

Bank Audit Presentation: Practical Challenges in IRAC Norms

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CHAPTER 1

The Foundation of Financial Health

Understanding IRAC Norms

What they are, why they matter, and how they shape the integrity of every bank's balance sheet. IRAC — Income Recognition, Asset Classification, and Provisioning — forms the bedrock of prudent banking in India, ensuring that reported financials reflect economic reality rather than optimistic projections.

HISTORICAL CONTEXT

The "Why" Behind IRAC

Before 1992, banks routinely recognised interest income on **all loans** — regardless of whether repayments were actually being received. This masked the true state of financial health across the entire banking sector, enabling institutions to report profits that did not exist in any recoverable form.

- In 1992 the Narsimham Committee recommended that the classification of assets of banks has to be done on the basis of objective criteria, which would ensure a uniform and consistent application of the norms.
- The provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realizable value thereof.



Key Principles of IRAC

Income Recognition

Recognised strictly on the record of recovery for NPA accounts — never on subjective, accrual, or projected considerations. Interest on NPAs must not be credited to income until actually realised.

Provisioning

Determined by asset classification, duration of non-performance, availability of security, and its realisable value. Provisions must be adequate to cover the bank's estimated credit losses.

Asset Classification

Objective criteria ensure uniform and consistent application across all branches and account types. Classification must be borrower-wise, system-driven, and free from discretionary judgement.



CHAPTER 2

The Automation Imperative

Challenges and observations in the journey towards fully automated IRAC and provisioning processes — and why manual intervention is no longer acceptable under the RBI's current framework.

The Push for Automation

RBI Directive

The RBI circular dated 14 September 2020 issued a clear directive: banks must fully automate their IRAC and provisioning processes.

Initial compliance deadline: 30 June 2021

Scope of the Mandate

The mandate covers NPA identification, income recognition, and provisioning calculations — all of which must achieve completeness and integrity **without reliance on manual intervention**. The RBI's objective is to eliminate the discretionary element that has historically been exploited to defer or suppress NPA recognition, thereby ensuring that reported asset quality truly reflects underlying credit health.

Scope of Automated Systems

RBI's automation mandate is comprehensive. Every element of the IRAC process must be system-driven, with no room for discretionary overrides at any level of the organisation.

1

Full Account Coverage

All borrowal accounts and bank investments must be captured within the automated system — without exception.

2

Regulatory Configuration

Asset classification rules must be hard-coded to comply with all regulatory stipulations, with **no manual override capability** permitted.

3

System-Based Provisioning

Provisioning calculations must be fully automated, factoring in asset categories, security value, and applicable regulatory requirements.

4

Continuous Day-End Processing

Asset classification — both down-gradation and up-gradation — must be an **ongoing, day-end process** driven entirely by the system.



CHAPTER 3

Defining Non-Performing Assets (NPAs)

The critical threshold — when a performing asset tips into NPA territory, and what that means for classification, provisioning, and income recognition obligations.

When Does an Asset Become Non-Performing?

Demand Loans / Term Loans

Interest and/or principal remains **overdue for more than 90 days**. An amount is "overdue" if it is not paid on the due date fixed by the bank.

Exceptions:

- Loans with moratorium for payment of interest and installment
- Housing Loan or similar advance to staff (interest payable after recovery of principal)
- Education Loans with moratorium

90

Days Overdue

Threshold for NPA classification on term loans and demand loans

Cash Credit / Overdraft Accounts

Account remains "**out of order**" for more than 90 days — continuously exceeding sanctioned limit or drawing power, or with no credit (or insufficient credit) to cover interest debited during the period.

90

Days Out of Order

Threshold for CC/OD accounts to be classified as non-performing

Additional NPA Triggers

1

Limit Review Overdue

Credit limit not reviewed or renewed within **180 days** from the due date of renewal triggers NPA classification.

2

Missing Stock Statement

Stock statement not received for **90 days or more** in Cash Credit accounts, and operations allowed for a further 90 days — a key indicator of operational dormancy.

3

Overdue Bills

Bills remaining overdue for **more than 90 days** from the due date of payment trigger NPA classification under IRAC norms.

4

Direct Agricultural Loans

Specific seasonal and crop-cycle criteria apply, with classification rules tailored to short-duration and long-duration agricultural lending patterns.

Additional NPA Triggers (Continued)

1

Bills Purchased / Discounted

Bills purchased or discounted remain overdue beyond **90 days** from the due date.

2

Securitization Transactions

Amount of liquidity facility remains outstanding beyond **90 days** from the date it became due.

3

Derivative Transactions

Overdue receivables representing **positive mark-to-market value** of a derivative contract which remain unpaid beyond 90 days from the specified due date for payment.

Core Definitions Under IRAC

The following are the most critical definitional anchors in the IRAC framework — each carrying specific regulatory meaning that directly affects classification, provisioning, and income recognition decisions:

Income Recognition

Income on NPA accounts is recognised only on **actual realisation** — not on accrual basis.

Asset Classification

Four categories: **Standard, Sub-Standard, Doubtful, and Loss** — determined objectively, without subjectivity.

