Role of Central Statutory Auditor's in a Bank Audit with Special Reference to Core Banking Environment

The assurance expressed by central auditors through their audit report that they have obtained sufficient and appropriate evidence for the purpose of expressing an opinion is negated by the scope limitation expressed on the nature of engagement. The SAs issued under the clarity project, in particular SA 200, would not support a fundamental scope limitation worded as "Subject to the limitations of audit set out in paragraph 1 to 5 above". The author is of the opinion that current standards do not support AAS-10 - "Using the work of another auditor" and that the responsibility of central auditors is joint and that they have to jointly execute the audit as if it were executed by a single auditor. Central auditors would, therefore, require to assume more responsibilities for the engagement and more so in a core banking environment where there are no books at the branches and all so called branch financial statements are generated from the centralised data base. Much thought would, therefore, have to go into the nature of sign offs to be obtained from branch auditors which could be relied upon by the central auditors.

CA. H. Anil Kumar

(The author is a member of the Institute. He can be reached at anilkay.rao@gmail.com)

The Issue

Size, geographic spread, complexity of a business and the regulatory requirements make the audit of any bank a challenge. Though auditing standards were first notified by ICAI in 1985 and subsequently revised/ replaced under the clarity project, the approach to audit, particularly bank audit, has seen no change in principle. While standards are adaptations of the International Auditing Standards, the application followed the ground reality. In the case of bank audit, the audit objective in recent years is to verify compliance with income recognition, asset classification and provisioning norms and disclosures required by RBI from time to time as these are the areas which are reviewed in detail by RBI in its Annual financial inspection and any deviation observed by RBI would have a bearing on an auditor's ratings.

Bank audit has gone through varied approaches in India. Initially the approach was transaction based. When the size of banks increased, the approach was a balance sheet audit approach which continues as of today. Though there is no formal risk analysis, the areas selected for higher substantive testing are on a consideration of risk-based on past experience. However, formal risk-based approach as set out in the current auditing standards in force are not followed.

While these are practical issues, audit reports[1] of banks contain following averments made by the auditors:

"We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion."

Therefore, the report creates an expectation in the reader that the auditor has obtained reasonable assurance in terms of the standards and not reasonable assurance based on what is possible as per the practice in vogue. However, the audit report also contains a disclaimer in the opinion paragraph, viz.[2] *"Subject to the limitations of the audit as indicated in paragraph 1 to 5 above and as required by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and also subject to the limitations of disclosure required therein"*. Therefore, the assurance is not without reservations on the nature of audit which is contained in the introductory paragraph of the report, viz.:

- It is a joint audit.
- Substantial reliance on the work of branch auditors. Only a small portion of the audit work has been done by the auditors.
- There are branches of the bank which have not been audited.
- The selection of the branches to be audited are made as per RBI guidelines and not based on selection by auditors.

The above reservations are significant and negate the assurance held out by the auditor that the audit has been carried out in terms of the SAs. Otherwise also, the gulf between what the auditor holds out in his audit report and what is actually done in practice has further widened after banks have moved to core banking.

The object of this article is to examine how this gulf should have been addressed.

Approach to Audit: Transaction Based Vs Balance Sheet Approach Vs Risk Based Approach

Bank audit has gone through varied approaches in India. Initially the approach was transaction based. When the size of the banks increased, the approach was a balance sheet audit approach which continues as of today. Though there is no formal risk analysis, the areas selected for higher substantive testing are on a consideration of risk based on past experience. However, formal risk based approach as set out in the current auditing standards in force are not followed. With increase in size and in response to incidents of fraud and error, banks have built up a strong and robust internal control framework. Compliance with these controls is reviewed by the internal audit department of a bank. The auditors place a strong reliance on these internal controls without a formal process of testing the same as required by the standards. This is in part to be blamed on the system of appointment of auditors. Auditors are usually appointed towards the fag end of a financial year and the entire audit process is expected to be completed before the end of April leaving little time for this exercise. A second reason is that the auditors have not received exposure to internal control review during their training as articles and the legacy still continues. Lastly, weaknesses in internal control in an area considered material to the financial statements would require an increase in substantive testing. A major area on which substantive testing is being carried out by auditors is on classification of advances and compliance with IRAC norms. Considering the size of the bank, auditors would not be able to commit further resource to carry out the desired level of substantive procedures. Change in the approach to audit in the banking sector, as in all areas of banking, would probably require to be driven by RBI. In the 1980s, deficiencies in coverage by auditors perceived by RBI was sought to be addressed by requiring the auditors to complete a long form audit report. While RBI has directed banks to adopt a risk-based strategy for internal audit, no such advice has been given to the statutory auditors or branch auditors.

