Bridging All The Expectation Gap—The Changing Role of Concurrent Auditors

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Forced by market conditions, banks worldwide have dramatically transformed their operations in past few years. The transaction-audit approach that evolved during the industrial age is not therefore suited to the information age, when the transaction is carried out on line and information/ data is transferred from one computer to another either within the same premises or at a distant location.

Business practices have changed mainly due to advent of technology, and so have the risks and hence the expectation to mitigate them is rising.

There is no doubt that traditional internal audit shops have some valuable strength, however many tend to remain largely focused on what they have been doing rather than on what is the expectation in the changed scenario. Also, most current functions do not encompass enough of the expertise or the range of risk-based information and financial analysis that today's banks require to thrive in fiercely fought market. The ability to manage these risks is often the key differentiator between the organization that survives and indeed thrives, and the one that flounders or, at worst, fails.

Such is the importance of the concurrent audit that it's not only the management, who is appointing authority, is interested but there are others who are equally interested for their different objectives. The prominent amongst them are: Govt/Public, Regulator (RBI), Investors/Depositors, and Analysts.

There is enormous pressure on the management to outperform the competitor or if possible the market and hence any laxity in the system is viewed seriously as they are treated as one of the reasons for underperformance. There is a similar pressure on the regulator and Govt. to ensure smooth functioning of the financial system and as banks are regarded as the engine of the financial system therefore any untoward events are linked with the performance and non-performance of the concurrent auditors especially where branches are subject to daily audit. In a similar manner investors and analysts are continuously and closely monitoring the effectiveness of internal controls in the banks.

The truth is that performance commands respect. If the auditor is using yesterday's approach in today's bank then expectation gaps widens and the result would be the loss of opportunity. However, there are elements of 'too much' or unrealistic expectation. The first part of

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this article discusses about the expectation gap and second part focuses on bridging this gap. Additionally, there is a discussion on the role of the concurrent auditors in view of the fast changing business practices and even-rising expectations. A profession must be alert to the desirability of role modification and revision in line with change in the need of the users and at the same time effectively communicate for expectations, which are not their duties.

What is expectation gap?

It comprises:-

Reasonableness gap (also called unreasonable expectations)- the difference between the expectations of users and the reasonable standard of auditing which the profession can be expected to deliver. For instance, if any fraud takes place concurrent auditors are straight way blamed for their non-performance. Another example could be 100% verification of vouchers. These can be categorized as unreasonable expectation.

✓ Performance gap (also called inadequate performance)- the difference between the reasonable standard of auditing which the Profession can be expected to deliver and the services which are being delivered by the Profession. For instance, if the skills of the auditors are lacking in the computerized environment, foreign exchange business practices, credit risks assessment tools, treasury operations, EFT (Electronic Fund Transfer) aspects, application and understanding of modern financial instruments and tools then this can be categorized as inadequate performance on the part of the auditors. However, here too auditors are not solely responsible for the performance below expectation, which can be seen by further bifurcating the Performance gap.

The performance gap can be further subdivided into:

✓ Deficient standards- the difference between the existing standards and those needed to properly serve the market place. Outdated books of instructions, no policy for information security and no job cards are few examples of deficient standards. Although auditors based on his experience in the industry can still point out or advise on matters, which are critical in his opinion, expecting performance in such scenario is asking too much.

✓ Deficient performance- the difference between the services being delivered by the Profession and the existing standards laid down by the bans, the regulator, by legislation and Profession. If auditor performance is below the expectation either because of lack of knowledge or seriousness then he is accountable for the same.

Listed below are some of the expectations compiled from the appointment letters/ comments on the reports of the concurrent auditors.

✓ 100% verification of vouchers is not carried out. (This requirement is there in large number of banks and the scope of work says that concurrent audit is a systematic examination of all financial transactions at a branch on a continuous basis to ensure accuracy

and due compliance with the internal systems, procedure and guidelines of the bank)

✓ Auditors merely fill the information required in the Reporting formats in a mechanical way and objective analysis is not done. (Reporting formats are to make report uniform and therefore any branch specific issue must be identified).

