

Bank Auditor's Role in the Emerging Supervision Regime

March, 2007

Hyderabad

A Presentation

By

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The old order changeth: yielding place to New and
God fulfils himself in many ways

Alfred Lord Tennyson in
The Death of King Arthur

What is Different About Banks*

- | | | |
|--|---|---|
| <p>1. The high need for physical security of cash and negotiable instruments</p> <p>2. Multiple jurisdictions</p> <p>3. Very high leverage</p> <p>4. Rapidly changing values which are difficult to determine</p> <p>5. Liquidity risk</p> | <p>6. Trusteeship</p> <p>7. Multiple products putting pressure on internal controls</p> <p>8. Geographically dispersed branches</p> <p>9. Complete access to payment systems</p> <p>10. Regulatory requirements influencing Accounting Principles</p> | <p>11. Customer relationships are vital</p> <p>12. Payment and settlement systems pose a systemic risk</p> <p>13. Complex financial instruments</p> |
|--|---|---|
- Source
• A Basel II document

A view on Leverage

(Rs. In crores)

Particulars	State Bank of India	Satyam	Infosys	Reliance
Debt	3,80,046	13	0	21,866
Net worth	27,644	4,335	6,897	49,804
Debt / Equity Ratio	13.74	0	0	0.43

Bank Audit – The Players

- The Board- and the Audit Committee
- The Internal Audit and Inspection Department
- The Supervisor (RBI) and of course,
- The External Auditor



The Shift in Supervisor Focus



- RBI was earlier concentrating on the accuracy of data, adequacy of provisions and compliance of regulations
- Basel I and Basel II have changed the supervisor focus



Basel I

- **Essentially recognised Capital adequacy as the first “Defence” in Risk evaluation**
- **Developed Criteria and Connections between asset classes and impact on Risk and Capital adequacy**
- **“Trained” the International Banking community to the Risk orientation of Banking Business**

Basel II

- **Expands the Supervisory concerns**
- **Recognises that capital adequacy is only a first Defence**
- **There are other measures bank must take to improve its Risk Management**

Basel II

- **Other Measures**
 - **Internal Limits on Exposures**
 - **Tightened Internal Controls on Operations**
 - **Strengthening Levels of Provisions and Reserves**

Exclusive Area of Supervisors

- **Licensing**
- **Ownership**
- **Transfers of Ownership**
- **Major Acquisitions**
- **Country Risks**
- **Reputation Risks**
 - **Money Laundering**

The Supervisor Expectations

- **Stability and Confidence in the Financial System**
- **The Management of the Bank rests with people of high integrity and standing *and* who are qualified to do the job.**
- **The bank has internal controls and risk management mechanism *consistent* with its strategies**
- **The bank is *adequately* capitalised**
- **There is close monitoring of liquidity risks: Banks are very delicate confidence holding institutions**

And How?

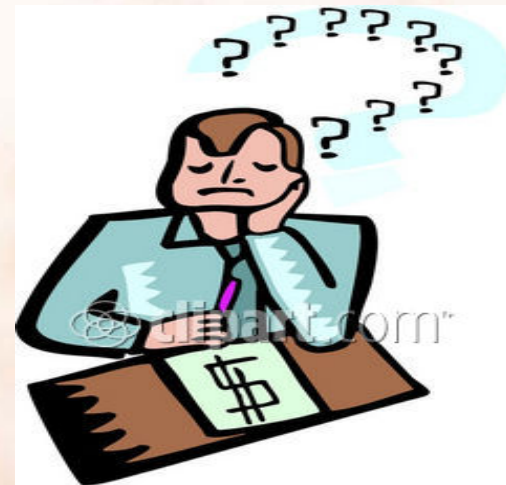
- **On Site Supervisions: Annual Inspections of aspects of Bank and**
- **Off Site Supervision: Collecting data and information on a variety of activities of the bank through Statistical returns**



Compliance - Why Now?

