Annual Review and Forensic Audit of Corporate Borrowal Accounts and Early Warning Signals

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In the financial year 2016-17, Fitch Ratings expects stressed assets ratio for Indian banks to improve marginally from 11.1 per cent in financial year 2015-16. The report states, "New NPL growth has started to slow down across many banks, but resolution of the existing large stock will be a slow and protracted process - as structural challenges in stressed sectors still persist while corporate leverage remains high. Therefore, credit costs are likely to remain high and will continue to be an overhang on earnings growth for a longer period, unless macroeconomic recovery and speedier reforms aid faster asset resolution or banks conduct greater capital-raising to push growth, or both."

During the current year, a steep rise in slippage in the loan asset quality is a matter of concern to banks, the Reserve Bank of India (RBI) and the Government of India. The growth in stressed assets (i.e. NPAs plus restructured standard assets) as on March end, 2015 was as high as 11.1 per cent of gross advances which adversely impacted profitability and capital of banks. To elaborate, the annual return on total assets of scheduled commercial banks declined from 1.09% during 2010-11 to 0.78 per cent during 2014-15. Similarly, CRAR came down to reach 12.70 per cent as on March end, 2015 as against 13.01% as at the end of March, 2014. During 2015-16, growth in stressed assets continued to be high and increasing. These disturbing trends call for strengthening credit monitoring system in banks to obtain early warning signals (EWS) of stress in borrowal accounts without much delay for initiating timely action. To obtain EWS, a close watch on developments in the borrowal accounts is a must. In addition, annual review of a borrowal account and forensic audit are also considered very useful sources to obtain EWS.

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Introduction

Banks are expected to conduct an annual review of a borrowal account, which is mandatory for large credit as per the recommendations of the Chore Committee, appointed by the Reserve Bank of India in 1979. Nowadays, this review exercise is found to be very useful in the context of arresting trends in non-performing assets (NPAs). Appreciating the timely review of borrowal accounts, the RBI has come out with stricter norms stating that a borrowal account will be considered as non-performing asset (NPA) if the annual review is not done by the bank within six months from the due date of the review and renewal of working capital limit. Further, the review exercise helps the bank to guide the borrower to initiate preventive action for early warning signals (EWS), if any. Though the annual review is being practiced in banks over the years, it remains more or less a ritual and, in the process, important EWS are not noticed from the review exercise.

Further, it takes a sufficiently long time to complete the review since too much data is collected. This may result in delayed action in respect of EWS. Therefore, there is a felt need to suggest a simple framework to take less time for review to obtain EWS in time for effective preventive action. Further, there has been a rise in the number of willful defaulters. Nowadays, such borrowers are adopting innovative modus operandi in diversion siphoning of funds and making bank credit almost free of securities. In view of this, in addition to effective annual review of borrowal accounts, forensic audit becomes all the more important. Towards this end, this paper attempts to discuss a simple framework for the annual review of the borrowal account and forensic audit to obtain EWS and initiate preventive action by referring to RBI guidelines, bank procedures, and best practices relating to large corporates.

Suggested Annual Review Exercise

Information Requirements

For meeting the working capital requirements of a corporate borrower, cash credit limit is sanctioned for a period of one year. Before the expiry of this cash credit limit, it is necessary to remind the borrower to submit the renewal proposal one month before the expiry of the cash credit limit. The bank carries out an annual review exercise to decide whether to simply renew, enhance or reduce the existing cash credit limit. For this purpose, banks seek minimum information from the borrower for carrying out the review exercise without much delay. Fortunately, a lot of information is already available within the bank such as profile of a borrowal account, conduct of various credit facilities, minutes of meeting of loan consortium held during the year, stock inspection reports, annual factory inspection report, market report, etc.

From the borrower, certain information should be collected in the form of renewal proposal which includes audited balance-sheet, profit and loss account and business plan for the next one year. The business plan should state production and sales estimates, operating cost, cash generation from operations, capital expenditure to take place, fresh capital to be raised, additional debt to be raised from the market, need for bank finance for working capital, etc. Along with the business plan, a formal request to renew or enhance limits should be made in the prescribed format of the bank along with the relevant documents.

