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Concept Of Bank Audit And Inspection.

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ABSTRACT

Financial institutions are the backbone of any financial system because of their role in spurring economic growth through maturity transformation and supporting payment systems.
There is little question that the financial system plays a strategic role in an economy, and even countries where banks credit roles have declined relative to other sectors of the financial sector, the banking industry remains at the core.

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CHAPTER-1

INTRODUCTION

Banks occupy the pride of place in any financial system by virtue of the significant role they play in spurring economic growth by undertaking maturity transformation and supporting the critical payment systems. The balance sheet and the profit and loss account of a banking company have to be audited as stipulated under Section 30 of the Banking Regulation Act, 1949. Special responsibility is cast on the bank auditor in certifying the bank's balance sheet and profit and loss account, since that reflects the sound financial position of the banking company.

The specificity of banks, the volatility of financial markets, increased competition and diversification, however, expose banks to risks and challenges. The protection of depositors' interests and ensuring financial stability are two of the major drivers for putting in place an effective system of supervision of banks.[1]

Credibility of an institution, particularly that of financial institution depends on its internal control and supervision mechanism that can promptly detect irregularities, if any, and take corrective measures and ensure non-recurrence of irregularities. Business of banking is susceptible to frauds. It is therefore necessary to have an internal control and supervision mechanism for ensuring that no one person is in a position to violate procedures, rules, regulations, guidelines, do an unauthorized act detrimental to the organization which remains undetected for an indefinite period or long time. Therefore, inspection and audit plays crucial role in success of banking operations.[2]

AUDIT OF BANKING COMPANY

The balance sheet and the profit and loss account of a banking company have to be audited as stipulated under Section 30 of the Banking Regulation Act, 1949. Every banking company's account needs to be verified and certified by the Statutory Auditors as per the provisions of legal framework. The powers, functions and duties of the auditors and other terms and conditions as applicable to auditors under the provisions of the Companies Act are applicable to auditors of the banking companies as well. The audit of banking companies' books of accounts calls for additional details and certificates to be provided by the auditors.[3]

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[1] Report of High Level Steering Committee for Review of Supervisory Processes for Commercial Banks dated 19th June, 2012
[2] Ibid
[3] Audits Of Banks: Lessons From Crisis/

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They include:

Whether or not;

information and explanation, required by the auditor were found to be satisfactory;

The transactions of the company, as observed by the auditor were within the powers of the company;

Profit and loss account shows a true picture of the profit or loss for the period for which the books have been audited and any other observations to be brought to the notice of the shareholders;

Special responsibility is cast on the bank auditor in certifying the bank's balance sheet and profit and loss account, since that reflects the sound financial position of the banking company. Apart from the balance sheet audit, Reserve Bank of India is empowered by the provisions of the Banking Regulation Act, 1949 to conduct/order a special audit of the accounts of any banking company. The special audit may be conducted or ordered to be conducted, in the opinion of the Reserve Bank of India that the special audit is necessary;

In the public interest and/or

in the interest of the banking company and/or

In the interest of the depositors.[4]

The Reserve Bank of India's directions can order the bank to appoint the same auditor or another auditor to conduct the special audit. The special audit report should be submitted to the Reserve Bank of India with a copy to the banking company. The cost of the audit is to be borne by the banking company.[5]

INSPECTION OF BANKING COMPANY

As per Sec 35 of the Banking Regulation Act, the Reserve Bank of India is empowered to conduct an inspection of any banking company. After conducting the inspection of the books, accounts and records of the banking company a copy of the inspection report to be furnished to the banking company. The banking company, its directors and officials are required to produce the books, accounts and records as required by the RBI inspectors, also the required statements and/or information within the stipulated time as specified by the inspectors. [6]

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[4] Supra Note 1

[5] Supra Note 2

[6] Marshall C. Cons, Bark Auditing –Cambridge, Mass.: Bankers Publishing Company, 1955

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CHAPTER-2

GOVERNMENT'S ROLE

The Central Government may direct the Reserve Bank to conduct inspection of any banking company. In such cases, a copy of the report of inspection needs to be forwarded to the Central Government. On review of the inspection report, the Central Government can take appropriate action. In the opinion of the Central Government if the affairs of the banking company are not being carried out in the interests of the banking company, public and or depositors, the Central Government may

Prohibit the banking company to accept fresh deposits
Direct the Reserve Bank to apply for winding up of the banking company under the provisions of the Banking Regulation Act.
Before taking action, the Government has to give an opportunity to the banking company to explain their stand. Based on the response, the Government can initiate appropriate action as required.[7]

SCRUTINY

Apart from inspecting the books and accounts of the company, the Reserve Bank can conduct scrutiny of the affairs and the books of accounts of any banking company. Like in the case of inspection, the Reserve Bank can handle the scrutiny as required.

