

Overview of Bank Branch Audit



The banking Industry in India works in highly regulated environment and uses a high end technology. This has insulated the Industry from external recessionary trends. However, the banks are facing competitive and stringent financial controls environment. Challenge to keep the costs of operation low on one side and keep the NPA in limit on the other side are major concerns. The role of auditor of the bank branches is important as a part of internal control mechanism. The audit staff needs appropriate training, experience and guidance to perform the assigned duty diligently. The auditor should understand the importance of such assignments, prepare himself with suitable planning, keep the documentation of work done, and have the knowledge of computerised environment and the reports and certificates to be issued. He should also study the RBI Guidelines and comprehend the guidance given by ICAI in the matter.



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Introduction

The banking industry in India is highly regulated by RBI. Continued globalisation and liberalisation has increased the need for banks to keep pace with development through high technological base. The banks currently face International Competition and stringent capital adequacy norms in terms of Basel III. Cost reduction on one side and meeting high customer expectation on the other side are the challenges currently faced by the bank. Increasing the customer and depositor base, retaining them with consistent, relevant and high quality services is the order of the day. The banks are also facing the challenge to increase CASA to keep the cost of money low. RBI's tightening provisioning norms from time to time has resulted in substantial provisioning requirement, leading to reduction in profits in the short run.

The recessionary trend has resulted in companies failing to meet their financial obligations to the banks. This has resulted in the increase of bad loans to the extent of 100% or more for several banks over the previous year. This phenomenon has forced the bank to submit number of corporate debt restructuring cases involving debt of several thousand crores. The need for strengthening due diligence, credit appraisal and post sanction loan monitoring system, are the measures required to be taken to minimise the ever growing NPAs in the Banking Sector. Banks would also face national and international competition after the approval of banking laws amendment bill, which allows more corporate houses to run banks and also pave way for more foreign investments in India.

Importance of Bank Audit Assignment

The Reserve Bank of India expects the Chartered Accountants to perform the task of Bank Audit with extreme caution and diligence. This requires high level knowledge and understanding of the working of Banks by the auditor. The success of the assignment of Bank Audit depends upon extensive planning and immaculate and timely execution thereof by the auditor. This needs long experience and expertise on the part of the audit team regarding technology, risk management system and new practices of supervision and control employed by the banks.

Preparations Prior to Starting the Audit

Extensive preparations are required by the audit team before the actual start of the bank audit. Understanding the terms of appointment, communication with previous auditor, peculiarities in the operations of the specialised branches allotted, changes in the level of NPA, type of business handled, the business mix in terms of large borrowers Vs. SSI Units, funded Vs. non-funded advances, commissions earned through related activities are some of the things the auditor should understand about the branch even before starting the audit. If the branch is deposit-oriented and then planning for checking of compliance with KYC Norms, chances of fraudulent withdrawals need to be properly evaluated. Branches handling foreign exchange transactions need appropriately experienced staff to handle the work efficiently. Reading of current RBI Circulars and Guidance Note on Audit of Bank issued by ICAI are essential, to keep oneself updated in carrying out effective audit.

No audit planning is possible until the audit team knows more about the branch. This can be done by analysing comments made by other auditors in their

reports such as - Internal audit, Concurrent Audit, RBI Inspection, System Audit, Revenue Audit, Stock Audit, etc. This reading will help auditors in selecting specific accounts for verification and also percentage of verification of various categories of Income & Expenses. The allocation of staff having appropriate level of knowledge and competence can also be decided, based on such reading. Special Questionnaires can be designed for checking the major percentage of advances of the branch such as – Retail loans, SSI, Agriculture, large Corporate Borrowers, etc. to help the audit staff in assimilation of data in an orderly manner. Substantial increase in ‘out of order advances’ would require more extensive scrutiny to identify new NPAs. Reported frauds during the year would increase the responsibility of the audit team manifold, to unearth unreported losses in the previous investigations by looking into violations of internal controls and supervision. Reading of internal circulars including closing circulars would enable the audit team to understand the changes in accounting policies, detailing of closing entries, and identifying the linkages which need to be established in various accounts maintain by the bank.

Document Verification

Several important documents as maintained by the bank are to be examined by the auditor. For checking of advances, which is one of the most important parts of the assignment, the auditor will have to verify documents submitted by the borrower such as project report, financial statements, business proofs, etc., documents obtained by the bank, such as – valuation reports, search reports, invoices, receipts, etc., documents prepared by the bank, such as – appraisal forms, sanction letter, mortgage deed, etc. and documents collected by the bank from third parties, such as – confidential report, Insurance, direct confirmations, etc. This verification is important for identifying defects in documentation which can jeopardise the interest of the bank if recovery of advance becomes difficult.

Security obtained by the bank, whether direct or collateral, needs to be properly examined for its legal enforceability and effective control and possession by the bank. The reports on valuation and physical inspection are extremely important to confirm the recoverability of the security.