Provisioning Norms

Prescribed rates of provisioning apply to each asset category — based on security cover, duration, and type of facility.

Writing Off NPAs

Write-offs may be full or partial; they do not extinguish the bank's right to pursue recovery from the borrower – TWO and PWO.



Special Mention Accounts (SMA): Early Warning Sub-Categories

Banks have been advised to create the following three sub-categories of SMA — a structured early warning mechanism to identify accounts showing signs of stress **prior** to their tipping into NPA territory. Timely identification enables proactive remediation.

SMA Sub-category	Basis for Classification
SMA – 0	Principal or interest payment not overdue for more than 30 days, but account showing signs of incipient stress (e.g., irregular operations, frequent TOD, bounced cheques)
SMA – 1	Principal or interest payment overdue between 31 and 60 days
SMA – 2	Principal or interest payment overdue between 61 and 90 days

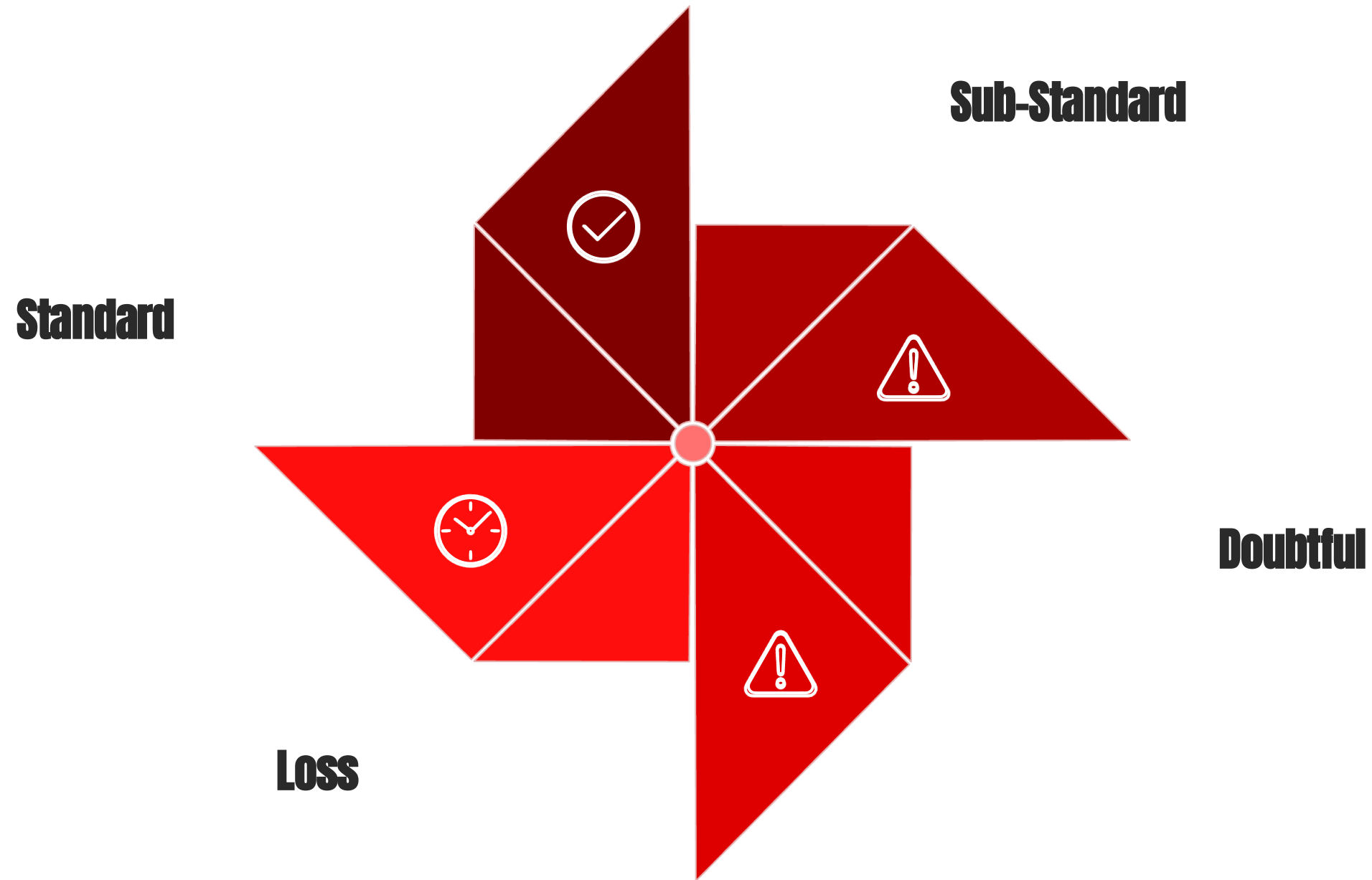
- ❏ Once an account crosses 90 days overdue, it transitions from SMA-2 to NPA — triggering income de-recognition, provisioning obligations, and regulatory reporting requirements.