[7] Supervision of the Indian Financial System dated 2nd March, 2001

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SUPERVISORY FUNCTION IN INDIA

The legal and institutional framework for bank supervision in India is provided under the Banking Regulation Act, 1949. Until 1994, different departments in Reserve Bank of India were exercising supervision over banks, non-banking financial companies and financial institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the Board for Financial Supervision was set up under the aegis Reserve Bank under Reserve Bank of India (Board for Financial Supervision) Regulations, 1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector.

To have better supervision and control, a separate board was constituted namely "The Board for Financial Supervision" as per the provisions of the RBI. The Board has the jurisdiction over the banking companies, nationalized banks, State Bank of India and its subsidiaries. The members of the Board are: Governor of the Reserve Bank of India as the chairperson, Deputy Governors of the Reserve Bank of India, and one of the deputy governors should be nominated by the Governor as the full time vice chairman, four directors from the Central Board of the Reserve Bank nominated by the Governor as members.

FUNCTIONS AND POWERS

The Board performs the functions and exercises the powers of supervision and inspection under the RBI Act, with respect to different banking companies. The department of supervision assists the Board. The Board has to report to the Central Board on half yearly basis. The Board meets on a monthly basis, with at least one meeting in a month. The vice chairman of the Board is the ex-officio chairman of the committee.

Apart from the above, the Governor may constitute an advisory committee to offer advice from time to time to the Board. The council will have at least five members who have special knowledge in different areas like accountancy, law, banking, economics, finance and management. The Governor presides over the meetings and the other members of the council are the vice chairman and other members.[8]

[8] Supra Note 6

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CHAPTER-4

CORE PRINCIPLES OF BANKING SUPERVISION

The Core Principles for Effective Banking Supervision are the de facto minimum standard for sound prudential regulation and supervision of banks and banking systems. Originally issued by the Basel Committee on Banking Supervision in 1997, they are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices.

The RBI has continued with the post-liberalization strategy of setting prudential norms based on international best practices within which banks are left free to operate. The compliance of the Bank with the Basel Committee's Core Principles on Banking Supervision was gone into in great detail and the gaps in supervision were addressed by setting up seven in-house groups to make necessary recommendations.

The reports of these groups were discussed by the BFS in a specially convened session and the agenda set for action to be taken to bridge the gaps. Since then, the compliance is being monitored on a regular basis. The BFS also authorized the release in the public domain of the assessment of compliance, and this document is being shared with overseas supervisory agencies and international financial institutions. The IMF also completed an assessment using the revised methodology of the Core Principles which was in line with the Bank's own assessment.[9]

RBI's efforts in this area have been well recognized in international forums and in August 1999, it was made a Member of the Core Principles Liaison Group (CPLG) of the Basel Committee for Banking Supervision, which has been set up to promote the implementation of the Core Principles worldwide. RBI has also examined the proposed New Capital Adequacy Framework currently under discussion by the BCBS, and has communicated its response to the Basel Committee. RBI is also represented on the Working Group of Capital of the Core Principles Liaison Group, which has been constituted to obtain the inputs of the non G-10 countries in the international standard setting exercise.

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[9] Supra Note 12

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PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

Sound and sustainable macroeconomic policies**;**

A well-established framework for financial stability policy formulation;

A well-developed public infrastructure;

A clear framework for crisis management, recovery and resolution;

An appropriate level of systemic protection (or public safety net); and

Effective market discipline

SUPERVISORY POWERS, RESPONSIBILITIES AND FUNCTIONS

There are twenty-nine Core Principles in all out of which we enlist a few:

Responsibilities, objectives and powers: An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups.

Cooperation and collaboration: Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors.

Supervisory approach: An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention.

Supervisory techniques and tools: The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.

