other banks.
- b. **Advances against Term Deposits of the Bank, NSCs eligible for surrender, IVPs, KVPs and Life policies** are not exempted from provisioning, and would attract provision based

on their classification Cases where the year- end outstanding is higher than the realizable security, must be looked into.

c. **Advances against gold ornaments, Govt. and all other kinds of securities** are not exempted from provisioning requirements.

d. **Additional provisions as per RBI Prudential Norms:**

i) **Migration of advances from Sub Standard to Doubtful Category**

Additional provision consequent, upon the accelerated time frame for Migration of advances from Sub Standard to Doubtful Category (18 to 12 months), was allowed by RBI to be phased out over a four year period commencing from the year ended 31-3-2005, with a minimum of 20% each year {Refer Para 5.3(iii)}.

Data is generated at branches for computation of provision at the centralised level.

ii) **Floating provisions and Provisions at higher rates for NPAs**

Beyond specific provisions as per the RBI Guidelines, the Bank may consider higher provisions as under:

- pursuant to a Board approved policy (and subject to a level being indicated) for provisions (for possible inherent weaknesses in accounts), to be termed as “Floating provisions”, which can be used for contingencies under extraordinary circumstances (to be defined); and utilization thereof for specific provisions in impaired accounts to be made with prior permission of the RBI.

Till utilized, **such provisions can be netted off from the Gross NPAs** for disclosure of net NPAs, or to be treated as part of Tier II Capital within the overall ceiling of 1.25 % of the total risk-weighted assets.

Para 5.5.4 requires the disclosure of the movement of floating provisions.

- Other provisions (not being Floating Provisions), on voluntary basis at rates which are higher than as per the prudential norms, which may be consistently applied/ adopted.

Certain Specific requirements:

- Provision needs to be made to cover possible shortfall in the sale of financial assets (at prices below the Net Book Value); and while actual shortfalls are to be charged off to the Profit & Loss Account, the excess, if any, resulting on sale of some such assets is not to be reversed out of the provisions built up for this purpose (Refer Para 5.8.10 of the Master Circular).

- **Provision for country risk** in respect of the country where the Bank's net funded exposure is one percent or more of its total assets.

Over and above the provisions bench-marked and stated above, as per Para 5.8.9 of Banks are expected to make country risk exposures based on the ECGC classification, on the basis of the slabs given (A1 and A2 -0.25%; B1 -5%; B2 - 20%; C1 - 25%; C2 and D (Off credit) - 100%) . In case of ‘Loss’ and Doubtful” assets the combined provision, i.e. including for country risk, is to be restricted to 100%.

The Bank may consider a lower level of provisioning (say 25% of the requirement) in respect of contractual maturity of less than 180 days.

e. **Projects under implementation – 3 categories:**

i) A provision equivalent of the Income already wrongly recognized in the past should be made in respect of assets, which are in reality are other than ‘Standard’.

ii) Funded interest should be fully provided for;

- iii) amounts converted into equity, debentures or other instruments should be fully provided for and not reversed till realization/redemption; **and**
- iv) provisions already held in NPAs sought to be reclassified or upgraded as 'standard' should not be reversed.

Where up-gradation is done in case of restructured accounts, the provision made earlier, net of the sacrifice, can only be reversed i.e. notionally worked out sacrifice will continue to be retained.

- f. Central Government guaranteed exposures- norms apply only if guarantee repudiated:**
Central Govt. guaranteed advances in default cannot be classified as NPA unless guarantee is invoked and repudiated.

If in default, classification, provisioning and income recognition **norms apply to State Govt. guaranteed advances and investments**, irrespective of invocation/repudiation thereof.

Balance Sheet Disclosures:

Provisions for NPAs as per prudential RBI bench-marked norms are netted off from the Advances portfolio of the Bank; as also if the Bank exercises to net off the Floating Provisions as aforesaid.

Provisions in excess of those necessary for the purpose including for "Standard" assets, being in the nature of reserves, are shown as part of undisclosed reserves under "Other Liabilities and Provisions – Others" in Schedule 5 to the Balance Sheet.