✓ Focus is only on identification & rectification and not to stop recurrence (preventive) controls. (Emphasis should be on prevention and regularization rather than fault finding & punitive)

✓ Concurrent auditors have a moral responsibility to the bank an are accountable for any act of omission. They should be vigilant, objective, and analytical in approach.

✓ Concurrent auditors to participate in the functioning of branches and assist them in identifying and weeding out defects/deficiencies.

✓ Frauds could not be detected on time even though branches are subject to concurrent audit on daily basis. (The RBI guidelines for concurrent audit says this audit is essentially a management process internal to the

establishment of sound internal accounting functions and effective controls and setting the tone for a vigilance internal audit to preclude the incidence of serious errors and fraudulent manipulations)

- ✓ A critical analysis of the quality of credit assessment is lacking.
- ✓ Reporting in the areas of foreign exchange business is lacking.
- ✓ System related issues are not commented upon. (Some of the banks have developed questionnaire for system related issues where auditors are required to comment as part of the concurrent audit and others also expect performance in this respect)
- ✓ Deputing very junior or new Article Clerks with inadequate exposure who become too submissive with the Senior Official. (Regular visit by a Senior Chartered Accountant is lacking who can assert sufficient authority on the branches).
- ✓ The internal inspectors detects large amount of revenue leakage even though branch is under concurrent audit net.

The following extracts from a debate under the title 'Frauds in Public Sector Banks' in the Rajya Sabha on April 27, 2000 reflects the expectation of the parliament.

"Day-by-day the depositors are losing their money because of various frauds in nationalized banks. There are reports that more than 27 State-owned banks have lost Rs.48,000 crores. A number of cases have been registered against the nationalized banks. The internal crime is going on in more than 28 nationalized banks. There is a need to review the concurrent audit. I (Shri N. Thalavai Sundaram) request the Government to take necessary steps to solve this problem. A committee should be constituted to check these frauds".

Some of the expectations as highlighted above can be classified as unreasonable expectation gap (for instance 100% verification of vouchers or prevention/ detection of all the frauds) while others as performance gap. A similar requirement for 100% verification of Form A1 and A2 (these forms are taken by banks for permitting payments in foreign currency) needs review-verification beyond a threshold limit would serve the purpose in better manner by allowing auditors to focus on material payments. Also related to this issue is the deficiency in the standards. A deficient standard leads to frauds in number of cases and auditors are held responsible for the same as it is perceived that once a branch is put under concurrent audit either irregularities/ frauds will not take place or would be detected and reported immediately after happening of the event. There is a similar expectation from investors/ depositors and other concerned people. Whether we like it or not all concerned people expect concurrent auditors not only to detect frauds but also to prevent it.

In the upcoming paragraphs, an attempt has been made to examine the existing scope of the concurrent audit in view of changed international practices in order to ascertain what is unreasonable expectation and what are the ways to minimize overall expectation gap.

The concurrent audit effectively is an internal audit though carried out on a continuous basis and the objective here is to minimize the time between the independent examination and the happening of financial transactions. In this respect, let's first examine the objective of 100% verification of financial transactions. Forgetting for the time being the practicality of doing the same, first question, which comes in the mind, is that what will be achieved out of this exercise. Note that per day vouchers varies between 300 to more than 2000 (a rough estimate) depending upon the size of the branches. And even if the same is done what is the guarantee that no irregularities

exist thereafter. A relevant point here is that number of banks have either moved to a more sophisticated computerized system or are in the process of doing that. Certain questions arising from the above discussion are listed below followed by answers for the same.

Are auditors expected to give equal weight to high risk and low risk areas so that 100% transactions are covered?

How relevant is the verification of all the financial transactions in the computerized environment?

Does internal audit include risk-based approach?