Stress Indicators: Early Warning Signals in Borrowal Accounts

These behavioural and operational signals — even before a formal overdue trigger — alert auditors and credit officers to accounts showing incipient stress. Identification at this stage enables corrective action before NPA classification:

- Accounts remain mostly above sanctioned limit; frequent cheque bouncing or dishonour
- Frequent TOD (Temporary Overdrafts) sanctioned and remaining outstanding
- Turnover in loan account much lower than purchases/sales declared in stock statements
- Discounted bills remain unrealised; frequent LC devolvement or BG invocation
- Non-submission of stock statements and financials on time; mismatch with audited figures
- Ad-hoc limits and undue delays in renewal of credit facilities
- Undue delay in commencement of funded projects
- Funded/unfunded limits not commensurate with actual business operations
- Bills discounting disproportionate to operations — possible accommodation finance
- Specific adverse economic or sectoral conditions materially affecting the borrower's business

Asset Classification Categories at a Glance



Each category carries progressively higher provisioning requirements and more restrictive income recognition rules. The transition from Standard to Loss represents a complete erosion of recoverability and requires full provisioning, with or without write-off from the balance sheet.

Asset Classification: Borrower-Wise, Not Facility-Wise

It is difficult to envisage a situation where only one facility to a borrower becomes a problem credit while all others remain healthy. Accordingly, **all facilities granted by a bank to a borrower must be treated as NPA** — not merely the particular facility that has become irregular.

Multiple Customer IDs

Where the same borrower operates under multiple Customer IDs in the CBS, ensure that NPA classification is done on the basis of **PAN** — consolidating exposure across all IDs.

Pool Accounts

Ensure that a borrower classified as NPA under a pool is **also classified as NPA by the bank in its own books** — even if the bank's individual account is performing.

Debits from Devolvement of LCs and Invoked Guarantees

When debits arising out of devolvement of letters of credit or invoked guarantees are parked in a **separate account**, the balance outstanding in that account must also be treated as part of the borrower's principal operating account for the purpose of IRAC norms.

- ❏ **Key Rule:** When calculating the overdrawn position of a CC/OD account, **both balances must be combined** — i.e., CC/OD outstanding plus devolved LC balance — before determining whether the account is "out of order." Failure to do so understates the effective exposure and may mask NPA classification.



Treatment of Bill Discounting Under LC

General Rule

Bills discounted under LC favouring a borrower **may not** be classified as NPA when another facility granted to the same borrower is classified as NPA — provided the LC-issuing bank honours its obligation on the due date.

Exception: When Bills Also Become NPA

However, if documents under the LC are **not accepted on presentation**, or payment is not made on the due date by the LC-issuing bank for any reason, and the borrower does not immediately make good the disbursed amount, the outstanding bills discounted will **immediately be classified as NPA** — with effect from the date when the other facilities had been classified as NPA.

Direct Classification to Doubtful / Loss Asset Category

In certain circumstances, an asset need not pass through the standard Sub-Standard → Doubtful → Loss progression. **Direct classification** to a more severe category is mandated where the facts on ground demand it:

Erosion > 50% of Security Value

If the realisable value of the security has eroded by **more than 50%** of the value assessed at the time of last inspection/valuation, the asset must be directly classified to the **Doubtful Category** — regardless of the period of NPA.

Erosion > 90% or Fraud

If the realisable value of security has eroded by **more than 90%**, or if the account involves **fraud**, the asset must be directly classified as a **Loss Asset** — requiring 100% provisioning immediately.

- 📄 Auditors must actively verify security valuations and flag any significant erosion that should trigger these direct classification rules — especially in cases where CBS may not have been updated with current valuations.

Upgradation of NPA Accounts

The path to upgradation from NPA status carries strict conditions. There is **no step-by-step ladder** at the time of upgradation — an account may be upgraded directly to Standard from any NPA category, provided all conditions are met:

1 Full Arrears Must Be Cleared

Upgradation is permitted **only upon receipt of entire arrears of interest and principal**. Partial payment does not suffice.

2 Restructured / DCCO Accounts

For accounts classified as NPA due to restructuring or non-achievement of DCCO (Date of Commencement of Commercial Operations), the specific instructions for such cases continue to apply.

3 Multiple Exposures

Where the lender has multiple exposures to a borrower, **"No Overdue" status must be achieved across all exposures**. One account in NPA and another in SMA is not permitted — the NPA status is maintained until all facilities are regularised.

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CHAPTER 4

The Long Form Audit Report (LFAR)

A lens on operational deficiencies — far more than a questionnaire, the LFAR is a critical early warning system for systemic risk in banking operations and IRAC compliance.

LFAR: More Than Just a Questionnaire

Origins & Revision

Introduced by the RBI in **1985** and most recently revised on **05 September 2020**, the Long Form Audit Report is a structured tool for surfacing systemic deficiencies, operational lacunae, and weaknesses in internal control systems.

Purpose and Scope

The LFAR acts as an **early warning signal** for operational risk, covering specialised branches, critical accounts, and the adequacy of controls surrounding IRAC compliance. Its scope is deliberately broad — examining everything from individual credit accounts to branch-level governance and system integrity. Its findings carry significant regulatory weight and can directly influence the main statutory audit report.

