



## **CHARACTERISTICS OF INTERNAL AUDIT OF LOANS THAT DO NOT WORK IN COMMERCIAL BANKS**

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### **Abstract**

*The article examines the definitions and descriptions of the concept of non-performing loans in the scientific field, the reasons for their occurrence, the dynamics of non-performing loans in the Republic of Uzbekistan over the past 7 years. The need for internal audit of non-performing loans in commercial banks, the procedure for its conduct, its specifics, the factors affecting them are described. In addition, it has been analyzed the internal audit loans in commercial banks of Uzbekistan, it has been given some conclusion and recommendations for the development of this sphere in the future.*

*Keywords: Bank, Credit, Non-performing loan, Internal audit, Uzbekistan*

### **INTRODUCTION**

Credit is one of the main sources of financing the financial needs of the population and businesses. When a borrower becomes insolvent for a variety of reasons, it can affect the lender's financial condition. These loans become non-performing loans or non-performing loans (NPLs) because they are not repaid on time. The study of the emergence of non-performing loans, its impact on the economy, the financial condition of the bank, its reduction will always be in the focus of scientists (Ozili, 2019; Yrigoy, 2018; Skarica, 2014; etc).

Internal audit plays an important role in preventing the emergence of non-performing loans in commercial banks, reducing credit risk. The reason is that the internal audit is carried out in a commercial bank, is constantly informed about the operations of the bank, the field of activity, its strategy, the activities of customers, the organization of business processes in the

bank, and so on. Internal audit, as a profession, has been researched over the years and has been constantly responding to the changing needs of enterprises. Thus, if initially dealt with accounting issues, internal audit is now focused on identifying the main risks of the organization, as well as assessing its performance (Munteanu, Zaharia, 2014).

In the Republic of Uzbekistan, the internal audit of commercial banks is considered as an independent expert examination (Regulation 992-1, 2004), established on a regular basis within the bank to inspect and evaluate banking activities in order to assist bank employees in the effective performance of their duties.

By conducting an audit of problem loans, the internal audit assesses the internal control system and analyzes the risks associated with the activities being audited, as well as the recommendations made in the reports prepared to achieve the bank's objectives. Thus, it increases management awareness with quality internal audit.

## LITERATURE REVIEW

The peculiarities of the methods of working with troubled assets in commercial banks show the conceptual approaches to this problem, as well as the lack of scientific work on the prevention and elimination of troubled assets in commercial banks.

Ozili (2019) notes that the study of non-performing loans (NPLs) is important because they reflect the quality of the loan portfolio of banks and the quality of the loan portfolio of the banking sector in the country as a whole. Understanding the factors influencing the level of non-performing loans is crucial for the banking regulatory authorities, which are responsible for the risk management function of banks and the stability of the bank.

In international practice, problem credit is closely related to the concept of non-performing credit. Bloem, Freeman NPLs (Non-Performing Loans) Non-performing loans are capitalized, refinanced, or defaulted loans with a 90-day or more delay in principal payments or / or 90-day or more interest payments; or assets for which the maturity is more than 90 days, with more serious reasons similar to those in which the debtor filed for bankruptcy.

The Basel Committee on Banking Supervision (Basel, 2016) also defaults on non-performing loan (asset) loans, ie there is a delay of more than 90 days or the bank does not repay the loan, does not ask to take measures to repay (securitization, refinancing, restructuring, delay in payment, etc.); the existence of impairment of the asset as a result of a decrease in the solvency of the payer; regardless of the number of overdue days, classifies the principal debt and the interest payable on it in the presence of evidence that it is impossible to pay in full.

In Uzbekistan (Regulation 2696, 2015) we can see a situation close to this situation, ie problem assets (loans) are loans classified as "unsatisfactory", "doubtful" and "bad". Yrigoy

(2018) links the emergence of non-performing loans in the structure of hotel-related loans to mortgage securitization. Skarica (2014) examined data on non-performing loans among 7 countries in Central and Eastern Europe between 2007 and 2012, using data on country-level non-performing loans, and found that this was not the case. The study notes that non-performing loans are linked to economic downturn, unemployment and inflation. Otamurodov (2018) links the reduction of non-performing loans to loan portfolio management. Ibragimov (2013) considered the audit of problem loans in commercial banks in the context of the audit of credit operations in general, highlighting the general aspects of the audit of credit operations.