[1] For the recommended format of the report see paragraphs 3 ,4and 5 of the illustrative format of the audit report of a nationalised bank given in Appendix-4 of the Guidance Note on Audit of Banks -2011 Edition)

[2] Ibid. It is unusual that in the illustrative format of the audit report given in appendix -4 of the Guidance Note on Audit of Banks -2011 Edition, the reservation extends to paragraphs 2 to 5 i.e. the scope paragraphs.

Is the "Whole" a Sum of the "Parts"?

Audit of a bank also continues to be a bottom-up approach based on the model followed when books were maintained manually. The accounts of a bank had to be consolidated from the financial statements of the individual branches and offices. In the manual era, year end and other returns received from the branches were consolidated at head office (H.O.) manually or with the aid of computers. In such a milieu, the branch returns used in the consolidation had to be audited at the branch level with the general ledger and other books maintained at the branch. Opinion on the accounts of a bank was based on the findings in these audit reports. This system of audit also held good when banks moved to computerisation up to the stage of totally automated branches. A major audit issue in that era was the status of reconciliation: between the general ledger and sub-ledger and between the H.O. and the branches.

Today, most if not all banks have moved to core-banking. The financial statements of the bank are drawn up at H.O. based on trial balance for the bank generated from the system and not from consolidation of branch returns. Certain year-end returns such as classification of advances which are generated at branch level are consolidated at H.O. for arriving at the information required to be disclosed in the accounts. In the manual era, the balance sheet and profit and loss account of the branch were prepared only for the purposes of classification of the items and aiding consolidation at H.O. and those were reported upon by the branch auditors. Those financial statements were also incomplete because many year-end entries were passed at H.O. and hence these financial statements never presented a true and fair view of the state of affairs of the branch as on the balance sheet date or the results of its operations. In core banking the data of the branch is already available with the H.O. and the branch balance sheets and profit & loss account are generated from the data base by the system. From the point of view of the financial statements of the bank the branch financial statements are not required and hence not generated. However, for the purposes of year-end audit, the bank generates the financial statements for each branch and office of which most would be audited and countersigned by the branch auditors. The bank also prepares a report showing each balance in the trial balance branch-wise, against which the reports generated from the core banking software in the form of financial statements of the branches and signed by the branch auditors are verified by the central auditors. Central auditors rely on the branch auditors' reports that these financial statements present a true and fair of the affairs of the branch and its profit for the year subject to the usual adjustments made at H.O. as they used to do when accounts were maintained at the branches. This approach to audit would be valid if the opinion on the "whole" could be based on the sum of the opinions on each of the "parts".

In a core banking scenario, whether the central auditor can simply rely upon an unqualified report of the branch auditor on these so called financial statements merely because the said branch auditor is a member of ICAI is a question has not been asked officially of ICAI and hence does not have an official answer. The answer is in an exposure draft of a proposed revision to AAS-10 -"Using the work of another auditor".