Annual Review Format

To ensure a comprehensive review of the borrowal accounts in banks, a need is felt to develop a format to study both qualitative as well as quantitative data/ information. The suggested framework in the form of a format, as discussed below, considers six parameters of financial health of a corporate. These may include sales performance, utilisation of assets, profit performance, liquidity and short solvency, capital structure, and overall dealings of the firm. To fill up the format, banks have to collect information from three sources namely, internal records, market report and borrower. After calculating a few indicators as indicated in the format, it would be easy to fill up the format which takes less time to obtain EWS, if any. The format is especially designed by studying the system of annual review presently carried out in the banks, RBI guidelines and experiences of banks. The review exercise for ABC Company Limited is suggested as under:

Early Warning Signals

1. Sales value of the company went up from Rs 300 crore in 2014-15 to Rs 400 crore in 2015-16, showing a rise of 33.3 per cent. But this rise is on account of hike in the selling price. Had there not been such a hike, the sales value would have remained constant. Similarly, sales quantity being constant, it is a matter of concern to the bank. But it is heartening to note that customers still buy the product of the company despite a steep rise in the selling price due to high quality of the product.
2. Total assets value went up by 100 per cent from Rs 300 crore in 2014-15 to Rs 600 crore in 2015-16. The total assets consist of fixed assets, current assets and non-current assets. There is a substantial increase in the value of fixed assets which went up from Rs 100 crore in 2014-15 to Rs 410 crore in 2015-16, a rise of 310 per cent. Further, from the site inspection it is found that fixed assets acquired are in the form of non-productive assets such as land and building. The company with its huge investment in non-productive assets is a matter of concern to the bank unless these are for genuine future requirements such as expansion, modernisation and diversification. Since the plant capacity is just at 67 per cent, there is hardly any scope to expand. Similarly, the quality of the product seems to be extremely good, not requiring any need for modernisation and diversification. This means that land and building newly acquired are not for business purposes but maybe for sale as real estate at a higher price in the future.

Exercise: Annual Review Format ABC Co Ltd.

(Rs in Crore)

S.No.	*Indicator*	*31.3.2015*	*31.3.2016*
1.	Sales Value (Rs)	300	400
	Sales Quantity (Units in Crore)	300	300
	Selling Price (Rs)	1.0	1.33
2.	Total Assets (Rs)	300	600
	Sales/Total Assets	1.0	0.67
	Fixed Assets (Rs)	100	410
	Current Assets (Rs)	170	175
	Non-Current Assets (Rs)	30	15
	Productive Fixed Assets (Rs)	70	70
	Non-Productive Fixed Assets (Rs)	30	340
	Plant Capacity Utilisation (%)	67	67
3.	Net Profit (Rs)	30	33
	Net Profit/Sales (%)	10	8.25
	Selling, Administration And General Expenses/ Total Expenses (%)	16	19
	Cash Surplus From Operations (Rs)	28	(17)
	Dividend (%)	8	10
4.	Current Ratio (CR)	1.05	0.89
	Stock Holding Level (Month)	2.0	1.8
	Receivables Collection Period (Month)	1.0	1.0
	Payments Period (Month)	1.0	1.33
	Bank Borrowings/Current Assets (%)	75	89
5.	Capital (Rs)	20	20
	Long-Term Debt/Equity (LTD:E)	0.5:1.0	3.0:1.0
	Cash Balance + Undrawn Limits	5	8
	Operational Commitments	8	56*
6.	Dealings With Bank, Financial Institutions (FIs), Workers And Government (Assessment)	Good	Unsatisfactory
	Market Reputation (Assessment)	Good	Very Good

Note: *Assumed to be pressing creditors such as statutory liabilities - wages, rent, rates, taxes, etc.

3. Net profit went up by 10 per cent during 2014-15 over the previous year's figures. However, net profit/total sales ratio, indicating profit margin, declined from 10 per cent in 2014-15 to 8.25 per cent in 2015-16 due to selling and administrative and general expenses which went up disproportionately. The company could have checked the rise in these overhead costs since these are controllable ones. It seems that the company spent money for meeting costs associated with the purchase of fixed assets such as stamp

duties, registration charges, lawyer's fees, etc. by debiting the profit and loss account. More importantly, cash deficit is reported during 2015-16 when the reported profit stood at Rs 33 crore. This indicates liquidity problem in business. But the company did not stop to declare higher rate of dividend based on the reported net profit though there was cash deficit from operations. Despite cash deficit, the company declared higher rate of dividend based on the reported net profits.

4. The problem of liquidity and short-term solvency is further confirmed from the current ratio which was as low as 0.89 on March end, 2016 as against 1.5 on March end, 2015. Due to liquidity problems, the company reduced the level of stock, collected payments from the customers on a timely basis and deferred payments to the suppliers of materials. In addition, cash credit account is overdrawn.