If we look at these studies, basically every researcher has looked at non-performing loans within a particular facility, highlighting the specifics of conducting an internal audit.

## RESEARCH METHODOLOGY

This empirical research is focused on the measures aimed at improving the international loans in the commercial banks. Such research method as comparative analysis of the practical data, statistic tables and other relevant data have been widely used in the research. Secondary data was subjected to descriptive statistics. Basing on the research results appropriate proposals and recommendations have been developed.

## ANALYSIS AND RESULTS

Bank management is becoming an increasingly complex process aimed at obtaining guaranteed returns that justify investments in bank capital, taking into account many factors of profitability, risk and liquidity, as well as various external constraints. One of the key elements of this process is to conduct an internal audit of the bank's financial condition. In the normal operation of the bank, the internal audit of its credit operations should be the basis of all management decisions.

According to the results of the internal audit, current management decisions, as well as the process of planning the bank, during which prospects for future development will be considered, the implementation of which should be ensured by the internal capacity of the bank. Internal audit deals with the analysis of business processes in commercial banks, including the credit management system. Credit itself is not a process, but the result of lending processes. Therefore, when an internal audit uses a risk-based approach, the auditor must first establish a link between the risks and the credit process, and then begin to develop an audit plan or program, depending on the approach chosen.

Before examining the internal audit process of non-performing loans, let us consider the indicators of the banking system of the Republic of Uzbekistan, the assets directly related to them, the assets at risk, the bank capital.

Table 1 Information on non-performing loans, assets, credits and capital of banks of the Republic of Uzbekistan (trillion soums)

№	Indicators	2013	2014	2015	2016	2017	2018	2019	Change (2019/2013)	
									trln.	%
									soum	
1	Assets	40,0	48,3	57,7	73,4	121,2	188,6	254,9	40,0	536,8
2	Risky assets	27,2	33,4	47,0	57,4	106,5	155,0	223,0	27,2	720,6
3	Loans issued	25,6	32,2	39,7	52,6	110,6	167,4	211,6	25,6	727,7
4	Capital	4,9	6,0	7,3	9,0	20,7	26,7	51,0	4,9	933,3
5	Non-performing loans (NPLs)	0,72	0,67	0,58	0,39	1,32	2,14	3,17	0,72	340,1

Source: Based on data from the Central Bank of the Republic of Uzbekistan.

Assets of the banking system of the Republic of Uzbekistan in 2019 will amount to 254.9 trillion soums, which is an increase compared to previous years and increased by 536.8% compared to 2013. In the structure of assets, we can see that the share of risky assets, in turn, loans, is high, but the increase in assets was also influenced by the rapid growth of bank capital. Non-performing loans also have an upward trend, but have increased less than loans.