Supervisory reporting: The supervisor collects reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.

Corrective and sanctioning powers of supervisors: The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the

banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.

Internal control and audit: The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into

Financial reporting and external audit: The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion

Disclosure and transparency: The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

Abuse of financial services: The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.[10]

[10] Financial Sector Assessment Program—Detailed Assessments Report on Basel Core Principles for Effective Banking Supervision, IMF, 2013

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CHAPTER-5

CONCLUSION

The importance of the financial system in an economy can hardly be overstated, and the banking industry remains at the core of the financial system, even in countries where its credit role has diminished relative to other financial sectors. Recent changes in the nature of banking, and the frequency in the past couple of decades of costly banking crises around the world, have only heightened the interest of policy makers and industry participants in the effective regulation and supervision of banks.

Therefore, few recommended action plan for greater compliance with the Basel Core Principles are:

Provide greater certainty regarding the independence of RBI by removing impeding provisions from related acts.
Provide greater clarity regarding the role of the nominee director in the public banks, which can blur the distinction between the legal powers of RBI as a banking supervisor and an active role of RBI appointed staff in the management or compliance function of a bank. .
Reconsider the strict rotation policies, so as to ensure staff can build up expertise in banking supervision and regulation.
Developing mechanisms for written material (including inspection reports) to be regularly shared on a timely basis;
Broadening and strengthening escalation protocols to promptly alert other relevant supervisors about concerns that a supervisor is developing; and
Regularly holding the semi-annual meetings on major banking companies, but also allowing the opportunity for a regulators-only discussion of issues regarding that banking company.

Only a stable financial system can fulfill its macro-economic function – the cost-effective transformation and provision of financial resources. A properly functioning banking system is indispensable for the performance potential of a country’s economy and an efficient banking supervision system is therefore essential for the whole economy. The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to

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identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures. In obtaining an understanding of the accounting process, the auditor may seek to identify the significant flow of the transactions and significant application systems that are relevant to the accounting process. When obtaining an understanding of the accounting process, the auditors, ordinarily, focus only on such processes that relate to the effectiveness and efficiency of operations and compliance with laws and regulations and impact the financial statements or their audit procedures. While obtaining the understanding of the significant flow of the transactions, the auditor should also obtain an understanding of the process of recording and processing of journal entries, and should also make inquiries about inappropriate or unusual activity relating to the processing of journal entries and other adjustments, Transactions flow automated across CBS, digital banking, payments and settlement systems, card operations etc. and their integration with external systems such as NPCI, international payment gateways, SWIFT and INFINET etc. (SWIFT INSIGHT :IN 1973 global finance saw a back-room revolution when a group of banks formed a co-operative to offer those moving money across borders a slick alternative to the clunky old telex. Today the electronic financial-messaging system of the Society for Worldwide Interbank Financial Telecommunication (SWIFT) transmits more than 5 billion bank-to-bank messages each year. In 2013 it oiled the transfer of trillions of dollars globally by the 10,500 banks, asset managers and firms that are its members. SWIFT does not initiate transfers, hold customers' money, or clear or settle payments. Rather, it provides a template that helps international transfers flow smoothly and be tracked. Electronic Payments effected through alternate products/channels are becoming popular among the customers with more and more banks providing such facilities to their customers. One such initiative by RBI is mandating additional factor of authentication for all Card Not Present (CNP) transactions. Banks have also to put in place mechanisms and validation checks for facilitating on-line funds transfer, such as: (if) enrolling customer for internet/mobile banking; (ii) addition of beneficiary by the customer; (iii) velocity checks on transactions. The dependence of banks on mobile banking service providers may place knowledge of bank systems and customers in a public domain. Mobile banking system may also make the banks dependent on small firms (i.e., mobile banking service providers) with high employee turnover. It is therefore imperative that sensitive customer data, and security and integrity of transactions are protected. It is necessary that the mobile banking servers at the bank's end or at the mobile banking service provider's end, if any, should be certified by an accredited external agency. In addition, banks should conduct regular information security audits on the mobile banking systems to ensure complete security.