B. Income:

- a. Generally, income:
 - i) can be accrued and needs to be recognized only on Standard Advances;
 - ii) cannot be accrued or recognized on NPAs comprising "Sub-standard", "Doubtful", "Loss" Assets, unless the same is actually realized/recovered.
 - iii) If accrued and recognised for the preceding year in respect of accounts identified during the year as NPA, income needs to be derecognised, to the extent not realized.
- b. Income realized in NPAs can be appropriated to Income provided the credits are not out of fresh/additional credit facilities sanctioned to the borrower.
- c. Subject to any instructions to the contrary from the constituent, the Bank, *according to the Prudential norms*, has a right to appropriate the recoveries to either income (earlier not recognized), or to principal; provided the Bank adopts a proper accounting policy and does it on a uniform and consistent basis.

However, keeping in view AS 9 Revenue Recognition issued by the ICAI, it would be appropriate to reckon the recoveries by giving priority to charges and interest and then to the principal.

In case the Bank adopts a policy to accord priority to principal, the account can never be upgraded till full recovery of interest (applied/unapplied).
- d. **Interest derecognized, if already accrued in the earlier year in respect of NPAs identified in the current year, is usually reversed to the current year's interest; and not provided or credited back to the constituent.**
- e. recoveries in excess of total acquisition cost of NPAs purchased from other banks, can only be appropriated as income.

C. Interest Suspense and Unapplied Income in NPAs:

Usually the income earlier recognized (by debit to the borrower), is reversed by crediting "Interest Suspense" or similar account, and without giving credit to the borrower.

Amounts not recognized as income/revenue are either held in Interest Suspense or similar account or recorded *on contractual basis* in other memoranda records (dummy ledgers).

It is imperative that track is kept of such unrecorded income as the precise figures are reported by the Bank for each year-end to the Reserve Bank of India

THE FOLLOWING NEEDS TO BE KEPT IN VIEW:

1. IMPORTANT TERMS DEFINED IN THE PRUDENTIAL NORMS

As per R.B.I. guidelines , credit facilities can either be **overdue** or **out of order**.

Overdue:

(applicable to installments of principal in term loans, servicing of interest and bills purchased and discounted)

If the interest/installment of term loan or a bill or any credit facility is not paid on the due date fixed by the Bank, it becomes overdue; and, except in case of agricultural advances, becomes NPA if the period of default in payment/repayment from the overdue date exceeds 90 days. Crop Loans will become NPA, if the installment of principal and/ or interest remains overdue:

- a. for two crop seasons for short duration crops; and
- b. for one crop season for long duration crops.

Where moratorium for payment of interest is granted, overdues should be reckoned from the due date based on the gestation period allowed and not with reference to the dates of the debits.

Where the due date is unjustifiably and repeatedly changed to avoid the borrowal account becoming NPA, the auditors need to examine the same to gauge the Bank's intention, before taking an adverse view.

Due Date

It should be taken as the date on which interest/installment is payable by the borrower.

Interest on various loan accounts is normally debited monthly, and interest should be considered as falling due for payment on the date of debit, unless otherwise contractually agreed.

Installment falls due for payment as per terms of sanction.

Overdues are with reference to the gestation period being over in cases of moratorium, where granted; and in case of staff housing loans default in repayment of principal and interest on the stipulated due dates would determine the status of NPA.

In the case of advances for project finance or for agricultural plantations where repayment holiday is granted for payment of interest, due date is only after the moratorium period has lapsed.

In cases of loans to staff, education loans and certain other advances, the interest /installment amount falls due for payment only after the expiry of the stipulated period.

In the case of loans against the Bank's own deposits, interest is due on the date(s) of debit to the loan accounts, irrespective of the dates of credit towards interest on Term Deposits.:

If not paid on due date fixed by the Bank, the amount becomes **overdue**.