LFAR and IRAC Norms



Dedicated IRAC Clauses

The LFAR contains specific clauses and questions on advances, NPA recovery, and the internal controls surrounding these areas. Auditors must address each with **substantive commentary** — not merely "yes/no" responses.



Systems & Process Assessment

Auditors are required to comment directly on the **adequacy of systems and processes** for IRAC compliance — going beyond mere numerical verification to assess whether the bank's operational infrastructure supports regulatory intent.



Impact on Main Audit Report

Adverse comments or findings in the LFAR may necessitate **qualifications in the main statutory audit report**, amplifying their significance considerably and potentially triggering regulatory scrutiny.



CHAPTER 5

Key Audit Challenges and Risks in IRAC Compliance

Where controls break down, what auditors must watch for, and the systemic vulnerabilities that create the greatest risk of misstatement and regulatory non-compliance.

Common Pitfalls and Risks

Incomplete Automation

Manual overrides in NPA classification and provisioning introduce the risk of misclassification, often **concealing the true extent of stressed assets** on the balance sheet.

Data Integrity Issues

Inaccurate source data feeding into automated systems compromises the reliability of key regulatory reports — undermining supervisory oversight.

Inconsistent Application

Varying interpretations of "out of order" or "overdue" criteria across branches leads to **non-uniform NPA identification** — a major concern in multi-branch audits.

Revenue Leakage

Incorrect interest crediting or failure to reverse unrealised interest on NPAs **distorts income and inflates reported profitability**, misrepresenting capital adequacy.

Weak Internal Controls

Inadequate review of limits, missing stock statements, and delayed facility renewals create **systemic vulnerabilities** in NPA management and classification.

Field Observations: CBS and Post-Classification Control Failures

The following deficiencies have been observed during statutory audits and represent some of the most commonly recurring control weaknesses in IRAC implementation. Mostly MOCs have been passed by the branch auditors for these issues:

NPA Date Inconsistency

The D1 (first NPA date) is changing vis-à-vis previous year data without valid upgradation and re-slippage — indicating possible manual tampering or CBS configuration errors.

Operations in NPA Accounts

Withdrawals (IMPS/cash) are being permitted in NPA accounts, indicating **weak post-classification controls** — debit freeze not being enforced as required.

Evergreening Indicators

Unusual debit/credit entries observed to **artificially regularise accounts** and avoid NPA tagging — a serious regulatory concern that may attract fraud classification.

Drawing Power Not Disabled

Drawing power remains active in **Doubtful/Loss category accounts** — enabling further drawdowns on accounts that should be frozen for recovery action.

Fraud Tagging Gaps

Fraud classification not applied consistently at **PAN level**, allowing the borrower's other accounts to escape fraud-related provisioning requirements.

Further CBS Data and Operational Deficiencies

Gold Loan Recovery Gaps

Doubtful/Loss category gold loan accounts without timely realisation of pledged gold — delayed enforcement undermines security cover and increases provisioning requirements.

Negative Amortization Risk

EMI and tenure not revised in **EBLR-linked loans** despite multiple rate hikes — resulting in negative amortization where the outstanding principal is effectively increasing.

Security Value Issues

Incorrect or obsolete security values maintained in CBS for NPA accounts; outdated valuations and stock statements used for provisioning calculations — overstating security cover.

Priority Sector Misclassification

Incorrect tagging under PSL (Priority Sector Lending) categories affects regulatory compliance reporting and may result in penal charges or shortfall contributions.

CBS Data Integrity Issues

Key parameters — security code, limit expiry, guarantee cover, security value, activity code, EMI, PSL code, PAN — not accurately captured, compromising system-driven classification.

The Impact of Non-Compliance

Every failure in IRAC compliance cascades into one or more of four serious outcomes — each with lasting consequences for financial stability, regulatory standing, and institutional credibility.



Financial Misstatement

Overstated income and understated provisions paint a falsely optimistic picture of profitability and capital adequacy — misleading investors, depositors, and regulators.



Regulatory Penalties

Non-compliance attracts **finances and sanctions from the RBI**, with the potential for enhanced supervisory scrutiny, corrective action directives, and management accountability.