5. Capital structure is also found to be unsatisfactory in terms of debt/equity ratio which was as high as 3.0:1.0 as on March end, 2016 as against 0.5:1.0 for the previous year. With capital balance remaining constant, the company had to depend on external borrowings. Since the company wanted to acquire non-productive fixed assets without having any genuine business plan, banks and financial institutions did not provide finance. Hence, the company might have raised funds from non-institutional sources in the form of deposits/loans received from associated concerns, etc. Further, the liquidity position is so critical that cash balance and un-drawn limits together are not adequate to meet even operational commitments such as dividend, taxes, outstanding salary, etc which are overdue and not paid.

6. Lastly, 'overall dealings' of the company with banks, financial institutions (FIs), workers and the government are assessed as 'unsatisfactory'. But 'market reputation' is rated as 'very good' due to increase in sales value, expanding the base of fixed assets, rise in net profit, customers being ready to buy the product even at higher price due to its better quality, higher rate of dividend and creditors being ready to extend credit. But in the books of the bank, the company is being looked down. This is a matter of concern.

As part of the annual review exercise, discussion with the finance executive of ABC Company is a must. The agenda of the meeting is to discuss observations made by the bank from the study of the above review format and suggest suitable line of action. After the meeting, minutes have to be recorded and sent to the company and co-banks.

It can be inferred from the review format that the company is in need of additional financial support to honour the operational commitments/pressing creditors of Rs 56 crore which are due as on March 31, 2016. Accordingly, a request is made by the company to the bank to extend financial support to honour the pressing creditors of Rs 56 crore. There are two options before the bank to act on the request of the company: either to allow further withdrawal from its cash credit account or to sanction a clean loan or a short loan to meet the obligation of the pressing creditors. One option for the bank is to extend the required support since it is a well-rated company in the market. The other option for the bank is to stop providing further financial support and initiate legal action. But the second option seems to be difficult considering recovery chances through legal action. If necessary help is not extended, it may like to switch over to any other bank. Therefore, it is preferred to extend the required financial help.

Prevention - Action Points

When decided to extend further financial help to ABC Company, certain preventive action in terms of EWS should be initiated. First, the company may be asked to give a break-up of Rs 56 crore as on March end, 2016. The bank should consider only statutory liabilities and not any other liability such as non-payment of interest/installment of funds raised by the company from non-institutional sources for acquiring land and building. In the above case, the entire amount of Rs 56 crore is due to pressing creditors. After deciding the commitments to be honoured, the next step is to conduct factory/site inspection to verify the present level of stock charged to the bank and find out how far the bank liability is not secured. During the factory or site inspection, it should also be attempted to physically verify the non-productive fixed assets purchased by the company.

Thereafter, the bank should ask the company to submit a projected cash budget stating month-wise cash receipts and cash payments for the next three months so that it would be possible to assess the repayment capacity of the company to honour additional commitments made by the bank. Lastly, since the credit risk is high, the company may be advised to offer collateral. If not possible to get collateral security, close monitoring is called for so as to ensure financial discipline. The decision of the bank should be communicated to the company. With this, the annual review exercise gets over.

In view of large-scale diversion of funds noticed in the case of corporates and double leveraging resorted to by them, it is imperative that banks should re-look at their old format of annual review of accounts to make it meaningful. The existing review format is so redesigned not only to get EWS based on the past data but also to predict future potential and/or probability of default and distance to default so that exit/corrective action can be initiated.

Forensic Audit of Large Corporates

Need for Forensic Audit

An annual review of big corporates is suggested to have a provision for forensic audit as a mandatory stipulation. The scope of the audit will be determined in each case depending on the position/potential threat in the account. For such big accounts, parameters that ought to be analysed under forensic audit should invariably include: a) transactional, b) financial, c) non -financial, d) external factors like sentimental analysis, litigation, etc., e) statistical model to predict probability of default, and f) EWS score of a corporate. For this, a dynamic device-based monitoring for institutional memory should be built up. The idea is to be able to have a 360 degree review of an account. In this age of digitization, there are external professional companies which can be entrusted to do it for banks. One such company called D2K technologies undertakes for public sector banks asset classification, provisioning, etc. where technology is leveraged to collate data from various sources and from the social media to provide meaningful inputs.

Predicting Loan Default as part of Annual Review

Default is nothing but manifestation of unnoticed stress in a loan account which could arise due to several factors. Diversion/siphoning of funds is one of them. Diversion/siphoning of bank funds is a matter of concern for banks. In this regard, banks should look at the review exercise done just preceding the date of default to know what was not analysed, what signals were missed with reference to the cause of default, etc. Manifestation of stress can be felt at least nine to 12 months before default. It is possible to obtain forewarning signals of potential stress in loan if annual review is done using the latest structured and unstructured data, understanding dynamics of the company and the industry in the backdrop of economic conditions in the country and the world, and using sentimental analysis and statistical technique for predictive analysis by employing artificial intelligence.