Out of order:

(applicable to advances other than Term Loans/Bills Discounted and Purchased)

An account (Cash credit/overdraft) should be treated as 'out of order' if any of the following conditions is satisfied :

- I) Where the outstanding balance remains **continuously** in excess of the sanctioned limit/drawing power;
OR
- II) Even though the outstanding balance in the principal operating account is less than sanctioned limit/drawing power, but
 - a) there are no credits **continuously** for more than 90 days as on the date of Balance Sheet/classification, or
 - b) the credits are not enough to cover the interest debited during the same period.

Drawing Power should be lower than the Limits sanctioned and terms normally warrant that the security should be net of the unpaid for liability on such security **and** further net of the stipulated margin; and if such unpaid liability is not netted, it would result in double finance availed of by the borrower – from the bank and supplier's credit.

2. CLASSIFICATION OF ADVANCES:

Advances comprise moneys laid out by the Bank by way of term loans, cash credits, overdrafts, bills purchased and discounted for the purpose of earning yields (interest/discounts etc.) and include all the interest bearing# advances granted to employees e.g. Clean Loan, Housing Loan, Conveyance Loan and other Advances to employees (other than those as an Employer) normally against security and/ or guarantee and covered by appropriate documentation, pursuant to due process procedures by way of appraisal, sanction etc.

(#non-interest bearing advances e.g., Festival Advances. Salary Advance to celebrate Festival and Flood Relief Advances to Staff should not be treated as advances but be shown under the head "Other Assets").

Banks generally have a laid down system to identify and classify a borrowal account into the classification attributable thereto as per the applicable Prudential Guidelines laid down by the Reserve Bank of India(RBI).

Broadly, Advances can be classified as either '**Performing**' or '**Non Performing**', depending on whether they disclose any inherent problem in terms of the risks of trade attached thereto and whether these, in the normal course, generate income for the Bank. Exercise of judgment with regard to operations in the borrowal accounts based on documentation, operations, security and guarantee cover and other monetary and non monetary factors will determine classification **based on the most adverse status of the account/facilities in any account**.

- a. **Performing Advances** are reckoned as Standard Assets where income can be accrued and recognized (on contractual basis) in the Profit and Loss Account.
- b. **Non-performing Advances** are considered to be those that cease to generate income for the bank.

These comprise borrowers identified and categorized as Sub-standard, Doubtful or Loss Assets for provisioning and in respect of which income is not accrued/recognized on contractual basis but recognised only on actual realisation.

If non performing, a Borrower, may be classified as under, either as sub- standard or doubtful or loss asset.

i) Sub-standard Asset

A sub-standard asset is one which has been classified as NPA for a period not exceeding 12 months. Such an asset will have well defined credit weaknesses that

jeopardise the liquidation of the debt and are characterised by a distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

(Additional provisions consequent upon migration from 18 to 12 months for sub standard assets are allowed to be phased over four years, commencing 31-3-2005, subject to a minimum of 20% each year). The basis adopted by the Bank for phasing such provision needs to be enquired into.

ii) Doubtful Asset

A doubtful asset is one which has remained NPA for a period exceeding 12 months.

Such an asset has all the characteristics of a sub-standard asset with the additional characteristic that, on the basis of currently known facts, conditions and values, the recoveries may be highly questionable and improbable.

In the case of erosion in the value of the security or frauds committed by the borrowers where the assessed realizable value of the securities has a significant shortfall – 50% or more, the asset would necessarily have to be included as Doubtful and provided for.

iii) Loss Asset

A Loss Asset (*irrespective of the period elapsed since its sanction/disbursal*), is one where loss has been identified by:-

- a) the bank, or
- b) the internal or external auditors, or
- c) the RBI Inspection,

but the amount has not been written off, wholly or partly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

In the case of erosion in the value of the security or frauds committed by the borrowers where the realizable value of the security as assessed by the Bank/ approved valuers/RBI is less than 10% of the outstanding, the asset would be a Loss asset.