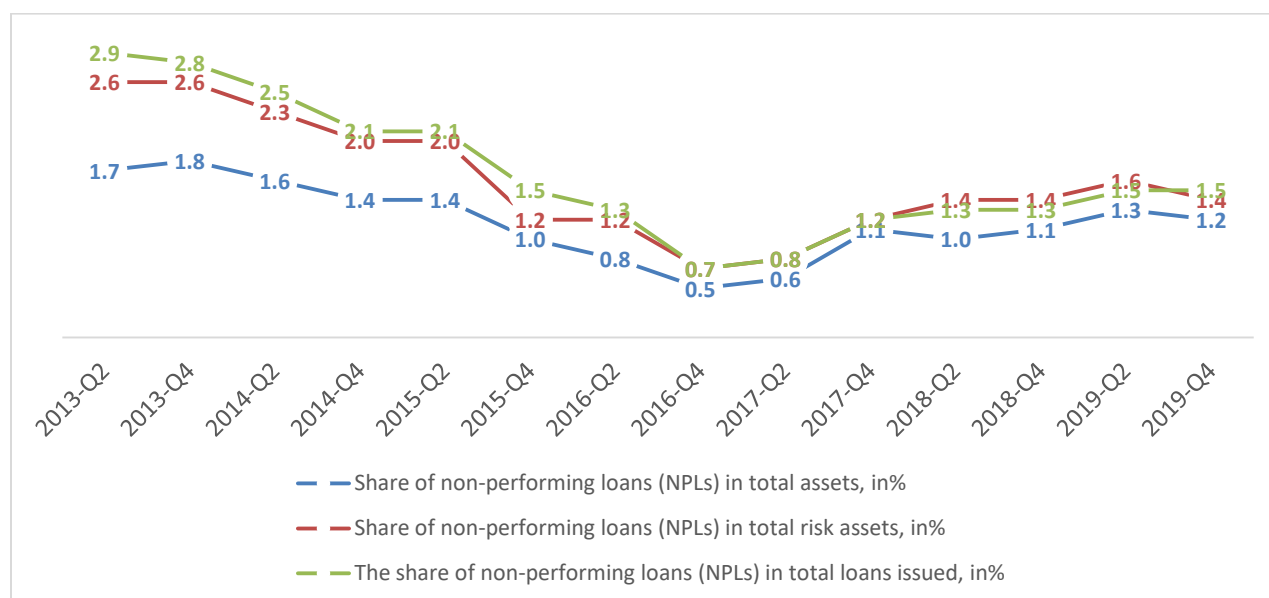


Figure 1. The share of non-performing loans of banks of the Republic of Uzbekistan in assets, risky assets, loans, in%.

Source: Based on data from the Central Bank of the Republic of Uzbekistan

The share of non-performing loans of banks in assets decreased from the 2nd quarter of 2013 to the end of 2016 and increased relative to the end of 2019 and amounted to 1.2%. The change in the share of at-risk assets and the structure of loans was close to each other, and at the end of 2019 was 1.4 and 1.5 percent, respectively.

Table 2 Information on non-performing loans of banks of the Republic of Uzbekistan and reserves created on them (billion soums)

№	Indicators	2013	2014	2015	2016	2017	2018	2019	Change (2019/2013)	
									billion	%
									soums	
1	Non-performing loans	720,0	674,4	580,8	391,5	1324,4	2140,5	3169,1	2449,1	340,1
2	Reserve created for non-performing loans (NPLs)	387,3	354,8	272,4	196,6	714,8	1000,1	1795,3	1408,0	363,6
3	Non-performing loans (NPLs)	332,7	319,5	308,5	194,8	609,6	1140,4	1373,8	1041,0	312,9
4	Non-performing loans (NPLs) cover non-performing loans	53,8	52,6	46,9	50,2	54,0	46,7	56,7	2,9	5,3
	(in%)									

Source: Based on data from the Central Bank of the Republic of Uzbekistan

The amount of reserves created by banks to cover non-performing loans varied accordingly to non-performing loans. We can see that the amount of reserves created in 2019 will allow to repay 56.7% of non-performing loans. A high level of this indicator means that the share of bad loans has increased if it is done in accordance with the requirements of regulatory documents. This is due to the fact that in the banks of the Republic of Uzbekistan (Regulation 2696, 2015) loan reserves are formed in the amount of "standard" - 1%, "substandard" - 10%, "unsatisfactory" - 25%, "doubtful" - 50%, "hopeless" - 100%.

These are the aspects that need to be considered at the micro and macro levels when conducting an audit of loans that do not have an internal audit in banks. At present, the audit of non-performing loans in commercial banks of the Republic of Uzbekistan is considered as part of the audit of general credit operations, and in some cases as a separate audit object.

A non-performing loan audit, like other internal audits, involves standard processes: preparation for an internal audit, planning, conducting an audit, and completing an audit.

In the internal audit of non-performing loans, it is advisable to conduct a separate audit of the lending entities on the form of ownership, amount, types and terms of loans.

At the same time, one of the main reasons for the emergence of non-performing loans is to calculate credit risk, pay attention to credit monitoring, credit documentation and, in general, pay attention to the environment in which the bank and the client operate.