Reputational Damage

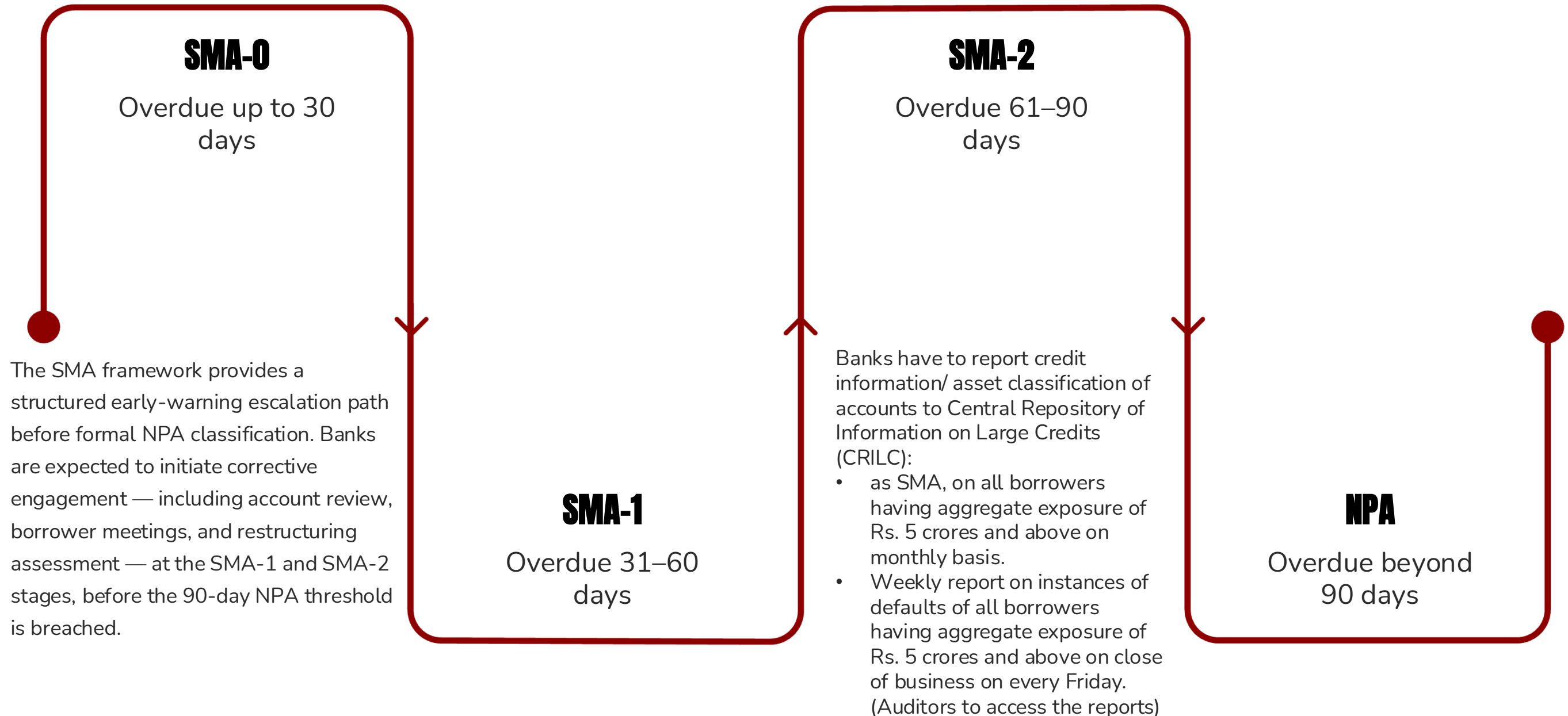
Loss of confidence among stakeholders, investors, depositors, and the public — with lasting consequences for franchise value and cost of funds.



Increased Credit Risk

Failure to identify and actively manage NPAs can escalate into **significant, unrecoverable credit losses** that threaten solvency and require capital infusion.

Prudential Norms Classification: SMA to NPA Progression



FAQ on Prudential Norms: Borrower-Level Classification

1 If one account of a borrower is NPA, will all accounts become NPA?

Yes — with the exception of loans against FDRs, NSCs, or KVPs, where the value of the security exceeds the outstanding amount. All other facilities to the borrower are classified as NPA.

2 Under consortium lending, if the lead bank classifies an account as NPA, will all banks follow?

No. Asset classification for individual banks depends on the **recovery position in each bank's own account**. Each member bank must independently assess overdue status based on its own records.

3 If an account is fully secured but overdue for the prescribed period, will it still be classified as NPA?

Yes. Security coverage does not exempt an account from NPA classification. Provisioning rates may differ based on security, but the classification itself is mandatory.

FAQ on Prudential Norms: Special Cases

1 Can an overdue account be exempt from NPA classification?

Yes — Central Government guaranteed accounts are exempted from NPA classification. However, consistent with all NPA accounts, **interest on such accounts must not be booked as income** even if they are not classified as NPA.

FAQ: Corporate Linkages and Advance Payments

1 If an individual borrower who is also a director/partner in a company becomes NPA, will the company's accounts also become NPA?

No. A company or partnership firm is a **separate legal entity**. The NPA status of an individual borrower does not automatically transfer to entities in which they hold a directorship or partnership — unless there is direct financial linkage.

2 If a borrower has paid 6 months' instalments in advance and then makes no payment for 6 months, will the account be classified as NPA?

No. Where advance payments create an **overflow in the account**, the CBS system automatically recovers interest debited from the overflow amount . The account is not overdue as long as the overflow covers debits — and is therefore not classified as NPA. The auditor should manually calculate the demanded amounts and the receipts to ensure this.