Rising demand due to borderless transactions

- Money Laundering**
- Terrorist Activities**
- Misuse of Tax havens**
- Reputation or Brand image attacks**



The Changing Bank Auditor

- The Past

- **Truth and Fairness**
- **Asset Side Audit (Balance Sheet)**
 - **Loans Audit**
- **Conservatism- the Overriding Principle**
- **Distributed Opinion**
- **Valuation of Investments not Benchmarked to the Market**
- **Liability Side-Ignored**
- **Risk & Internal Control evaluation given a go by**

The Changing Bank Auditor

- The Present

- **Truth and Fairness**
- **Standardisation**
 - **Accounting standards**
 - **Reporting**
 - **Long form audit reports**
 - **Multiple user reporting**
- **The slow impact of technology**
- **Supervisor review as a part of the audit process commences**

The Changing Bank Auditor - The Future

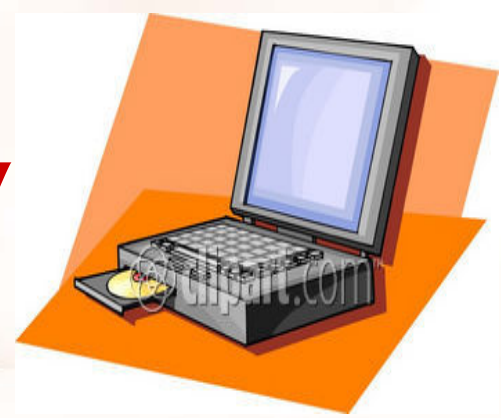
- **Truth and Fairness**
- **The impact of Technology**
- **Recentralisation- Core Banking Solution**
- **High Supervisory Demands**
- **Shortening of Audit Periods**
- **Risk and Capital Adequacy : need understanding by the Auditor**
- **Asset and Liabilities are constantly revalued based on market realities**
- **Impact of Globalisation on Standardisation**
 - **Accounting standards need to be understood by**
 - **Auditors**
 - **Bank Officials**
 - **Supervisors**

External auditor & Audit Committee

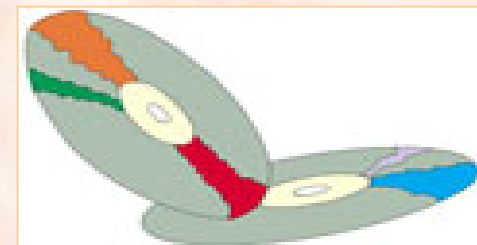


- **External Auditor has to work very closely with the Audit Committee.**
- **Independence, Integrity and Professionalism**
- **The Audit Committee has to work throughout the year with the External auditor**

The Impact of Technology



- **Core Banking Solutions centralise Data**
- **Audit need not be distributed at diverse locations**
- **Access to records, now easier than ever before**
- **Need to evaluate Control environment on a continuous basis**
- **High Operational Risks needing changing focus of auditor to the IT environment.**
- **Products - not locations need to be audited**
- **High level of Fragmentation**



The Core of the Work of the External Auditor

- **Assess Internal Audit**
- **Review Internal Controls**
- **Profile the Risk Base**
- **Review the System of reporting to Audit Committee**
- **Document significant risks and weaknesses**
- **Integrate audit of the IT environment in the opinion forming process**

External Auditor- Skill Sets

- **Expert in Bank Audits**
- **Ability to work closely with Audit Committees**
- **Networking with Branch Auditors to conduct audit as per his plan**
- **Benchmarking with Best Practices in the Industry**
- **Hands on approach on the Policies and Guidelines of the Bank on a Real Time Basis**

External Auditor- Skill Sets

- **Thorough understanding of the IT architecture**
- **Expert view on Risk**
- **Deep knowledge of management structures in Decision Making**
- **Familiarity to document credit and operational risks and evaluate weaknesses**
- **Expert knowledge of Accounting Standards**
- **Ability to work with Large Teams**

Branch Audits

- Appointed by RBI through a fair system of allocation and dialogue with ICAI
- Some questions
 - Is the customer happy?
 - Can he do without it?
 - Is he getting a consistent opinion?
 - Is it necessary?