For example, the current fight against the coronavirus pandemic in the world, including the introduction of quarantine in many countries, a sharp decline in production and consumption, disruption of global production chains and trade links, falling commodity prices in world financial markets and deteriorating conditions. (PF-5969, 2020). This situation has a negative impact on the financial condition of individuals and legal entities, which in turn can lead to non-repayment of loans and the occurrence of non-performing loans if they receive loans from commercial banks.

The total amount of loans currently issued by commercial banks to tourist operators, hotel business entities, transport and logistics companies and other enterprises of the tourism industry, as well as businesses facing financial difficulties due to restrictions on foreign trade operations (PF-5969, 2020) Deferral of debt repayment of 5 trillion soums (excluding fines) until October 1, 2020; By June 1, 2020, the task is to conduct a stress test of the loan portfolio, as well as to present the results of the assessment of asset quality in banks where there is an increased risk of problem loans.

It is obvious that the occurrence of non-performing loans is also closely related to force majeure. The internal audit service is also required to carefully study the circumstances surrounding the occurrence of credit risk. In preparation for the internal audit of non-performing loans, it is advisable to collect accounting information on these loans, information in credit reports, information on the activities of the client.

At the planning stage, work will be done on the organization of accounting for loans on non-performing loans, internal control system, risk and importance, scheduling of audits and involvement of specialists working with troubled assets in the audit team. It is advisable to involve lawyers as experts. At the same time it is necessary to create an audit program.

The audit involves gathering, evaluating, and analyzing evidence related to the problem asset being investigated. In order to use the advice of lawyers in the audit of non-performing loans, it is necessary to use the standard AXS 501 Specific features of obtaining audit evidence in individual cases.

To audit problem loans, it is necessary to use a separate audit option for loans to individuals and legal entities. The loan portfolio of interbank loans should not be added to this. It is recommended to calculate the average percentage of formation of loan reserves for borrowers, which should be extrapolated to the sum of active operations, taking into account the accrued income on loans and the relevant off-balance sheet liabilities of the bank.

Extrapolation of losses on credit operations is carried out using the following formula:

$$E_{sr} = \frac{AR_{ca}}{LP_s} * (LP_t - TA_{of} - LP_i)$$

Where  $E_{sr}$  is the extrapolation of the selection results;  $AR_{ca}$  - the amount of reserves calculated according to the results of the analysis, taking into account the requirements of the method;  $LP_s$  - loan portfolio based on the results of the selection;  $LP_t$  - total loan portfolio (including off-balance sheet liabilities);  $TA_{of}$  is the total amount of off-balance sheet liabilities;  $LP_i$  is a loan portfolio of insiders.

In assessing non-performing loans, it is necessary to comply with the requirements of the Regulation of the Central Bank of the Republic of Uzbekistan No. 2696 "On the classification of asset quality in commercial banks and the order of formation and use of reserves to cover possible losses on assets."

Given that commercial banks (PQ-4611, 2020) are required to organize accounting on the basis of IFRS from January 1, 2021 and prepare financial statements on the basis of IFRS from the end of 2021, non-performing loans should be fully assessed in accordance with IFRS 9 Financial Instruments Standard will be.

At the stage of completion of the audit, a general report on non-performing loans is prepared, on the basis of which conclusions are formed. It provides information on the main factors that caused problems with these loans, who served them, the monitoring staff, the work to be done to repay the loans.

## CONCLUSION

Loans play a key role in the assets of commercial banks. The clients of the bank, who received the loan, are engaged in various activities, operating in different conditions. This in turn affects the payment of the loan and the interest accrued on it. It is precisely these situations that lead to the occurrence of non-performing loans. The increase in the share of risky assets in the bank's assets, various force majeure situations have a direct impact on the increase in non-performing loans.

Overdue loans disrupt the lending process, have a negative impact on cash flow, lead to a decrease in the bank's liquidity, reduced profitability, difficulties in lending to other customers. Preventing this further increases the need for internal audit, which is one of the main tools of corporate governance.

Non-performing loan audits are unique in that they require internal auditors to be highly qualified. Internal audit staff will need to be thoroughly familiar with IFRSs and IFRSs.

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