Basis of classification as NPA in different types of facilities

The broad criteria for classification of the borrowers as NPA is given below as regards credit facilities of different types; and any doubt about the NPA classification must be internally resolved within one month of the normal date of NPA :

i) Term Loans

a. Agricultural Loans:

With effect from 30-9-2004, loans granted for short duration crops and that for long duration crops, are to be segregated for determination of the period of default in servicing the principal/interest; which default (overdue) for a period of two crop seasons for the former will become NPA, and for default of one crop season, will become NPA in the latter.

b. Other Term Loans:

Such loans become NPA where installments of principal and / or interest remain overdue for a period of more than 90 days from the end of the quarter.

ii) Bills Purchased and Discounted

A bill Purchased and Discounted should be treated as NPA if the bill **remains overdue** and unpaid for a period of more than 90 days.

iii)* Cash Credits and Overdrafts

A Cash Credit or Overdraft Account should be treated as NPA if the account remains “**out of order**” for a period of more than 90 days(Refer to definition of “out of order”)

****While interest is charged on a monthly basis, the NPAs need to be reckoned with reference to the period of default/ non servicing of the interest for 90 days from the end of each quarter i.e. where interest is not fully paid from the end of each quarter.***

“Quarter” does not necessarily mean calendar quarter, as determination of NPA is an ongoing exercise.

A borrowal account may migrate to a more adverse category within less than the normal stipulated retention period in each classification status, where conditions so warrant and if the account is observed as intrinsically weak on facts or evidence, and deserves a higher provision/write off (including prudential write off).

Temporary Deficiencies/Non monetary factors:

Existence of temporary deficiencies may not warrant classification of an account into NPA where defaults in accounts are remedied, particularly in circumstances where the borrower becomes NPA due to:

- non-receipt of stock statements for a period of **3 months** and older statements being used for working out drawings power, which would make the account irregular and if drawings are permitted for 90 days **thereafter, i.e. after irregularity of 3 months;**
- non-review/renewal of limits or non-regularization of ad hoc limits **within 180 days** from the due date/date of ad hoc sanction.

Temporary deficiencies in irregular/overdrawn accounts can also be cured if **all amounts in default** are paid out of genuine sources and not being stray instances of credits.

*(It has been clarified in *RBI Circular DBOD.No. BP.475/21.04.048/2005-06 dated 27-9-2005, to one of the banks that in case of a borrower who is a sole proprietor and has several accounts/facilities, all borrowal accounts will be classified in the most adverse status in any facility.*

In case a partnership account becomes NPA, the personal accounts of all the partners will be treated as NPA. However, if the accounts of one or more partners become NPA, the Partnership account shall not be automatically treated as NPA. Logically if all the partners are NPAs, the partnership firm shall also be NPA).

*(*not applicable to rescheduled/restructured loans to farmers who have suffered production/income losses due to natural calamities for two or more successive years in the last five years)*

iv) Upgradation of loan accounts classified as NPAs

If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as ‘standard’ accounts. With regard to upgradation of a restructured/ rescheduled account, which is classified, as NPA refer Master Circular issued by RBI.

v) Accounts regularised near about the balance sheet date

The asset classification of borrowal accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory

evidence to the Statutory Auditors/Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

vi) Asset Classification to be borrower-wise and not facility-wise

- i) It is difficult to envisage a situation when only one facility to a borrower/one investment in any of the securities issued by the borrower becomes a problem credit/investment and not others. Therefore, all the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not the particular facility/investment or part thereof which has become irregular.
- ii) If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.

vii) Advances under consortium arrangements

Asset classification of accounts under consortium should be based on the **record of recovery of the individual member banks** and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books,

viii) Accounts where there is erosion in the value of security/frauds committed by borrowers

In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers it will not be prudent that such accounts should go through various stages of asset classification. In cases of such serious credit impairment the asset should be straightaway classified as doubtful or loss asset as appropriate.

- i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.
- ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

3. SECURITY AND GUARANTEE:

a) Security

For the purpose of making provisions, the importance of determining the realisable value of securities, estimated on a realistic basis, and the guarantee cover available, need to be kept in view for computing the unsecured portion/deficit, if any, particularly in case of Sub Standard Accounts.

