

New Age Banking and Auditing – It's different

The transformation in the banking sector coupled with the high level of computerisation has brought to the fore the need to reinvent the overall audit approach as the traditional approach has somewhat become outdated.

Banking Scenario:

In last one decade the Indian Banking sector has witnessed a very high level of conceptual revolution in terms of organisation structure, business model, accounting, operations, control environment, customer interface, customer service, regulatory compliance, information dissemination and a whole lot.

The banking sector has moved from:

- Traditional banking to high level financial advisory
- Traditional products of deposits and lending to boutique of financial services/para-banking activities
- Branches to Service outlets
- Customer of branches to customer of bank
- Multi-level organisation to centralised organisation
- Decentralised data processing to centralised-data processing
- Manual accounting to complex computerised-data processing and accounting

In today's time a bank is driven by IT, Processes and Products and it operates in fairly complex control, compliance and regulatory framework and environment. In terms of IT, the banking sector has rolled out highly sophisticated and complex IT systems. Majority of the banks today are functioning on Core Banking Solutions (CBS). CBS is an integrated software system that

facilitates integrated and real time processing of data.

Apart from this there are lots of changes and challenges emerging in the Indian Banking sector in terms of evolving Indian GAAP, adoption of Corporate Governance Code (Clause 49 of the listing agreement/SOX 404) and Translation of Accounts (US GAAP/IFRS). All the banks listed on Indian Stock Exchanges are required to comply with Corporate Governance Code (Clause 49 of the listing agreement) and those banks which are listed on New York Stock Exchange (NYSE) are required to comply with Sarbanes Oxley (SOX) Act 2002 and also prepare and present the financial statements as per US GAAP.

In terms of Indian GAAP, there are lots of revisions of the existing standards that have far reaching impact for example revised AS 15 (Revised) on Employee Benefits. Recently, Exposure Draft of AS 30 and 31 on Financial Instruments has also been issued by the ICAI. This accounting standard is likely to have wide impact of the financial statements of the banks.

The paradigm shift in the banking sector has resulted in reinvention of the audit approach. The traditional audit approach in such a highly complex and computerised environment has been rendered outdated and redundant. The audit fraternity is grappling with the fear of the unknown while dealing with bank audits. In case of new generation private sector banks and foreign banks the complexities are much larger than those in public sector banks.

Key Challenges:

Roles and Responsibilities:

In public sector banks the audit is generally conducted by multiple firms including central auditors and branch auditors. In case of private



– CA. Manoj Daga

*(The author is a Member of the Institute.
He can be reached at manoj.daga@
haribhaktigroup.com)*

sector banks and foreign banks, the audit is conducted by a single firm due to centralised data base. Consequently, the responsibilities of auditors in such banks are much wider.

Books of Accounts:

The main emphasis in the audit report is on “books of account”, however, in view of high level of computerisation, theoretically there is no such thing as “books of account”. The data recording, processing, interface, transmission and storage is built within the system and there are no physical books of account. At times the auditors don’t have access to the main GL and other sub-system, instead they are provided with dump/archive files for the purpose of audit. Now it is really strange that we have to report on books of account however, what is provided is dump files.

Though the banking and auditing has taken a 360-degree turn, the audit report still continues to be traditional.

Management Representations:

The oral and written representations provided by the management during the course of an audit help in forming an audit opinion, to a large extent. While the audit report fact does recognise the significance of management estimates, it does not specifically cover management representations. Though one may argue that it is indirectly covered in the words “information and explanations”, still it deserves specific reference in the report.

Unique Business Model:

In today’s time the business model is largely driven by products and each service is offered as a product to its customers. Each product has unique features and there is a separate team for handling each of the products. For example is case of advances the portfolio is broadly divided into wholesale and retail banking and further retail banking is divided into auto loans, mortgage loans, loan against shares, housing loans, personal loans, credit cards, etc.

High Level of Fragmentation:

In many banks the operational activities are highly fragmented in terms of the processes and there are different owners for each fragment. For example, the account opening forms or credit application forms are collected at branches/service outlets, the processing of forms/applications is done at central processing centres, customer data is maintained in transactions processing systems at some other location, customer servicing is done from some other location, documents are maintained at some other locations and so on. Even at each of the locations different activities are handled by different units/owners. Consequently for end to end mapping of activities/processes, one has to approach multiple units/owners and there is no way one can have entire view of any activity at one place.