Are auditors expected to pre-

vent and detect frauds during the course of the assignment?

Do concurrent auditors need the skills of IS auditors apart from having understanding of banking business practices.

Before we try to answer above questions, let's check how Institute of Internal Auditors (an authority on the internal auditing) defines the term Internal auditing and what are the recent changes in the internal auditing practices.

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

The first thing to note in the above definition is that the main objective of internal auditing is to assist the organization to achieve its objective. So if the organization objective is to create 'shareholders value' then that is the aim of the internal audit. Recent changes in internal auditing practices will provide the base to address the issues highlighted above. Effective January 2004, The Institute of Internal Auditors' (IIA) Internal Auditing Standards Board has significantly revised its International Standards for the Professional Practice of Internal Auditing (Standards). The Standards have been updated to reflect current risk management and governance requirements and also address consulting opportunities.

Based on the above we can infer that concurrent audit basically is an assurance service that assures about adequacy and effectiveness of control systems, accuracy of the financial transactions including physical verification of the assets charged to the bank.

First three questions are addressed here. Vouching each transaction from "cradle to grave" — to catch and prevent all frauds and irregularities- is neither practicable nor it achieves any objective and never forget the cost of doing that. If it were so then there should not have been any irregularities/ frauds in the branches covered

Relevant Key Changes

- Internal auditors should have knowledge of key information technology risks, controls, and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing. Internal auditors should consider the use of computer-assisted audit tools and other data analysis techniques.
- The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.
- Consulting is not mandatory for internal auditors. The Standards provides guidance should an internal auditor choose to perform consulting services. Assurance and consulting services are further defined in the introduction to offer an understanding of the distinctive activities of each.
- Periodic internal and external quality assessments and ongoing internal monitoring should be part of a quality assurance and improvement program, designed to help the internal auditing activity add value and improve the organization's operations.
- The internal auditor should be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.
- The internal auditor should exercise due professional care by considering the extent of work needed to achieve the engagement's objective, relative complexity, materiality, or significance of matters to which assurance procedures are applied, adequacy and effectiveness of risk management, control and governance process, probability of significant errors, irregularities, or non-compliance, cost of assurance in relation to potential benefits.

under daily audit. This suggests a re-look on the scope of the audit especially when the RBI has made it mandatory to all the banks to implement Risk management system.

An effective solution would be the introduction of features of risk based auditing in such scenario. As highlighted above in the definition of internal audit, it does include review of significant risks. Moreover, in computerized environment requirement of 100% verification appears to be out of sync. For instance, there is justification in verifying bank guarantee commission for each transaction in the manual system, however, in core banking solution environment if the auditor has verified parameter setting and tested few transactions, the job is over for commission checking. Rather such an environment requires different skills and approach. Continuing with the same example, the auditor should focus more on such transactions where system computed commission has been amended manually in order to verify their validity. Usually system allows such flexibility to give special benefits to a particular customer.

Risk-based auditing is more efficient, because it directs audits at the high-risk areas, as opposed to financial areas, which may not represent such a great risk and it also reduces the risk of over-auditing. There is a general perception that risk based auditing starts with risks, however, it is not correct. Risks do not exist independently; circumstances only constitute a risk if they threaten the achievement of an organisation's objectives. Thus the starting point for risk based internal audit is the organisation's objectives.

A discussion on Risk based auditing is beyond the scope of this article, nevertheless, a comparison of the Traditional approach and Risk based approach is given below to initiate discussion in future about the utility of the later approach.

In simple words, a risk is a set of circumstances that hinder the achievement of objectives, internal controls are designed to mitigate the risks and internal auditing provides assurance that internal control mitigate risks to an acceptable level.