The following points are relevant:

- i) **Primary as well as collateral securities** must be considered for valuation. The securities should preferably be evaluated as at the year-end.

Valuation Reports may be more relevant in NPA Accounts and the periodicity at which these are obtained may be ascertained, and a reasonable periodic interval normally accepted.

- ii) The **latest Stock Statements**, as near the Balance Sheet date, should be called for and be considered. A view may also emerge based on the comparison of the latest audited financial statements and the financial data submitted corresponding to the date of such statements (say, for the earlier year), to see if there are any major deviations therein, as provoke an enquiry.

RBI has made it mandatory that in case of NPAs with balances in excess of Rs.5 crores:

- Stock audit be got done by external agencies once a year; and
- Collaterals (immovable properties) are be got valued once in three years by valuers.

Such reports must be examined.

Visits to godowns:

It may normally not be necessary to visit the godowns for verification of stocks where there is reasonable evidence on record that inspections have been made at periodic intervals **and the existence and market value of security** are not in doubt e.g. where Godown Registers so indicate, and there is no adverse finding in the

Inspection Reports or by other banks in consortium arrangements.

Where there are serious doubts or where internal procedures are not carried out, godown visits may become necessary.

- iii) Book Debts, though not a tangible security, is to be reckoned as a security and advances against Book debts are required to be disclosed in the financial statements as "Secured by tangible securities", with a suitable disclosure, in the annual accounts.
- iv) The surplus of the securities over the first charge can be considered as security in cases where 2nd charge has been created in favour of the Bank, and there is reasonable certainty that upon satisfaction of the first charge such surplus can be available.
- v) The realisable value of other securities should also be taken into account. These would include realisable value of LIC Policies, shares and other approved securities.

b) Credit Guarantee(ECGC/DICGC/CGTSD):

For the purpose of provisioning (other than for assets in " Sub Standard" category), the availability of credit guarantee cover is the criteria irrespective of whether or not the claim is invoked, to determine the unsecured portion of the advance.

4. SPECIAL CONSIDERATIONS:

a) Agricultural Advances

In respect of agricultural advances, the repayment of interest/ instalment is synchronised with crop seasons for long and short duration crops; and the determination of NPA is linked to defaults in servicing based on the overdues related to the crop seasons.

This is subject to reschedulement etc. for farmers in areas of natural calamities and crop failures, for which various RBI Circulars may be referred.

Short/Long duration crops:

With effect from 30-9-2004, the determination of NPAs would depend on the status of overdues in short duration crops or otherwise. Where interest /installments are **overdue** for more than two crop seasons for short duration crops, the advance becomes NPA, while for long duration crops it is **overdues** for one season or more.

b) Consortium Advances

In respect of Consortium Advances, the bank must classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances, irrespective of the fact that the leader may not have remitted funds out of the pooled collection as the share of the bank.

c) Apportioned Limits/Transfer of accounts from others branches:

- In respect of apportioned limits:

The Asset Classification adopted by the Main branch should be adopted by all other branches. If a branch has got apportioned limit, it needs to ascertain the Asset Classification from the Main branch. If the branch has apportioned limit to other branches, the Asset Classification has to be done taking into consideration the overall position in the account with all the branches. The main branch should inform the Asset Classification to the respective branches before the year-end.

- Advances transferred from other branches:

In case where a borrowal account is transferred from another branch, the status and operations of the account in the pre-transfer period needs to be ascertained to determine the effect thereof on classification.

d) Loans Granted under Government Sponsored Schemes

For loans granted under Government sponsored schemes such as SEEUY, PMRY etc. the assets created out of Bank finance and the subsidy received from the Government and kept under Deposit/Sundry Liabilities are available as securities besides credit guarantee cover under DICGC wherever eligible. Hence NPA, if any, under this category shall be either sub-standard (if adequate security cover is available including subsidy) or doubtful, and not a loss asset.