FAQ: CGTMSE and Restructured Accounts

1 Will accounts covered under CGTMSE be treated as Central Government guaranteed and exempted from NPA classification?

No. CGTMSE coverage is **not** considered equivalent to a Central Government guarantee. Such accounts must be classified as NPA as per IRAC norms. However, as per RBI Master Circular dated 1.4.23 (Para 5.9.4): *"In case advances covered under Credit Guarantee Schemes (CGTMSE, NCGTC etc.) become Non-Performing, no provision need be made towards the guaranteed portion."*

2 Will a restructured account become NPA?

Yes. A restructured account — where the terms of the original sanction have been modified due to financial difficulty — is classified as NPA from the date of restructuring, unless specific conditions for continued Standard classification are met under the RBI's restructuring guidelines.

Appropriation of Recovery in NPA Accounts

The accounting treatment for recovery in NPA accounts depends on the **credit policy approved by the Board of Directors** of each bank. RBI states that the same should be uniformly followed across the Bank. The order of appropriation varies by account type and recovery scenario:

Normal NPA Accounts

Recovery is typically appropriated in the order of: **service charges** → **interest** → **principal**, or alternatively **principal** → **service charges** → **interest**, as per the bank's Board-approved credit policy.

OTS / Restructured / IBC Accounts

For accounts under **One-Time Settlement, restructuring, or Insolvency and Bankruptcy Code (IBC)** proceedings, recovery is typically appropriated in the order of: **principal** → **service charges** → **interest** — prioritising principal recovery to maximise the effective credit impact. NCLT order should be followed.

- ❑ Auditors must verify that branch-level recovery appropriation is consistent with the bank's Board-approved policy — deviations can distort income recognition and provisioning adequacy calculations.

INCOME RECOGNITION

- For NPA accounts income should be recognized on realisation basis.
- Advances against TDR, NSC, IVP, KVP and Life policies – interest may be considered on due date if there is adequate margin.

When an account becomes non-performing, unrealised interest / fees / commission of the previous periods should be reversed or provided – manual as well debited by CBS

- UIPY – unrealized interest of previous year
- INCA – interest not collected account
- Interest income on additional finance in NPA account should be recognized on cash basis.

In project loan, funding of interest in respect of NPA if recognized as income, should be fully provided.
If interest due is converted into (unlisted) equity or any other instrument, income recognized should be fully provided (if listed, income recognized to the extent of MV)

Fees & Commissions earned on renegotiation/rescheduling of debts to be recognized over the period of time covered by the renegotiated or rescheduled extension of credit.



What is Renewal of CC/OD Limits?

CC/OD limits are valid for a period of **12 months** and must be renewed annually to re-assess the working capital requirements of the borrower. Renewal is based on a comprehensive review of financial performance and projections.

- **Actual financial performance** as per audited/unaudited financials of the last year and achievement of projected targets
- **Current year performance** as per provisional financials and projections for the next year
- Based on the review, the bank may **maintain, decrease, or increase** the limits in line with the borrower's assessed working capital requirements

What is a Short Review?

Definition

A **short review** is a temporary measure applied when a CC/OD account has become due for renewal but renewal has not yet been completed — keeping the account operational on an interim basis pending full renewal.

Trigger Scenarios

- **Non-submission of financials** by the borrower — including CMA data, ITRs, and GST returns — required for proper renewal assessment
- **Pending at bank's end** — where all requisite papers have been submitted by the borrower but internal processing or credit approval is still in progress

❏ Short reviews must be time-bound. Accounts in short review status for extended periods without progression to formal renewal are a red flag during statutory audit. Several times it is observed that such accounts slip to NPA.

General Drawing Power (DP) Calculation

Drawing Power represents the maximum amount a borrower is permitted to draw under a CC limit at any point in time, calculated from the latest stock statement and book debt statement submitted to the bank. Most accounts are classified as NPA due to improper DP calculations by the branches.

A) DP Against Stocks

01

Total Stocks (as per stock statement)

02

Less: Obsolete / non-moving stocks

03

Less: Trade Payables (creditors for goods)

04

Less: Stipulated Margin

05

= DP Against Stocks

B) DP Against Book Debts

01

Total Book Debts (receivables)

02

Less: Book debts beyond prescribed age (e.g., >90 days or >180 days)

03

Less: Stipulated Margin

04

= DP Against Book Debts

C) Total Drawing Power = A + B

What If Creditors Exceed the Value of Stocks?

A nuanced but critical DP calculation scenario arises when trade payables (creditors) exceed the value of stocks — creating a **negative DP against stocks**. The treatment depends on the bank's credit policy.

Component	Stocks (Rs. lacs)	Book Debts (Rs. lacs)
Total Value	100	500
Less: Obsolete / Aged	—	—
Less: Creditors / Margin	300 (creditors)	200 (@ 40%)
Net DP	(200) — Negative	300

❏ **The Key Question:** Is the Total Drawing Power Rs. 100/- (i.e., netting negative stock DP against book debt DP) or Rs. 300/- (ignoring the negative stock DP)?

In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (*circular no. No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association*).

Three Key Elements for Agriculture NPA Classification



Duration of Crop

Long duration crops — those with a crop season longer than 1 year. **Short duration crops** — those with a crop season of less than 1 year. This distinction fundamentally drives the applicable NPA classification threshold.