Complex IT Structure and Environment:

In today’s time the banks operate in a highly-complex IT structure and environment. In many banks there are multiple transaction processing system whereas in some banks there is integrated Core Banking System. The data recording, processing, interface, transmission and storage is handled through high level of computerisation.

Audit Approach:

The transformation in the banking sector coupled with the high level of computerisation has brought to the fore the need to reinvent the overall audit approach as the traditional approach has somewhat become outdated. In today’s time the focus of audit is more on processes, products and controls and less on financial numbers. It would not be incorrect to state that 80% of the time is devoted towards mapping of business processes, understanding of industry developments, review of internal controls, capturing and review of IT environment, etc. and only 20% of the time is spent on verification of financial numbers.

The following paragraphs deal with some of the important audit procedures that are recommendatory while conducting the audit of a large-sized computerised bank.

Processes and Products:

In today's time the banking operations are largely driven by products and processes. The banks generally have robust systems in place for defining the products and processes and these are well documented in the form of operating instruction, guidelines and circulars.

While launching any new product, the banks generally carry out a detailed study from the point of compliance, controls and accounting implications. The process flow of each and every activity related to those products is approved and documented.

As an auditor it is important to review/assess/document:

- Process documents/manuals in respect of all the key/critical processes
- Internal guidelines, instructions and circulars in respect of key products
- Internal accounting manuals, policy documents, operating instructions, etc.

Internal Control Environment:

The banks generally have well defined and documented internal control system and procedures. Moreover, in terms of RBI guidelines, the banks have either extended the scope of concurrent audit or have put in place a complete system for Risk Based Internal Audit. The internal audit function in bank is totally in-house, partially in-house and partially outsourced or totally outsourced.

It is interesting to note that in case of companies that are listed on NYSE, the Sarbanes Oxley (SOX) Act 2002 encompasses extensive testing, implementation and documentation of internal controls. While conducting the audit of banks in India that are listed on NYSE, the documentation for SOX testing and implementation comes as a handy material for overall assessment of internal controls. In the

future, in view of the evolution of Corporate Governance Code in India, similar importance will be attached to effectiveness of controls in future.

As an auditor it is important to assess/review/document:

- Overall internal audit approach (in-house or outsourced)
- Scope and coverage of internal audit, audit plans for the year and reporting format.
- Risk Matrix/Profiling for Risk Based Internal Audit
- Internal audit reports and system of follow up/final action/closure thereof
- System of reporting of significant audit issues to the Audit Committee.
- Effectiveness of the critical controls by performing walk-through/test of controls.
- SOX testing, implementation and documentation.

IT Environment:

The banks generally have well defined and documented IT structure and policy. Moreover in terms of RBI guidelines, the banks have put in place well defined system of IT Audit. In view of high level of computerisation, the traditional approach of transaction audit has lost its effectiveness and it has somewhat become difficult. More emphasis is, therefore, on assessing and documenting the effectiveness of IT controls. The basic approach should revolve around the universal concept of test of controls and substantive checking.

As an auditor it is important to assess/review/document:

- IT Structure and Policy
- IT environment (hardware and software including new system/version/upgrade)
- IT controls (access, physical and logical controls, back up system, disaster recovery and business continuity plans, etc.)
- IT Audit Reports and the follow-up thereof.

- Processing of data (online/batch) and interface of data (main and sub-system)
- Reconciliation of data (main GL and sub-systems)

Other Support Approaches:

Apart from emphasis on processes, internal controls and IT, the auditor has to give due importance to the following audit procedures:

- Review of critical manual applications and the controls thereon.
- Continuous interaction with various process owners/heads/department.
- Mapping of end-to-end processes and controls for closure of financial statement.
- Review of critical operations outsourced to external agency.
- Review of work performed by an expert.
- Review of Annual Financial Inspection

Report of RBI and the management replies thereon.

- Continuous review of latest master circulars displayed on RBI website.
- Review of minutes of the Board of Directors and various committees of the Board.
- Benchmarking of best practices within the banking industry.
- Comprehensive comparative analysis.

Takeaways:

To conclude there are three important takeaways for the members who are involved in the statutory audit of banks:

- I: Standardise the audit approach and procedures.
 - II: Reinvent the audit approach and focus more on processes and controls.
 - III: Build strong documentation process.
-