

Risk Management in Bank Branch Audit

Risk is present in any activity which is carried out and audit is no exception. Any activity that is conducted can go wrong anytime, sometime or at all times despite the controls that have been designed and implemented to specifically address and mitigate the risks inherent therein. Risk is that residual threat, gap or vulnerability that one is finally exposed to. Read on...

The key to risk management is to anticipate, in a formal, structured manner what can go wrong, how and why it can go wrong and what could be done to ensure that we zeroise, minimize the possibilities of things going wrong. The gross or the inherent risk has to be within the risk appetite and the residual risk within the risk tolerance. Risk is a function of probability or likelihood of the adverse event happening and the impact or the loss caused if the event was to actually happen.



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Risk needs to be managed effectively by identifying, analysing, evaluating, measuring, monitoring, treating and communicating risk on an ongoing manner

Risk cannot operate in a silo and would always be mapped by a control. The controls have to be pro-active, automated, corrective and collaborative. Controls ensure that the risk finally gets treated to an acceptably low level.

Banks are trustees of public money and regulated by the RBI. They receive funds from public in the form of deposits like fixed deposits, savings / current

accounts and lend it onward for business purposes at a spread. Numerous transactions in cash, ATM, cheques, pay-orders, drafts, NEFT, RTGS take place daily in a bank branch. The sheer volume and the value of transactions necessitate that the banks have various checks and balances in place to ensure that the transactions are processed timely and correctly as per internally laid down policies.

Banks are exposed to various risks, namely - Operational, Credit, Regulatory, Legal, Technology, Reputational, Money Laundering, Security, Market, Liquidity, Interest rate, Competition, Liquidity, Concentration, Social media



risks and Fraud risks. Branches based on their business and customer mix will be exposed to some or all of these risks in varying degrees. Hence it is imperative that the risk profiling of the bank branch under audit be drawn up so that the auditor can focus on the key risks really impacting the branch.

Banks institute various controls namely maker checker, segregation of duties, job rotations, mandatory leaves, job descriptions, certifications, authorizations, ratifications, audits, verifications, confirmations, inspections, reconciliations, balancing, delegations etc. Any manual or detective control should be flagged of for upgradation to a preventive, system -based control.

The bank branches should have a formal mechanism of identifying risks at the gross level and mapping the controls to these risks to arrive at the residual risk. It is the foremost responsibility of the bank branch to have a robust risk management process in place. Absence of a formal risk identification process is in itself a major risk which has to be reported appropriately by the statutory bank branch auditor.

Bank branch audit process

In a bank branch audit, the auditors certify the branch financial statements as true and fair (free from material misstatements), issue mandatory certificates as required by the Bank and the

regulator besides issuing the LEAR. The bank financial statements comprise of Balance sheet, Profit and loss account, Cash flow statement, accounting policies and notes on accounts.

The risk is that auditor may certify the financial statements as correct but auditor could have missed out on something in the conduct of audit due to absence of following a structured audit methodology accentuated by time pressure to complete audit.

A thing well begun is said to be half done. The auditor should plan his audit considering well the limited time available at his disposal and the co-operation he will get duly factoring further ongoing contingencies, if any.

An audit is an independent and objective examination of financial statements with a view to express an opinion thereon. The audit opinion could be unmodified, qualified, adverse or a disclaimer. An audit has to be conducted in accordance with the Standards on Auditing (SAs). These standards require audit to be conducted as per prescribed methodologies and more importantly document the same. Various Standards on Auditing (SAs) have prescribed different requirements for auditors. Non- compliance of the same will tantamount to professional misconduct under the provisions of the Chartered Accountants Act, 1949.

The first & foremost in any audit & bank branch audit being no exception is to conduct the audit in

accordance with the Standards on Auditing & having adequate documentation in place to evidence the aforesaid compliance

While Chartered Accountants are extremely sound in the basics of accounting, taxation, law & audit, what they need to strengthen is the robustness of their documentation. SA 230, "Audit Documentation" specifically deals with the fundamentals of documentation while various other SAs have specific documentation requirements namely -

- SA 220 - Quality Control for an audit of financial statements.
- SA 240 – The Auditor's Responsibilities relating to fraud in an audit of financial statements.
- SA 250 - Consideration of Laws and Regulations in an audit of financial statements.
- SA 260(Revised) - Communication with those charged with Governance.



