Statutory Bank Branch Audit: Strengthening Audit Plan

Auditors are expected to report to Reserve Bank of India anything fraud, any act of excess power or foul play in economic transactions. Paragraph 8 of Standards on Auditing SA 240 (Revised) *Auditor's Responsibilities Relating to Fraud In an Audit of Financial Statements* of ICAI requires an auditor to be responsible for *maintaining an attitude of professional skepticism throughout the audit* while obtaining reasonable assurance, and prescribes him to consider the *potential for management override of controls* and to remember that audit processes, which empower the auditors in evaluating and verifying the financial statements of various enterprises, may not help them effectively *in detecting fraud*. Regulations today bind them to apply heightened professional skepticism considering the potential for management override of controls. This article attempts to identify some of such potential areas exposing the risk of or causing material misstatements, which would help the branch auditors in strengthening their audit plans. It aims to identify some potential areas, not equally applicable to all branches, of management override of controls while not suggesting an audit approach or procedures. The author advises that auditors, while planning their audits, should identify all such potential areas, considering the type and size of the branch.

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Technology-enabled business processes and products, and varied platforms/applications at banks, demand for enhanced auditors' understanding of financial reporting process and relevant controls in place. Making auditing exception-based and pressing time-lines to submit plethora of audit reports and certificates with a lack of visible audit-trails make auditing complex and challenging. Above all, sometimes, intentional manipulative practices add to these auditing complexities.

Auditors are required to report to Reserve Bank of India anything susceptible to fraud, fraudulent activity, any act of excess power or any foul play in any transaction. According to Paragraph 8 of Standards on Auditing SA 240 (Revised) *Auditor's Responsibilities Relating to Fraud In an Audit of Financial Statements* of ICAI, *"When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures*

that are effective for detecting error may not be effective in detecting fraud…" Today, regulations force auditors to apply heightened professional skepticism, considering the potential for management override of controls. Following is a discussion on some of such potential areas exposing the risk of or causing material misstatements, which would help the bank-branch auditors in strengthening their audit plans:

1. Business Figures

Pressures–to-perform and related incentives many a time conduce the organisational management to incur accounting manipulations and window dressing of business figures, which not only misstates the financial data, but causes some loss to the concerned banks too, e.g. increased SLR (statutory liquidity ratio) and CRR (cash reserve ratio) costs on inflated business figures. Generally, window dressing entries are made at year- or quarter-end to achieve performance and regulatory targets and are not supported with any business transactions. Some of the common ways of incurring widow dressing in industry include:

- Transfer entries, not supported with cheque/debit authority from customers, from unutilised credit limits to deposit accounts before near year-/quarter-end and reversing immediate after year-/quarter-end. And, also allowing loans against such term deposits
- Transfer of funds from unutilised credit limits to other bank accounts of borrowers and getting reversed immediate after year-/quarter-end
- Scheme manipulations, such as classifying non-priority sector advances into priority sector advances

Following first-hand procedures, applied at planning stage itself and revealing sudden spurt/down fall, would help indicating such window dressing:

- Comparing quarter-end figures of advances and deposits with that of immediate previous Friday and of immediate next Friday
- Comparing last fortnight volume of advances with that of immediate previous fortnights of the year
- Comparing monthly average rates of interest on advances with that of average rate of interest on year-/quarter-end

If abnormal variances remain unexplained or are not explained satisfactorily, auditors should investigate towards the reasons thereof.

2. Rushed Sanctions and Deposits

To achieve budget and regulatory/government targets, practice of, sometimes, rushed sanctions at banks near year-/quarter-end, tend to result not only in procedural lapses and deviations of laid down controls relating to appraisal, sanction, disbursement and documentation, e.g. not obtaining complete application forms, non-execution/non-registration of charge and other non-compliances, but in business also beyond delegated powers at times. For example, allowing excess/ad hoc amount in a newly sanctioned account without first getting confirmed the branch action from higher authorities, as per bank's guidelines.

Comparing volume of advances for last fortnight of the year with that of previous fortnights would help indicating such rushed sanctions for evaluation of compliance of laid down controls.

Also, to meet the year-/quarter-end deposit targets, particularly of low-cost CASA (current account savings account), accounts of bodies/organisations are opened as SB accounts, which are prohibited to be opened as SB accounts in terms of paragraph 9.1.3 of Manual of Instructions (June 1998) of the RBI Department of Banking Operations and Development. List of such certain prohibited bodies/organisations can be referred to in the said manual or at the IBA (Indian Banks' Association) website.