Crop Season

The crop season is determined by the **State Level Bankers' Committee (SLBC)** for each state and crop type. Auditors must refer to the applicable SLBC notification for the relevant state and financial year.



Repayment Period as Fixed by the Bank

The repayment period as specified in the **original sanction letter** is the reference point for measuring overdue status. Deviations from the sanctioned repayment schedule trigger NPA assessment.

Sub-Standard Advances: Agricultural Loans



Agricultural loans follow distinct NPA classification criteria — aligned to crop cycles rather than calendar months — to account for the seasonal nature of agricultural income and repayment capacity.

Short Duration Crops

A loan for short duration crops (crop season < 1 year) is classified as Sub-Standard if principal or interest remains overdue for **2 crop seasons** from the due date.

Long Duration Crops

A loan for long duration crops (crop season > 1 year) is classified as Sub-Standard if principal or interest remains overdue for **1 crop season** from the due date.

- 📄 The crop season applicable to each borrowal account is determined by the **State Level Bankers' Committee (SLBC)** of the relevant state. Auditors must cross-verify the applied threshold with the appropriate SLBC notification.

Provisioning Requirements by Asset Category

Provisioning rates are prescribed by RBI and must be applied uniformly. Rates vary by asset category, security coverage, and duration of NPA — with higher provisions required as assets deteriorate further.

Category	Sub-category	Rate
Standard — General	All performing accounts	0.40%
Standard — Agriculture & MSME	Priority sector	0.25%
Standard — Real Estate	Residential mortgage exposure	0.75%
Sub-Standard — Secured	NPA ≤ 12 months, with security	15%
Sub-Standard — Unsecured	NPA ≤ 12 months, no security	25%
Doubtful D-1	Sub-standard > 12 months, up to 1 year in Doubtful	25%
Doubtful D-2	1 to 3 years in Doubtful category	40%
Doubtful D-3	Over 3 years in Doubtful category	100%
Doubtful — Unsecured Portion	All Doubtful, unsecured component	100%
Fraud	Any category — fraud identified	100%

Undesirable Practices to Avoid NPA Slippage

The following practices are considered **undesirable** under RBI guidelines and may constitute window-dressing, evergreening, or deliberate concealment of stressed assets. Auditors must remain vigilant for these patterns:

Evergreening Through New Loans

Granting new loans specifically to adjust or repay existing irregular loans — creating the appearance of regularisation without genuine repayment capacity.

Conversion of Non-Fund to Fund Limits

Converting non-fund based limits (LCs, BGs) to fund based limits to absorb devolvments without triggering NPA classification on the original credit facility.

TOD to Adjust Irregular Loans

Granting Temporary Overdrafts (TOD) and using them to adjust outstanding irregular loans — masking overdue status and delaying NPA identification.

Discounting Bills / Cheques

Discounting bills or cheques that are subsequently not realised — providing artificial cash flow to service overdue obligations without genuine underlying transactions.

Misuse of Office Accounts

Unauthorized use of internal office accounts to park or route transactions that should be reflected in borrowal accounts — a serious internal control failure.

Accounts Not Identified by CBS: Case Study 1

CASE STUDY

Facts of the Case

A party is availing a CC limit of **Rs. 1.95 crore**. The limit was last renewed on 23.02.2025. Per the terms of sanction, the limit was to be **gradually reduced by Rs. 2.50 lacs per month** (due to unsatisfactory past performance) with effect from 01.03.2025, until it reached Rs. 1.70 crore by 01.12.2025.

However, **no reduction in the limit was made** — the balance continues to remain around Rs. 1.95 crore since the last renewal.

Why CBS Did Not Classify It as NPA

In CBS, the sanctioned limit remains at Rs. 1.95 crore — the incremental reductions required by the sanction terms were never updated in the system. As a result, the outstanding balance continues to fall **within the original sanctioned limit** as recorded in CBS, and no "out of order" flag is generated.

- ❏ **Audit Implication:** The account should have been progressively restricted. The failure to update CBS with the stepped-down limits means the account is effectively out of order — but CBS will not self-identify it. This requires manual verification against sanction terms during audit.

Accounts Not Identified by CBS: Case Study 2

CASE STUDY

Facts of the Case

An account remains **without renewal** as financial documents have not been submitted by the borrower. No reasons for non-submission are available on record. The branch has **renewed the account in the system** despite no actual renewal having taken place — with no fresh financials, CMA data, or credit assessment completed.

Why CBS Did Not Classify It as NPA

In CBS, the system records show the account as having been renewed — hence, it does not meet the criterion of being unrenewed for more than 6 months. The **artificial system renewal** prevents the NPA trigger from activating, even though no genuine credit review has occurred.

- ❏ **Audit Implication:** This is a serious irregularity — potentially a deliberate attempt to avoid NPA classification through system manipulation. Auditors must cross-verify system renewal dates against actual credit appraisal files and obtain evidence of underlying renewal documents.

Case Study: No Creditors Ltd. – Drawing Power Recalculation

CASE STUDY

During the statutory audit of March 2025, the following was observed in the CC account of **No Creditors Ltd.** with Lena Bank:

The Issue

Stock statements submitted throughout the financial year **declared nil creditors**. However, the borrower's Audited Balance Sheet for 2024 disclosed creditors of **Rs. 239.32 lacs**.