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Banks without end-to-end encryption can facilitate transactions up to Rs. 5000/-. The banks through adequate security measures may address the risk aspects involved in such transactions. (Circular DPSS.CO.No.2502/02.23.02/ 2010-11 dated May 4, 2011) RBI Circular dated 4th December 2014 on Mobile Banking Transactions in India - Operative Guidelines for Banks has felt the need for greater degree of standardization in procedures relating to on-boarding of customers for mobile banking (new customers, existing account holders whose mobile numbers are available with the bank but not registered for mobile banking, and existing account holders where mobile number is not available with the bank), as also the subsequent processes for authentication, including accessible options for generation of MPIN by customers. Where banks are providing E-Wallet facility, auditor should evaluate proper controls and checking of transactions through E-Wallets and presentation of the balances of E-Wallet in the financial statements based on underlying arrangement for providing such facility.

Based on the recommendations of a High Level Steering Committee (HLSC) for Review of Supervisory Processes of Commercial Banks, the Reserve Bank of India had in September 2012, introduced a Supervisory Program for Assessment of Risk and Capital (SPARC) for commercial banks. This Risk Based Supervision (RBS) approach helps the regulator in focusing on evaluating both present and future risks, identifying incipient issues and facilitating prompt intervention/ early corrective action - as against the earlier compliance-based and transaction testing approach (CAMELS) which was more in the nature of a 'point in time' assessment. The RBS approach also benefits the regulator by optimizing its use of supervisory resources and assisting the regulated entities in improving their risk management systems, oversight and controls. RBI is empowered under section 21 of the Banking Regulation Act, 1949, to control advances by banks in general or by any bank in particular. Among the measures that the RBI can adopt for this purpose are to prescribe purposes and extent of advances, margin requirements, maximum exposure to a single Banking in India borrower, rate of interest and other terms and conditions, etc. Besides these measures (which are usually called 'selective credit control' measures), RBI also controls the total volume of bank credit by varying bank rate through open market operations or by varying cash reserve and similar requirements. Bank rate refers to the rate of interest at which the RBI re-discounts the first class bills of exchange or other eligible instruments from banks. Variations in bank rate affect the interest rates charged by banks - generally, interest rates of banks move up or down in tandem with movements in bank rate. Under Base Rate system that came into effect from July 1, 2010, all categories of domestic rupee loans of banks are priced only with reference to the Base Rate, subject to certain

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conditions. For monetary transmission to occur, lending rates have to be sensitive to the policy rate. At present, banks follow different methodologies for computing their Base Rate like average cost of funds method, marginal cost of funds, blended cost of funds (liabilities) etc. Open market operations involve sale or purchase of government securities in the open market. When RBI buys government securities from banks in the open market, the funds in the hands of selling banks increase, enabling them to expand credit, and vice versa. Banks are required to maintain at least a prescribed minimum percentage of their demand and time liabilities in India in the form of cash and/or current account balances with the RBI (called 'cash reserve ratio'). Additionally, they are required to maintain a further percentage in the form of cash and/or other liquid assets (called 'statutory liquidity ratio'). Varying the cash reserve ratio and/or statutory liquidity ratio enables the RBI to increase or decrease (as the case may be) the funds available to banks for lending and other similar purposes. A major development that has implications for banks throughout the world is the 'International Convergence of Capital Measurement and Capital Standards' generally known as the Basel Accord. Basel III ensures better quality of capital and robust liquidity risk management. The smooth functioning of the payment and settlement systems is a prerequisite for stability of the financial system. In order to have focused attention on payment and settlement systems, a Board for Regulation and Supervision of Payment Systems (BPSS) was set up in March, 2005. The launch of the Real Time Gross Settlement System (RTGS) and NEFT (National Electronic Funds Transfer) has led to a reduction of settlement risk in large-value payments in the country. Similarly, IMPS (Inter bank Mobile Payment Service/Immediate Payment Service) is a mobile-based payment mechanism introduced by the National Payments Corporation of India to allow customers to transfer money instantly, facilitating instant remittance across multiple platforms. The setting up of NSDL Guidance Note on Audit of Banks (Revised 2018) and CDSL for the capital market settlements and CCIL for G-sec, forex and money market settlements have improved efficiency in market transactions and settlement processes. A series of legal reforms to enhance the stability of the payment systems have been carried out. With the introduction of the Payments and Settlement Act in 2008, the Reserve Bank has the legislative authority to regulate and supervise payment and settlement systems in the country.

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