Costs of Audit

- **Cost of Statutory Audits**
 - **Expensive: Value for Money?**
- **Competition will force banks to look at audit costs**
- **External audits will increasingly use banks own systems of inspection and internal audits to complete their work**
 - **Cost effective**
 - **Greater understanding of business**
 - **Better direction**



A comparison of audit cost

(Rs. In crores)

	SBI	Andhra Bank	Federal Bank	HDFC	IDBI
Audit Fees	100	8	3	0.6	1
Net Profit	5661	485	225	871	1099
Exp	27302	1142	592	2799	561
Audit fees as % of NP	1.76%	1.64%	1.27%	0.68%	0.17%
Audit fees as % of exp	0.37%	0.70%	0.48%	0.02%	0.09%

What do we like to see?

- A complete audit of the IT architecture
- Complete evaluation of Internal controls on a war footing and implementing solutions to cover areas of weaknesses.
- A regular audit of the manner of making provisions
- A tight system of valuing underlying assets of NPAs
- A reasonable understanding of incidents of Fraud and management responses to the incidents
- Regular interaction with the Audit Committee and the Internal audit department (at least 8 times a year) on audit plans of the external audit and the Inspection department
- Ensure that people in charge of the conduct of the audit of the banks are technically qualified and aware of the audit concerns of auditors and supervisors
- Ensure that a proper system of communication exists between the top management and lower down on audit issues.

Supervisor and External Auditor they are different

- Supervisor is concerned with the maintenance of a sound system of Internal control
- Supervisor is concerned with the accuracy and integrity of the financial records and management concerns regarding the financial position
- Financial statements are NOT prepared for supervisory needs
- The Auditor is concerned with the evaluation of the system of internal control to enable him to form an opinion. His evaluation may give different results from the supervisor's evaluation as the objectives are different
- The Auditor's examination of financial records is to ensure that there are no material misstatements which will affect his expression of opinion

Where can the supervisor and the external auditor work together?

- The Annual Financial Inspection of the RBI
- Auditor's concerns communicated to the management could form the basis of some of the supervisory reviews
- High Risk reviews and Failure need close monitoring from both Auditor and Supervisor
- Information consistency of data provided to the Supervisor can be checked by the Auditor
- The evolution of Accounting Policies in the banking sector –especially norms for evaluating NPAs should be worked together.



Some Common Concerns of External Auditors and Supervisors

- **Problem Assets, Loans & Provisions**
- **Large Exposure Limits**
- **Risk Management Structures**
 - **Credit Risks**
 - **Market Risks**
 - **Liquidity Risks**
 - **Operations Risk**
- **Internal Control and Audit**

Likely Trends

- **Branch Audits will diminish**
- **Special & Focused audits will increase. A new opportunity for the Auditors**
- **Boards will have a greater say in Appointment of Auditors**
- **Centralised audits will mean larger teams at lesser number of locations with expertise**
- **Throughout the year audit**
- **Closer working with RBI**

External Audit – The shape of things to come

- **Doing More with Less**
- **Effective Usage of Both Internal and External Resources**
- **Creating the Integrated Auditor**
- **Adapting to New Products**
- **"Tuning In" on an Organization's Strategic Relationships**
- **Auditing in a Highly Automated Environment**
Addressing Management Concern with the Cost and Other Effects of Fraud

Some Issues on Supervisor/External Auditor



1. Should the Supervisor appoint the Bank Auditor or should it be the Shareholders of the Bank?

Issues of Independence

Competence

Institutional memory

2. Should the supervisor have unlimited access to the Bank's records.. Real time?

3. Should the External Auditor have real time access to the Bank's records?

Some Issues on Supervisor/External Auditor

- 4. Should the External Auditor have access to the supervisor concerns?**
- 5. Is there a conflict of interest on supervisory concerns and external audit functions?**
- 6. Risk and opinion on financial Statements .. Are they unrelated in scope?**

THANK YOU