Collecting the scheme-wise list of SB accounts, particularly of government offices, would indicate such accounts and would help identifying instances of violations of the RBI directives, causing huge interest loss to the bank and misstating the financial statements.

3. Transactions in Excess of Powers

Pressures also sometimes lead management acting in excess of powers, and lack of default checks in the computer systems, not restricting unauthorised acts, could be one of the facilitating factors for such acts. Identifying such instances becomes difficult when such acts are omitted from record, e.g. allowing

Review of system-generated exceptions, e.g. override default check, particularly at the year-quarter-end, would also help evaluating such transactions. Auditors should consider examining the ad hoc allowances during the period, irrespective of the year/quarter- end adjustments for compliance of laid-down guidelines. Auditors, while relying upon the legitimate sounding judicious business decisions, should examine into such transactions in excess of powers, drilling down on the facts to see whether more such transactions have taken place.

Generally in CBS (core banking solutions) environment, balancing of subsidiary ledgers is taken assumed and the entries in impersonal accounts, e.g. suspense, sundry credits, special debits, intermediaries, proxy, clearing adjustment, sundry creditors, etc., are pruned and zeroed at balance sheet dates, skipping the audit scrutiny for errors and irregularities. Layering of entries/inappropriate grouping of impersonal account heads into GL (general ledger) heads at the year-/quarter-end in impersonal accounts, expose the risk of potential material misstatement.

a fresh ad hoc amount, without first adjusting the existing overdue ad hoc amount, for that no authority is authorised in the bank, and omitting to record in ad hoc register.

Auditors' reviews should consider including the accounts regularised at near year-end, and showing financial pressures, e.g. ad hoc not regularised timely, frequent request for excess/ad hoc, and frequent cheques returned. Periodic monitoring information on large accounts submitted to the controllers can give first-hand idea of adverse features in such large accounts. Review of system-generated exceptions, e.g. override default check, particularly at the year-/quarter-end, would also help evaluating such transactions. Auditors should consider examining the ad hoc allowances during the period, irrespective of the year-/quarter-end adjustments for compliance of laid-down guidelines. Auditors, while relying upon the legitimate sounding judicious business decisions, should examine into such transactions in excess of powers, drilling down on the facts to see whether more such transactions have taken place.

4. Non-Performing Assets (NPA)

System classified NPA slippages and provisioning burden, sometimes, tempt management to resort unfair practices at branches. Such practices make branch auditing complex and auditors struggle to find the best way to audit NPAs. In view of this, auditors should consider following while planning the audit of NPAs:

- Restructuring of loan accounts having no financial viability/reasonable certainty of repayment, or taking into account the cash-flows based on unrealistic assumptions
- Repeated rescheduling of highly overdue accounts, such as in housing and educational loan schemes
- Irregular bulk reviews of credit limits at the near year-/quarter-end, not supported with current financial information and pending for other compliances
- Regularising accounts at the near year-/quarter-end by transfer entries not supported with business transactions, from group borrowal accounts or by extending unauthorised credit facilities too
- Valuing securities in sub-standard and doubtful assets, not supported with current independent valuation and inspection reports.
- Converting the credit facilities, in which securities are lost/depleted, into clean facilities

Review of system-generated log of changes in asset classification would help evaluating whether all manual changes made in asset classification are in order. Going through the periodic statements submitted to controllers on potential NPAs, and on accounts overdue for review/renewal, particularly at the quarter-end immediate before the year-end, would also help indicating such features.

5. Incomes and Expenses

Inappropriate recognition including non-recognition, advance recognition or delayed recognition, or inappropriate measurement of incomes/expenses, can misstate the financial statements materially. Following are some of the suggested audit procedures which auditors should consider while auditing incomes and expenses:

- Reviewing reconciliation of INC (interest not collected) and URIPY (unrealised interest of previous year) with NPA accounts would help locating omissions to derecognise INC and URIPY in NPAs.
- Review of system-generated manual interest report would help identifying instances of manual entries made and reversed, if any, immediately after the year-/quarter-end, e.g. incomes recognised erroneously in the current period and reversed subsequently after the year-end.
- Comparison of non-interest incomes with that of previous corresponding year revealing wide variances, if any, would help indicating instances of inappropriate recognition of incomes, e.g. recognising NPA cash recoveries in sundry incomes.