Auditor's Action

In the absence of monthly creditor details, the auditor used the **last available creditor position** (from the audited balance sheet) to recalculate Drawing Power for the entire financial year — resulting in substantially lower DP throughout the year.

Outcome

After recalculation, the closing outstanding exceeded the recalculated Drawing Power **throughout the financial year**. As a result, the account was classified as NPA via a Memorandum of Changes (MOC).

- ❏ This case highlights the critical importance of scrutinising the consistency between stock statement declarations and audited balance sheet data — particularly creditor disclosure — during the drawing power audit. It is for the borrower and the branch to satisfy the auditor that the calculations are not proper.

Red Flags in Operations of CC Accounts

Cash Credit accounts are among the most frequently misclassified accounts in bank audits. The following operational patterns serve as **strong indicators of financial stress or fraudulent activity** that warrant deeper scrutiny:

Turnover Mismatch

Turnover in the CC account does not commensurate with the sanctioned limit and the sales figures declared in stock statements, MSOD, or QIS — suggesting inflated sales projections or diversion of business through other banks. Manual dr & cr turnover entries passed by the branch.

Frequent TOD / Ad-hoc Requests

Repeated requests for Temporary Overdrafts or ad-hoc limits indicate chronic overutilisation of the sanctioned limit and may signal that the borrower's working capital position is fundamentally unsustainable.

Stagnant Balance

A stagnant balance in the CC account — with no meaningful credit entries — is a classic sign of a "dead account" being kept technically alive through minimal transactions.

Cheque Returns & LC/BG Stress

Frequent returning of cheques, repeated devolvement of LCs, round-tripping transactions, unsatisfactory credit reports of LC beneficiaries, and frequent invocation of Bank Guarantees are all serious red flags requiring escalation.

Red Flags in Stock Statements

Stock statements are a primary tool for drawing power computation — and a frequent vehicle for misrepresentation. Auditors must scrutinise stock statements for the following indicators of manipulation or inaccuracy:

Year-End Discrepancy

Huge difference between stocks declared in the stock statement as on 31st March and the **closing inventory in the audited Balance Sheet** for the same date — indicating possible stock inflation for DP purposes.

Excess Inventory vs. Assessment

Stock statement shows a **substantially higher level of inventory** compared to the level originally assessed by the bank at appraisal — suggesting inflated stock declarations to support higher drawing power.

Abnormal WIP and Stock-in-Transit

Abnormally high proportions of **Work-in-Progress and Stock-in-Transit** — both difficult to verify physically — are common mechanisms for inflating stock values.

Under-Reported Creditors

Abnormally low level of creditors in the stock statement compared to original assessment or audited financials — reducing the creditor deduction in DP calculation to artificially inflate available drawing power.

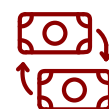
Red Flags in Audited Balance Sheets

The borrower's audited financial statements are a critical independent source of evidence during bank statutory audit. The following features in audited balance sheets should trigger enhanced scrutiny of the credit account:



Statutory Auditor Qualifications

Qualifications, adverse opinions, or emphasis of matter paragraphs in the borrower's own audited financial statements raise immediate concerns about the reliability of financial data submitted to the bank.



Related Party Transactions

Abnormally high transactions with related parties and large unadjusted old advances to suppliers may indicate diversion of funds — a key risk in working capital credit assessment.



Investments and Statutory Dues

Large investments in subsidiaries, unpaid undisputed statutory dues (GST, PF, ESI, TDS), and mid-term resignation of auditors are all significant warning signals requiring explanation and follow-up.



Deferred Tax Non-Compliance

Excess provision of Deferred Tax Assets in non-compliance with **AS-22** inflates reported net worth — potentially misrepresenting the borrower's capital base and debt service capacity to the lending bank.

Issues raised by regulators and to be focused by auditors

- CASA accounts having debit balance
- Cases where DCCO has not been achieved as per sanction and still account is being classified as standard.
- Monitoring of internal Office accounts especially adjustment/ reconciliation of entries in internal accounts outstanding for more than 6 months.
- Data Integrity issues having bearing on financial statements
- Ensure that the moratorium period and revised repayment schedule entered in Finacle is as per the terms and conditions of sanction, particularly on Covid Restructured accounts
- LTV ratio in case of Gold Loans and Housing loans
- Classification of Agricultural advances to NPA. Also ensure reversal of Unrealised Interest as per the RBI circular.
- Automation and accuracy of the lending rates especially in case of resets in Finacle
- Ensure that the amounts required to be transferred to DEAF are properly reflected.
- Ensure short renewals are as per the RBI norms and are reviewed by the higher authorities

Subsequent Recoveries

- Fully closed accounts.
- AS-5 Events occurring after the Balance Sheet date.
- Source of recoveries.
- Recovery of all arrears.
- Best judgment of the auditor based on the full knowledge of the account.
- No window dressing or ever greening of the account.
- RBI inspection post our audit.

THANK YOU