In the manual era, accounts of an office of the bank were based on books maintained in that office and entries therein could be made by only those who had physical access to the books. Interaction between offices of the bank was only through the inter-branch account. In such a situation, the branch financial statements were based on the books of the branch in which entries were made and approved only by staff of the branch. Branch auditor was not unduly concerned about the controls outside of the branch audited by him. The same held true in the era of totally automated branches. However, in core banking scenario, the reality is different. Data of the bank is stored on a central server. Separate accounts of the branch per se do not exist. Entries in a branch could be initiated and posted from any of three sources: by the branch personnel, by the system or by personnel from another office. Entries could also originate externally from another bank or agency. Financial statements of a branch are a view of the data based on a key relating to the branch. In such a situation, can the audit opinion on the "whole" be based on the sum of the opinions on each of the "parts"? In a core banking scenario whether the central auditor can simply rely upon an unqualified report of the branch auditor on these so called financial statements merely because the said branch auditor is a member of ICAI is a question which has not been asked officially of ICAI and hence does not have an official answer. The answer is in an Exposure Draft of a proposed revision to AAS-10 -"Using the work of another auditor". The Exposure Draft titled Revised Standard on Auditing (SA) 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) has not been issued as a standard, though comments have been sought in 2008

and more than three years have passed since. This standard is most relevant for audit in the core banking environment, where the branch auditor is reporting on "whether proper books of account are maintained at the branch" based on the "books" in the central server i.e. at H.O.

The challenge posed to auditors from the core banking could be seen from the following example: In a bank, the employees' pay and other benefits are maintained on the human resource management service application maintained at H.O. Branches inform the regional office of the attendance of the employees on a monthly basis. The data is keyed into the HRMS package at the ROs. The pay and deductions are worked out by the HRMS software. The HRMS software generates the journal entry for the salary for the bank as a whole, debits various salary and allowances accounts for the expenditure, credits the control accounts for deductions and recoveries and credits the net salary to individual employee SB accounts maintained on the core banking software by a straight through process. Branches would only get an advice of the entries passed without the supporting details. Pay slip reports are not generated because the employee can view the details of his pay directly through the computers maintained at the branch and take a print if he so desires. The salary and allowances related to the employees of the branch would appear in the financial statements generated by the core for the branch. The branch auditor could ask for the details in support of the entry. The information required could perhaps be furnished by the branch from the HRMS package if any such facility is available at the branch level or required reports have to be obtained by the branch from the appropriate office. If the same are not furnished, the branch auditor could issue a disclaimer in his report. In practice, as the entry has been passed under the authority functioning under the controlling office and outside the branch, and in the absence of instructions from the central auditors in this regard, branch auditors will not consider it necessary to verify the payroll with the accounts and consequently salary and other related expense accounts may very well go unaudited though the same are included in the financial statements reported upon by them.

AAS 10 or SA-600 -"Using the work of another auditor", is based on and explains the following paragraph of AAS-1 "Basic Principles Governing an Audit":

"When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance."

Auditing a nationalised bank is a greater challenge as the number of central statutory auditors is more than one. ICAI has issued a standard AAS-12 titled "Responsibility of Joint Auditors". An interesting feature of this standard is that it is not mandated that the objective of the audit be achieved by the joint auditors collectively, i.e. they are not expected to achieve the same audit objective that is required under SA 200, had the audit been carried out by a single firm of auditors. Therefore, this pronouncement helps audit firms arrive at a working arrangement where the "audit work" is divided.

AAS-1 is now withdrawn and SA-200 the standard replacing AAS-1"Basic Principles Governing an Audit" does not have an analogous paragraph.

In the absence of the same, it would not be appropriate for the central auditors to rely on the branch auditors' reports on the financial statements of the branch, without determining their relevance to the opinion on the financial statements of the bank as a whole. The auditors also cannot claim that they have carried out the audit in accordance with the auditing and assurance standards of ICAI as required by the revised standard SA 700 unless they have satisfied themselves that the work of the branch auditors is reliable.

Challenges of a Joint Audit

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the audit work allotted without being affected by the quality of work of the other auditors. An audit firm, as one of the joint central statutory auditors, is entitled to rely upon the work of other co-statutory auditors if it is backed by a proper sign off. A grey area is the responsibility for the aspects of "audit work," which are not divided. According to AAS-12, in respect of matters not divided, the responsibility shall be joint.