Traditional approach	Risk Based approach
Focused mainly on policy and procedures	Focused mainly on business objective and risk management.
Transaction based	Process based
Compliance is the key objective	Risk identification and process improvement are the key objective

Auditors are under attack around the world for not doing enough in the war against frauds. There is no doubt that scope of work for concurrent audit covers not only fraud detection but also prevention (RBI guidelines says to preclude the incidence of fraudulent manipulations). The above discussion on internal auditing confirms that Fraud detection or prevention for auditors is a secondary duty. However, can we avoid one question." where were auditors?" whenever fraud takes place be it in a public or audit committees. The perception of the society is "Better audit less fraud"- to bridge this expectation gap continuous communication with the concerned people is the need of the hour.

In view of accepted international practices as highlighted above, if concurrent auditors are pointing out indicators of frauds' (commonly known as 'Early Warning Signals') they are doing fair job as detection and investigation of frauds required altogether different approach and skills. Therefore, any expectation beyond this would be categorized as unreasonable expectation. It will not be out of order to mention that in most of the cases signals of the auditors are either not acted upon or it has significant time lag. It is the effectiveness of the exercise of Internal control in practice that really counts, not their apparent merits according to any textbook. Therefore, a bank could regard itself as perfect if their auditors were able to tick off all the items of a checklist in a rather mechanical manner. However, when problems come on surface it tries to find out: what went wrong and to learn the control lessons for the future. But it is bit late at that stage. Therefore, one good test of effectiveness is to consider management's reaction. For instance, where TOD (Temporary Overdrafts) is allowed on continuous basis and such situations are reported but routinely approved, then management should not be surprised if, sooner or later, they face unexpected happenings. Take another live example to understand the meaning of effective control. A senior manager was signing on regular basis vouchers for the amount more than he was authorized for and when pointed out, not only it was ignored by the branch manager under the pretext of running

the branch smoothly but also in the periodical meeting, senior management categorized this observation as a routine one. After some time, the same staff was posted in London branch of the bank and he did the same mistake. The local auditor reported it and reaction came from the Bank Of England (the regulator) directly to the head of operations leading to a stern warning to the staff member. The examples on this count could be numerous. Therefore, a rapid and effective response to a control problem demonstrates that management expects it to continue that way. The fact is that it is the effectiveness and not the simple existence, of controls that counts. What gives an organization adequacy of Internal Control rests not on the rule Book (Books of instructions), but essentially on the "Culture" where people know instinctively what is right, are encouraged to express concerns on matters of Internal Control or risks and above all, everyone understands that a problem is to be shared, not uncovered by an audit. A practice where a particular member of the staff makes mistakes on consistent basis despite being repeatedly pointed out speaks itself of the weak control environment. The quality of control environment varies from bank to bank and the difference is quite evident at branch level of the same bank.

The last question deals with: whether concurrent auditors should have the skills possessed by the IS auditor. Though concurrent auditors are not expected to have expert knowledge of IT auditing working knowledge is very important. Shift of banks from legacy system to Core Baking Solutions in recent years requires not only change of approach but also skills in IT audit.

How Should Chartered Accountants Respond to the Rising Expectation Gap?

Bridging of unreasonable expectation gap is possible by way of effective and continuous communication with the concerned parties. ICAI as a professional body is better placed to this-an initiative could be taken by sending questionnaire about the expectation to all concerned followed by a brainstorming session and

then formulating adequate strategies in this respect. This would also attract to those who have closed their door in the recent past for chartered accountants (the major reason could be traced to the expectation gap) and also to those who have so far not opened. Though there would be numerous suggestions on this account from the esteemed members, listed below are a few of them for initiating the process of dialogue.