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- SA 300 - Planning an audit of financial statements.
- SA 315 - Identifying and assessing the risks of material misstatement through understanding the entity and its environment.
- SA 320 - Materiality in planning and performing an audit.
- SA 330 - The auditor's responses to assessed risks.
- SA 450 - Evaluation of misstatements identified during the audit.
- SA 530- Audit Sampling.
- SA 540- Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.
- SA 550- Related Parties.
- SA 580- Written Representations.
- SA 610(Revised) - Using the work of internal auditors.
- SA 701 - Communicating Key Audit Matters in the independent auditor's report.

- SA 720(Revised) - The auditor's responsibilities relating to other information.

It is imperative that auditor reads the Standards on Auditing afresh before commencing a bank branch audit and draws up a checklist on the areas and the depth of its coverage during the course of the audit. The documentation has to be completed daily, on an ongoing manner in the course of audit. The audit file should be updated and signed off first after review by the signing partner before he proceeds to sign off the accounts.

Each bank also issues accounts closing instructions along with the audit appointment letter. The auditor has to diligently examine that the branch has duly complied with these instructions especially in regard to those on accounting policies. Any non-adherences will have to be duly qualified in the auditor's report.

The auditor should obtain the organization chart as that will make him aware of the various branch functions, activities carried by each branch official and the functional inter linkages. This ensures that he does not miss out any activity especially the key performance indicators (KPI) or key risk areas (KRA). Checking this in sync with the Trial Balance will ensure that all activities finally having a financial impact completely come under audit radar.

Key changes in RBI circulars that impact the accounts

especially on NPA classification, provisioning and asset restructuring will need to be looked in depth. The auditor should verify whether the bank is tracking the 45 Early Warning Signals of Fraud as indicated in the RBI circular dated 7th May, 2015 on Framework for dealing with loan frauds. The ICAI publishes a Guidance Note on Audit of Banks every year. It is imperative that the auditor reads the Guidance Note to update his knowledge. The "Advisory for statutory bank branch auditors w.r.t. specific considerations while conducting Distance audit/ remote audit / online audit of bank branch under current Covid 19 situation" issued by the Auditing and Assurance Standards Board of ICAI in May 2020 should be looked into if the situation is also applicable that time.

Frauds (including cyber security frauds) is another area which the auditor should be sceptical about. While in the limited audit time it is not possible to do a detailed deep dive, any major control weaknesses noted or pending from issues brought out in earlier audits should be highlighted. The auditor should also comment on the adherence to the anti-fraud policy of the bank, process for identification of fraud scenarios, control mapping & training thereon.

The entire audit team has to be made aware and sensitized of the finer nuances of bank branch audit. Attending year end seminars on bank audits, reading the bank branch audit articles published in the ICAI



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Journal, refresher materials published by the Regional Councils of ICAI should definitely aid knowledge.

Revenue recognition is a key area and the process of updation, accurate application and modification of interest rates both on deposits and advances will have to be verified.

NPA identification is an area where the RBI inspection always finds divergences. The crux of all bank branch audits is to ensure that IRAC norms have been correctly complied with. NPAs have to be identified from the system without any manual intervention. Any issues in interpretation of IRAC norms could be sorted out in consultation with the Central Statutory Auditors (CSA). The correspondence should be in writing so that it can serve as an audit trail to justify the rationale for taking a particular stand.

Another area which the auditor should focus on is KYC-AML. The process of reporting in the CTR, identification of alerts and its subsequent reporting as suspicious in the STR should be verified. Even if the reporting process is centralized, the transaction diligence is done at the branch and the robustness of the diligence process should be verified. FATF recommendations and the red flag indicators pointed out by IBA should be borne in mind.