In practice, as appointment of audit firms as central auditors is only for a period of three years, no audit firm is familiar with all the areas of the bank. Hence, the division of audit work amongst the auditors is usually carried out in many banks by the banks in discussion with the auditors. In making such a division of work, the bank would be guided by past experience and may not consider the changes which have taken place in the business of the bank and the requirements of the engagement standards which are applicable to the auditors. The division of work would usually be by departments at H.O. and regions/divisions/zones for consolidation and not by function or line of business. Division of work also depends on the number of joint auditors. In some banks, to accommodate the auditors, the balance sheet and profit & loss account are allotted to one auditor and another audit firm verifies the consolidation of notes. In such a situation, no audit firm amongst the joint auditors has a sense of the whole. The documentation would indicate the departments and regions allocated. However, the documentation of division of responsibilities may not state which auditor is entrusted with the work of evaluating the financial statements of the bank as a whole and examining the relationships between various components. It appears that in some banks, except for the auditor verifying the consolidation of accounts, other auditors do not see the financial statements till the date of the board meeting. Obviously auditors have to realise that they are collectively responsible for forming an opinion on the financial statements and, therefore, they have to take more responsibility for the allocation of work amongst themselves. Along with the allocation, there should be a clear description of the responsibilities associated with the division so that "the matters not divided" are clearly identified.

Some of the issues which need to be discussed and sorted out jointly so as to address audit risk are:

- Jointly determine the materiality at the financial statement level and component level
- Determine performance materiality for the financial statement level and component level
- The auditor verifying the financial statements including the notes on accounts would be taking upon himself the role of the principal auditor and he would be responsible to ensure that the division of work is comprehensive and completely addresses all the significant audit areas
- The nature of sign-offs required by each auditor from the other joint auditors in respect of the areas allocated as well as from the branch auditors
- Review the impact of the bank's information system on the respective areas allocated and give their requirements to the central auditor who is auditing the data centre
- Examine the circulars issued by the respective departments for compliance with RBI guidelines as well as for planning their audit
- Review the minutes of the board/audit committee and other committees wherein the notes originating from the departments and matters relevant to the audit areas allocated are considered
- Examine the closing circulars issued by the bank in respect of matters relevant to the areas allocated to them for compliance with RBI guidelines and Accounting Standards
- Identify issues/instructions and audit procedures for advice to co-auditors as well as the branch auditors
- Fixing the limits for errors to be concerned as "trivial"

The joint auditors need to complete the discussions on the above areas well in time to formulate the audit plan and draft the instructions to the branch auditors. The auditors also need to have a discussion amongst themselves to identify possible sources of fraud and error and ensure that the audit plan and procedures address these risks.

Role of Branch Auditors

In the core banking scenario, when the financial information relating to a branch are stored in the central server, they are not components on which the branch auditor could express a true and fair view which could be relied upon by the central auditors. Under the SAs, the branch auditor cannot express a true and fair view unless he has independently carried out a review of the IS and how it affects the financial statements of the branch. Therefore, the work allocated to the branch auditor should be very specific so that the sign off

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by a member of the Institute could be relied upon by the central auditor. In allocating the work, the central auditor should focus on assertions which are material to the financial statements of the bank as a whole and which are best verified at the branch level.

These could be:

- Verification of schedules relating to classification of advances and compliance with IRAC norms;
- Review of balances and accounts in the general ledger and sub-ledger of the branch in accordance with such criteria as may be determined by the central auditor;
- Verification of sample transactions extracted by the central auditor from the core data such as:
  - Transactions in suspense accounts/sundry debtors
  - Acceptance and repayment of deposits
  - Entries in interbank reconciliation account
  - Entries relating to centralised payroll
  - Items of income and expenditure
- Physical verification of cash and security items;
- Review of exception reports identified as relevant by the central auditors.

Though most of the above items are being carried out even now by the branch auditors, the difference would be in the nature of sign offs to be obtained from them and which could be relied upon by the central auditors.

Conclusion

The secret, therefore, to audit in a core banking environment is for central auditors to accept their joint responsibility for the audit as envisaged under SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing". Once that is done, the approach will unfold by itself and, in such an audit, the joint auditors will not find the limitations as now presently expressed through their audit report. A beginning could be said to be made when the auditors jointly issue an engagement letter to the management. ■