✓ Concurrent auditors traditional testing of control activities (Policies, Procedures and processes that help ensure a bank carries out management directives. Examples include approvals, verifications, reconciliation, and security of assets and segregation of duties) should include two additional components that are derived from the way management runs a business; control environment (The tone of the organization influences the control consciousness of its people. Examples include the integrity, ethical values and competence of employees; management's philosophy; and input provided by the board of directors) and risk assessment (Identification and analysis of risks relevant to achieving organization's goals, determination of how such risks should be managed and implementation of a process to address risks associated with change). Control environment hardly get attention of the auditor. For instance if a staff member without sufficient background or adequate knowledge is handling foreign exchange business then control environment is very weak and despite his best efforts errors or frauds may take place. What is important is that a change in focus is required to achieve desired results. In future, concurrent auditors can't just audit control activities they will have to play a key role in identifying areas to improve risk management process. However, if the risks of the business were not understood then traditional checklist tasks would continue to increase expectation gap. Banking is about taking risks. Auditors need to understand that without taking risks, bankers cannot make money. The important point here of course, is that such risk taking is informed and within the set parameter. There is an evident and pressing need for a dialogue on these and related issues. Auditors must be able to anticipate change, predict change, react to change, facilitate change, and prepare for it as the banking busi-

ness is changing and becoming more complex and risky.

✓ Good auditing and accounting skills are unlikely, in themselves, to be enough when dealing with banking transactions and practices. The expectation of client and regulator require for a greater knowledge of the Bank's business which means that the team of auditor:

- Acquire atleast working knowledge of IT auditing
- Understanding of foreign exchange business, financial instruments and risks arising therefrom needs improvement (Suppose a borrower converts his domestic loans into foreign currency loan and uses currency swap/ currency options/ forward contracts etc. to hedge the risks, then auditors must have sound understanding of such transactions otherwise verification becomes difficult. In checklist auditing approach one can still get away with this by mentioning: "No irregularity observed" and this fraught with risks)
- More Senior level involvement (In a typical audit, the most experienced person comes in to make the initial assessment, then they disappear except occasional visits and leave the staff to themselves. The engagement partner may have been told by the branch manager that there was strength in the controls and less experienced people may not recognize weaknesses or potential new problems because they don't have the background or the experience. If the senior auditor is not involved on a continuous basis, irregularities/ frauds may not be caught. Remuneration against the expectation and required skills in the changed scenario is very low. And therefore expectation without addressing this would not give desired result. The best benchmark should be: what banks would have paid had they engaged their own staff of the similar skills)
- The Support of specialist training and technical back up (Regional centers of the ICAI is the best forum to facilitate knowledge sharing)
- To be in touch with the market practices. (This is where chartered accountants are better off as compared to the in-house audit team of the banks, knowledge gained in risk management practices of various banks will be crucial in reviewing risks management exercise of a particular bank. In order to leverage this knowledge expertise, continuous dialogue is required)
- To have updated knowledge of relevant legislatures regulation and circulars issued by the Bank.
- To be aware of emerging business issues.
- In addition to tests of details (this includes, physical examination, confirmation, recalculation, enquiry etc.) focus should also be given on analytical procedures (this involves a comparison of the value of an actual ratio/trend/ account balance/ transaction etc. i.e. based on amounts recorded in the accounting system with the value of the expected ratio/ trend/ account balance/ transaction etc. The objective of this comparison is to identify and investigate the reason for any unusual or unexpected relationship between the actual and expected values. This is more helpful in detecting and preventing frauds. For instance a sudden rise in the working capital borrowing without any change in the industry trend and sales pattern of that organization gives more reason to probe matter further or atleast highlight the issue. Another example can be given: a borrower suddenly shifting from demand LC to usance LC basis of procurement of material or substantial increase in buying or selling from related parties. Note that these kind of transactions usually have all inputs of approval and difficult to identify by test of details.)

- Change in mind set up- by banks as well as auditor. (Discussion with the vigilance officer of the banks revealed that auditors simply chose not to pursue identified audit issues, perhaps fearing the time spent investigating those issues would miss client-imposed deadlines/not liked by the senior management/ not be remunerative.)

Conclusion

Without these factors at the very least, the service is likely to lead to client dissatisfaction, whilst, at worst, it could lead to what is generally feared is professional misconduct and loss of business opportunity. ■