Other areas to be focussed upon are -

- 1) Adherence to key policies like Credit, KYC-AML

- 2) Risk classification of accounts as High, Medium and Low
- 3) Priority sector classification
- 4) Balance transfers to DEAF
- 5) Reversal of last year's MOC
- 6) Stock audit reports especially calculation of correct drawing power
- 7) MIS reports generated especially exception reports
- 8) Reconciliation of Inter Office accounts
- 9) Suspense account monitoring
- 10) Monitoring end use of funds and fund diversion
- 11) Classification of Guarantees as financial and performance
- 12) Pending issues from reports of various audits
- 13) Booking of fixed assets and providing depreciation thereon
- 14) Cash and ATM Operations
- 15) Remittances, SWIFT and Foreign Currency account operations wherever applicable

A key requirement in bank branch audit is the issuance of the LFAR which is a detailed questionnaire requiring the auditor to comment on the internal functioning of the branch for the entire year. The auditor is at the branch physically or virtually only for a few days at the year-end while his comments cover the entire



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year. The comments made in the LFAR are based on his observations of the processes / systems in operation at the time of his audit. The auditor relies on Management Representation Letters, Concurrent, stock, internal audit reports and previous years LFAR. The auditor should comment on the LFAR points only after conducting verification of these concerned processes. He should clearly state in his observations, the basis of arriving at a particular response to the question. This should state what he did (area covered), how he did (audit methodology) and to what extent he did (transactions sampled). The reliance on the Management representations, Concurrent audit reports wherever done should be explicitly stated. Discussions with concurrent auditors is a must.

Management Representations if not received should be explicitly stated and appropriate disclaimers should be made in the concerned LFAR question

The auditor should not use the LFAR to state issues which otherwise would have been a

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matter of qualification in the auditor's report. The LFAR can only add to the qualification in auditor's report but can never substitute it.

The auditor is also required to issue various certificates as part of the audit requirement. The certificates should be verified for data accuracy and compilation from the source records. In case, any calculations are manually done, then the process needs to be verified for robustness. Necessary professional scepticism has to be exercised and cross corroborative evidence to support the validation should be verified wherever available. The auditor can only give a reasonable or limited assurance in case of certificates which has to be strictly borne in mind. The certificates are to be issued in terms of the "Guidance Note on Reports or Certificates for Special Purposes (Revised 2016)" issued by the ICAI.

The certificates issued should state in detail the documents verified, the actual issues verified, methodology of



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verification and the extent of verification.

From the previous year, the branch auditors of public sector banks also have to issue report on Internal Financial Controls Over Financial Reporting as it was made mandatory by RBI for public sector banks. The auditor should specifically refer the "Technical Guide on Audit of Internal Financial Controls in Case of Public Sector Banks" issued by the Auditing and Assurance Standards Board of ICAI (especially Appendix V of the Technical Guide which gives illustrative risk control matrices in respect of various areas. The Appendix V covers 17 points on advances and 7 points on deposits)

The real challenge for the auditor is the time pressure, availability of data, obtaining timely, correct and complete responses to the issues raised. Auditor requires a skill of framing the right question and attentive listening to obtain the relevant information on time and in entirety. The branch management responses to the queries raised have to address the issue and should be duly incorporated in the auditor's report. Sign off from the branch head should be specifically obtained on the responses submitted. The auditor should also factually state the date of commencement of audit and the actual man-hours spent. The auditor should not bow down to the time pressure and sign off without complete verification. The auditor should at the audit commencement stage issue a complete list of details needed which should be updated daily taking stock of what details are received and



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what details are pending. The auditor should be in regular touch with the CSA and the Regional Bank Audit Department (RBAD) co-ordinating the audit communicating the status of audit and constraints faced especially delays hampering the smooth conduct of audit. If despite the fact, the auditor's report still has to be signed off on a particular date because of non-negotiable deadlines, the auditor could qualify or disclaim in the auditor's report as appropriate, keeping the concerned CSA & RBAD in loop.

Conclusion

The auditor should approach a bank branch audit in a similar manner to any statutory audit considering well the time constraints, finer aspects of how a bank functions and the ever-changing RBI regulations mandating governance of banks.

Planning and training are key. Appropriate guidance of peers should be taken wherever felt necessary.

The auditor has to apply necessary due care and diligence with the right blend of professional scepticism clearly documenting the audit process from start to end.

Auditor has to stand firm ethically and do the right things right.

Whenever there is a risk, one needs to derisk. Every risk can be derisked. ■■■