Back-ended subsidies if received under certain schemes are expected to be treated not as Deposits, but as a liability under the head "Other Liabilities" till such time as these can be appropriated towards the last installment of the Term Loan, if in "Standard" category.

If an NPA, the loan would have to suffer a provision at its gross value i.e. without adjustment of the subsidy or its being treated as a security.

No interest can be charged on Advances to the extent of such subsidy received.

e) Advances granted under rehabilitation packages approved by BIFR/term lending institutions(TLIs)- Provisions:

Where additional facilities are granted to a unit under rehabilitation packages approved by BIFR, term-lending institutions or the bank (on its own or under a consortium arrangement), provision should continue to be made for the dues in respect of existing credit facilities. As regards the additional facilities, provision need not be made for a period of one year from the date of disbursement in respect of additional facilities sanctioned under rehabilitation packages approved by BIFR/term-lending institutions.

Similarly, no provision need be made for a period of one year in respect of additional facilities granted to **sick small-scale industries** unit in accordance with a rehabilitation package/nursing programme drawn by the bank itself or under a consortium arrangement.

After the period of one year, the banks in consultation with their auditors would take a view whether there is need for making provisions for the additional facilities sanctioned at par with the old outstanding dues

Such Advances, if in Standard category, need to be critically examined.

f) Post-shipment Supplier's Credit:

Where ECGC cover is available and any guarantee is invoked after the exporter files a claim with ECGC, EXIM Bank would pay to the Bank, the guaranteed amount within 30 days. The advance, to the extent of such receipt shall not be NPA.

g) Devolved LCs/Guarantees

In respect of LCs/Guarantees issued, where the beneficiary invokes the guarantee/LC, the Bank makes payment to the beneficiary, such amounts are due for payment immediately. In case the amount is not recovered even after 90 days such accounts are to be classified as Non-performing assets.

5. RECLASSIFICATION OF ADVANCES- Upgradation:

Generally accounts classified as doubtful or loss assets should not be upgraded other than by way of recovery of dues, **from the borrower's own funds and not arising out of fresh facilities sanctioned.**

If the overdues are recovered and if accounts fall under the norms prescribed for Standard Asset then the asset can be reclassified as standard asset.

Logically, there can be no Interest Suspense in accounts classified as Standard.

If the installments/interest are rescheduled for payment under nursing etc., the account should show satisfactory performance **for a continuous period of 1 year** and then only it can be classified as Standard Asset.

6. INCOME RECOGNITION

The income needs to be recognised in keeping with the basic requirements of the Accounting Standard - "AS-9-Income Recognition".

Income Recognition refers to accounting of interest income, commission and other charges/income at the branch in respect of advances and for other services.

Income Recognition on advances is based on record of recovery and operations in the account. For the purpose of Income Recognition, the **availability of security/credit guarantee cover, is not the criteria.**

The following should be kept in view:

- a) Interest on Sub-standard, Doubtful, and Loss Assets should not be debited/applied to borrowers' accounts once they are so identified/categorised, **unless actual realisation takes place. If the unrealized amount is debited to the Borrower and taken as income, it must be derecognized.**

On accounts identified for the first time as NPAs during the year, the interest income accrued but not realised:

- i) must be derecognised and reversed to "Interest suspense" or similar account, if it pertains to the preceding year; and
- ii) not be recognised, to the extent not realised for the year; and to the extent already recorded, it must be reversed to "Interest Suspense" or similar account.

This will apply to Government guaranteed accounts also. (Refer para 3.2.1 of Master Circular dated July 2, 2007)

In the cases where the borrower has many accounts and all the accounts are to be treated as NPA because one account has become NPA, then the interest realised on regular accounts can be accounted and treated as income **to the extent the amount stands realised**. In respect of accounts where interest is not realised, the interest cannot be taken as income.