Provisions and contingent liabilities in terms of Accounting Standard-29 *"Provisions, Contingent Liabilities and Contingent Assets"* of ICAI is one of such areas of management's judgments/assumptions, exposing the risk of potential subjectivity and over/understatement of expenses, e.g. penalty notice

received for non-registration of lease deed, suit filed by the landlord for payment of enhanced rent and unsettled customer complaints, etc. Auditors should inquire into all such events and should evaluate the appropriateness of management's judgments and underlying assumptions for recognition and measurement of expenses/disclosure of provisions.

6. Impersonal (Sensitive) Accounts

Generally in CBS (core banking solutions) environment, balancing of subsidiary ledgers is taken assumed and the entries in impersonal accounts, e.g. suspense, sundry credits, special debits, intermediaries, proxy, clearing adjustment, sundry creditors, etc., are pruned off and zeroed at balance sheet dates, skipping the audit scrutiny for errors and irregularities. Layering of entries/inappropriate grouping of impersonal account heads into GL (general ledger) heads at the year-/quarter-end in impersonal accounts, expose the risk of potential material misstatement.

Auditors, having determined the reconciliation of subsidiary ledgers, should consider scrutinising the full ledger, particularly of zeroed impersonal accounts, to check and determine whether all significant entries pruned off, are supported with substance/business transactions.

7. Monitoring of Large Borrowal Accounts

Besides the potential management override of controls, unscrupulous borrowers sometimes also expose risk of/cause material misstatements. Following are activities of borrowers tantamount to frauds, in terms of the paragraph 3.2 of the RBI Circular No. DBS.FrMC. BC.No. 1/23.04.001/2011-12 dated 1st July, 2011, auditors should consider in their audit plans:

- *Diversion of funds outside the borrowing units*: Laxity in effective supervision over operations in borrowal accounts or lack of effective monitoring of the end-use of funds can lead to diversion of funds outside the borrowing units. Especially, credit facilities disbursed in cash, instead of directly to suppliers; and also the borrowers having group accounts showing financial pressures, should be considered as more exposed to the risk of potential diversion of funds. To this, auditors should consider having a cursory look on, particularly, at the near year-/quarter-end transfer entries in few of such large borrowal accounts. This simple exercise would throw significant light on substance of transaction/end-use of funds and would help identifying indications of potential diversion of funds in personal SB accounts of promoters/loan accounts of group concerns.
- *Fraudulent removal of pledged stocks/disposing of hypothecated stocks/inflating the value of stocks in stock statements and drawing excess bank finance:* Experience lessons that accounts with multiple banking arrangements and showing financial pressures/indiscipline features should be considered as one of such areas exposing the risk of such fraudulent activities. At first, auditors are suggested to collect the information on large multiple banking borrowers at planning stage, and to check whether multiple banking information has been shared among the banks in accordance with the RBI guidelines, meticulously. To evaluate compliance of the RBI Circular No. DBOD No. BP.BC.46/08.12.001/2008-09 dated 19th September, 2008, auditors should collect information on large multiple banking borrowers availing sanction limits ₹5 crore and above, and should check and determine whether
    - information has been exchanged among the banks, at least, at quarterly intervals,
    - regular professional certification for compliance of various statutory prescriptions have been obtained, and
    - CIBIL reports have been used.

Lack of transparency in stock statements, e.g. not furnishing information on quantities, method and basis of valuation, aging of debtors and creditors, are also few of the first-hand warning indicators, auditors should consider while examining appropriateness of valuation of stocks.

Heightened Professional Scepticism: Pressing Need with Multiple Benefits

A careful consideration of the above-said potential areas may help in strengthening the audit plan. However, traditionally, management override has not been a focus of statutory bank branch audit plan. With the growing financial statement frauds and forcing regulatory mandates, it has become a pressing need to consider such potential situations while planning a bank branch audit.

Although statutory bank branch auditing can neither be relied for detecting all frauds nor be aimed to discover the planned fraud-schemes, it does play a key deterrent role in prevention of financial-statement frauds. Performing audits with heightened professional skepticism demands vehement cooperation from management. On enabling side, auditing with heightened professional scepticism, detecting the material misstatements and playing a proactive role in fraud prevention would improve governance besides supporting the management's efforts of managing the fraud-risk. ■