Observations on Advance Portfolio

Advance portfolio is the major asset in the bank balance sheet which earns substantial revenue, other than that for services given by the bank for which separate

charges are recovered. The observations on advances would include documentation defects as stated above, non-submission of stock statements, inadequacy of insurance, inadequacy of drawing power, diversion of funds, over trading, high leverage, defective lien, weak post disbursement follow-up, inadequate supervision and inspection, improper monitoring of account, insufficient and delayed response to the problems of the borrower. The observations can also result into recommendations for monitoring of advance including for lodging of claims and initiation of legal action. Early warning on possible defaults can be the outcome of appropriate checking of documentation and operations in account. In short, the comments on the advance portfolio should be to take appropriate view of safety of the bank. Reserve Bank of India has issued specific circulars on deficiencies found by their inspecting teams in sanctioning of loans and monitoring of advances by the commercial banks. Reading of such circulars would help the audit team in conducting the audit of advances more effectively.

Computerised Environment

All banks are currently working in highly advanced computerised environment which requires understanding of the software and the internal control systems through hardware and software. Knowledge of effective use of the software for carrying out audit is necessary to complete the work in time and with quality. Exception reports generated by the system are of immense use for the purposes of audit. The auditor needs to be cautious about the data entry relating to new accounts opened either for deposits or advances, as incorrect entries would result into wrong output for classification of accounts which are finally to be certified by him. Any authority with the bank to operate the changes in matter relating to preferential treatment for a) charging of interest on advances or b) charging of any income by way of commission or c) in payment of interest, that need to be verified for exercise of such authority at appropriate level by generating concerned report.

Reports to be Given

Several reports are required to be signed by the auditor. They include Statutory Audit Report, Long Form Audit Report and Tax Audit Report. Writing replies in the Long Form Audit Report gives the real test of the quality of the work done. While planning the audit and allocation of work, auditor has to list out the areas under report. This will avoid inadequate

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documentation required to answer the key questions. Auditor checking the financials of specialised branches for the first time, would require extra time for understanding the transactions and documenting all the information required to prepare his report. This time needs to be estimated and budgeted. The comments in various reports would also need to be in tandem with each other in order to avoid the confusion of the reader. Ideally, all reports need to be reviewed by the same person, along with overall review of financial statements so as to obviate such errors.

The auditor should also know in advance as to the authority to which he should report and the number of copies required to be issued. E.g. the reports on fraud found above ₹ 1 crore will have to be directly sent to the Reserve Bank of India. Inadequacy of information should be clearly stated and auditor should give a disclaimer statement by refusing to give his opinion on such matters. Generally, reporting by Statutory Auditor is expected to be only factual and the auditor is neither expected to give solutions nor required to give any follow-up reports on his observations.

Certificates to be Issued

Bank depends heavily on auditors for certification of key areas of bank's finances. The certificates to be issued include – Statements on Capital Adequacy, Non Performing Assets, Ghosh-Jilani Reports, Statement of Liquidity on selected days, classification of Advances, etc. The list of certificates to be issued is generally long, with several copies required to be taken. Auditor is expected to assign the work of checking such certificates well in advance to the staff members, so as to avoid rushing of validation of data at the last minute. The audit team should obtain the requisite expertise to check the data in such certificates, by analysing the RBI circulars on risk, KYC, NPA, Basel, Fraud, etc. Keen observations and detailed understanding of the questions as well as the documents available would make the task of issuing certificates easy for the auditor.

Non-Performing Assets

Non-performing assets refer to the advances where interest and other charges recoverable are not being actually realised. Such income is accounted only when received. This is a deviation from accrual accounting system followed by the bank. The Reserve Bank of India's Guidelines relating to NPA, as well as those issued by the concerned bank, needs to be properly understood by the audit staff. Any error in understanding the guidelines on income recognition and provisioning would result in unnecessary arguments between the bank officials and the auditors. On the other hand, appropriate views taken by the Audit team on scrutiny of Advances can result in identification of Non Performing Assets which are not reported by the bank. Such identification would result in additional provisioning and reversal of interest and other income accounted by the bank.

Other Areas

Trends in interest recovery in relation to movement of advances and trends in interest payment in relation to movement of deposits would give the auditor an indication about overall correctness of accounts of the branch. Any diversion trends would require further checking and increased transaction checking.

The auditor has to see that various "Parking" accounts, which are in the nature of suspense accounts, adjusted or explained before finalisation. If such accounts show balance, depending on the materiality, the auditor needs to qualify the accounts or suggest appropriate provisions.

The auditor needs to be vigilant about window dressing of accounts, i.e. increasing loans and deposits by entering into contra transactions in connivance with borrowers. This inflates the respective portfolios and is done to meet the target given to the branch. The auditor needs to be aware of the methods by which such window dressing is done.

There can be many other areas of checking such as – House Keeping, Clearance of Advances given to employees and outsiders on capital and revenue accounts, calculation of depreciation, checking of internal control of cash and information technology environment, etc.

Conclusion

From the above overview, it will be clear that carrying out the bank branch audit is not an easy task. Enormous preparation and training is required on the part of auditor, to face the challenge of auditing a specialised industry working in fully computerised environment and dealing with huge amount of cash and public money. Such training is available to the professionals through various seminars, conferences and certification courses arranged by ICAI on the subjects of Statutory Audit, Internal Audit and Concurrent Audit of Banks. Further information can be obtained about the method of audit from the publications of ICAI including Guidance Notes on Audit of Banks. However, as a caution, I wish to state that the professionals, by accepting the bank audit, are entering into a high risk area of work. Therefore, unless appropriate expertise is available with the firm, no such assignment should be accepted. ■