It is necessary that a scoring model shall be built up for EWS and this be made part of the annual review exercise. Further, this should combine score obtained from transactional analysis, analysis of financial statements and market reports, statistical model output, etc. A poor score may need a reference to/intervention from higher authority/escalation to top management depending upon the reason discerned from such an analysis. With core banking in use, it is feasible to cull data from the back-end for such analysis. It is necessary to have robust data-warehousing techniques. For this purpose, institutional memory should be built up and every bit of information related to account, irrespective of when and where it originates, be stored digitally, including information on social media, cases filed by and against the company and its directors, news appearing in print and electronic media, etc.

The model having these attributes was used to back-test the result for a construction company in Mumbai by D2K for which strategic debt restructuring (SDR) was invoked by a consortium of banks. The predictive model, had it been used during the review, could have forecast loan default a few months in advance Thus, this technique would essentially eliminate any kind of subjectivity or bias in the analysis.

Statistical Models for Predicting Loan Default

The statistical models for prediction may be made part of an annual review. To elaborate, any company which is facing a liquidity crunch will depict typical behaviour of deposit and withdrawal in the account. We must not forget that liquidity crunch will lead to insolvency and companies try to borrow on a short-term or adhoc basis from banks/outside institutional sources to tide over this liquidity crunch. From the analysis of deposits, withdrawals and outstanding balance of a company which is passing through a liquidity crunch, it was observed that weighted average number of days during which cash deposited in a cash credit account was withdrawn becomes shorter and shorter as the company moves along the path of liquidity crunch.

Shortening of the weighted average days is built into the model and is used as EWS during the review of the account. To illustrate, if an amount of Rs 10,000 is deposited today, say day 0, and withdrawn on the next day, then the score is 1.0. The full amount represented by 1.0 and the number of days after deposit is 1.0 . If this amount is withdrawn over a period of three days by withdrawing 25 per cent of the amount i.e. 0.25 on the next day and 0.4 of Rs 10,000 on the 2nd day and 0.35 of that amount on the 3rd day then the weighted average number of days will be (0.25*10000*1+0.4*10,000*2+0.35*10,000*3)/10000=2.1 days. Interest charged in the account cannot be as meaningful as this analysis.

The highest debit and lowest debit/credit balance along with the date on which it occurs sends a signal during the review as one parameter of transactional analysis. This is captured by a statistical model. Another parameter shall be the round tipping adopted by companies to mislead banks in consortium account or under multiple banking. One credit entry is routed (maybe on the same day) through various banks to inflate credit turnover or to use the loan amount as owned fund inducted as margin to avail further finance. Technology can be used to upload the soft copy and eliminate such entries and stop borrowers from hoodwinking banks. Alternatively, the RBI can share information from the gateway to help banks detect round tipping.

A graph of the share price of companies having forward linkage (FL) and backward linkage (BL) of the company and peer group company will also provide a wealth of information. If the share prices of industries in the FL group are going down, then sooner or later this company will face pressure on its revenue. Similarly, if a company in the peer group is seen having its graph of share price going up and if the graph of this company is below the peer group, then it will signal some issues which a banker should look into. This is the time that the bank should plan an exit strategy. Likewise, graphical presentation of outstanding over a period of one year or more, particularly from the date of last enhancement, will reveal how the funds have been used and whether it leads to enhanced credit turnover in the account or not. This can be gauged from the amount of the credit i.e. dip in debit balance as seen in the graph.

Banks, while doing appraisal, should look at the balance-sheet and other financial statements which are mostly one/two quarters' old and not look at the status/ data/financial standing/warning signals after the balance-sheet date. While doing review of accounts, the banker should look at financial risk in the internal rating and understand the cause for deterioration in rating, if any, and understand its implications.

Conclusion

From the annual review exercise as discussed above, it is possible to asses both strength and weakness of the company from the banker's angle. This assessment is based on analysis of both quantitative and also qualitative data/information. This assessment is carried out by using the suggested format. Banks should not consider the annual review merely as a mandatory requirement. It is helpful for banks to make a thorough check-up of operational performance and financial health of the company once a year and work out suitable course of action. Lastly, there a need to create a lot of awareness on the part of branch managers about the growing importance of annual review and impart necessary knowledge and skills to carry out the same more meaningfully. Towards this end, the review carried out for ABC Company seems to be a modest attempt.

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