- b) Other income by way of charges, commission etc. to the extent not realized must also be reversed and derecognised/ not recognized.
- c) In case of NPAs comprising Advances against gold ornaments, Govt. and all other kinds of securities , as well as those against the Bank's Term Deposit Receipts, Kisan Vikas Patras, IVPs, National Savings Schemes and Life Policies (which are not exempted from provisioning requirements), Income may also be recognized on realization.

d) **Export Finance-**

Where ECGC cover is available for post shipment credit, and guarantee if invoked within 30 days from EXIM bank under the EXIM Bank guarantee-cum -refinance programme, and in the event of a default, **to the extent the amount is received**, the advance is not NPA for asset classification/provisioning .

In case amounts have been deposited by the importers in a local currency/country, pending clearance of remittances to India to the exporters, the prudential norms for income recognition, asset classification and provisioning are made applicable after a period of one year from the date on which the amount is deposited by the importer in a bank abroad; provided that the advance was not NPA prior to the deposit

e) **Interest Suspense Account (Interest debited to Borrower but in default in NPA):**

The amounts held in Interest Suspense Account or similar account, should not be reckoned as part of provisions. Amounts lying in the Interest Suspense Account should be deducted from the relative advances, and provisioning as per the norms should be made on the balance after such deduction. In case the same has ever been subjected to tax, care must be taken to ensure that on recovery, the same is not taxed again - (also keep in view AS 22).

f) **Recoveries in NPA Accounts/Appropriation**

The method of recording recoveries and recognition of income, needs to be understood and the Bank follows exercising its right of appropriation in a uniform and consistent manner,

Revenue Recognition as per AS 9, issued by ICAI needs to be kept in view; and income not earlier recognized (when certainty did not attach to its realization), should be recognized upon subsequent recovery.

In nutshell the order of appropriation, in the absence of any specific instructions of the constituent, should be:

- interest suspense,
- unapplied interest,
- the principal in default, and thereafter
- the principal;

unless there are also stipulations as regards right of recompense, which would require recovery and recognition prior to appropriation towards the principal.

It , therefore, needs to be enquired as to whether the element of sacrifice earlier given in accounts restructured, rescheduled or rehabilitated, on the condition of the Bank's Right of Recompense, is being considered as income in accounts.

Where recoveries are effected in NPA Accounts beyond the “Interest Suspense”, the unapplied income must be applied by debit to the borrowers’ accounts to the extent income is recognised.

(It is imperative that the Dummy/memorandum registers to record unapplied interest, are kept updated on the basis of the applicable contractual rates, unless in respect of advances in litigation, such action is not required).

The borrower can be upgraded only on curing of the defaults that lead to the NPA status, i.e. upon the recovery of interest and principal in default and full recovery in cases of restructuring/rehabilitation etc.

Recoveries that cannot be appropriated need to be retained in the books of the Branch as a Liability.

g) Broad Principle

Income can be recognised and accrued on all Standard Accounts (**including Central Govt. guaranteed advances in default, where guarantee is not invoked**). In all other categories of advances, being NPAs (including State Govt. guaranteed Advances), income will be recognised on actual realisation/recovery.

h) Overview of divergence, if any:

Comparison and analysis of the aggregate of year-end “Interest Suspense” and “Unapplied Interest” with that of the previous year-end would reveal any divergent trends between the status of classification and income, and should be considered as a good audit tool.

i) Leased Assets

The *finance charge* component of finance income [as defined in ‘AS 19 Leases’ issued by the Council of the Institute of Chartered Accountants of India (ICAI)] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

7. PROVISIONING – Standard Assets:

Reference must be made to RBI Master Circular regarding variant rates of provisioning for the components of the Standard Advances.

Banks would, for the year 2007-08, be required to segregate the advances in the Standard category into those relating to:

- a. agricultural and SME and Direct Agricultural advances;
- b. **residential housing loans beyond Rs.20 lacs;**
- c. - personal loans (including credit card receivables),
- loans and advances qualifying as capital market exposures,
- commercial real estate loans, and
- loans and advances to Systemically Important NBFCs(-Non Deposit Taking); **and**
- d. **other standard advances**

REFERENCE MAY BE MADE TO THE RECKONER FOR CATEGORISATION (E I) and THE CHART FOR BASIS OF PROVISIONING (E II) .