Technical Aspects in Audit of Bank Branches

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Key Aspects to note

- Significant aspects reg. IRAC norms dt. 1Oct21
- IFCoFR for Public Sector Banks mandatory from Financial Year 2020-21
- New LFAR format applicable 5 Sep 2020
- RBI direction dated 14Sep2020 mandated Automation of NPA and Provisioning within CBS not later than 31 December 2021
- RBI Master Directions on Digital payments Feb 2021

Session Outline

- Understanding your Audit Environment
- Transaction Audit - Technical Considerations
- IRAC Automation - Audit Pitfalls
- IFC & LFAR

Knowing your Audit Environment

Why should Branch Auditor bother about System Controls ?

Mandatory Modules

- Customer Master & Maintenance
- Retail Products – Deposits, Loans. Trade Finance
- Clearing, Collection, Remittances
- General Ledger
- Reports/Queries

Optional Modules

- NPA
- Internet Banking,IVRS,Tele/Mobile
- ATM, RTGS, NEFT
- Lockers, Inventory
- Treasury
- CRM
- AML
- Data Warehousing, BI

Assessing IT Impact on Branch Audit

Typical Branch Technology Profile

Risk Assessment & Audit Planning

- SA 315 – Identifying and Assessing the **Risk of Material Mis-statement** through *understanding the Entity and its Environment*", impact on:
  - Auditors procedures for obtaining sufficient understanding of the accounting & internal control systems
  - Evaluation of inherent risks and control risk to assess audit risk
  - Design and perform tests appropriate to meet audit objective

Key Challenges

- How to know the source(systems) of financial data and Account Heads?
- Do I need to learn the entire CBS and Apps?
- How to perform Audit of Systems Config (Parameters)?
- How to use CBS Features?
- How to identify System control issues?
- Veteran CAs vs. Computer agnostic vs. Tech Savvy Auditors!

Planning

- Understanding the Branch business and technology profile, Branch Risk Profile
- Previous Audited FA set, Concurrent/ Inspection/ Systems/Fraud Audit Report
- Fraud Reports, Customer compliants
- IFC testing communicated by SCAs to Branch Auditors
- Audit of returns filed with Central repository of Information on Large Credits (CRILC) for advances over Rs. 5 Crores, which maintains history of the borrowers from inception.

Key Preliminary Considerations

- Opening Meeting
  - Who should be present?
  - Changes in Accounting Systems/IT landscape since last audit
  - Problems & Issues during last year impacting FA
  - Global System Issues – nature and impact, IT Control – CPPD/CPC etc.
  - Special Issues – ATM, RTGS, Chq. Truncation, Digital Banking Channels, SWIFT terminals etc.
  - Frauds and Modus in Branch as well as Region & Bank as a whole
  - Customer Complaints etc.
  - Minutes
  - E-mail for Read Only Audit Login to CBS
- Branch Walkthrough – Process Walkthrough

Digital Audit Approach

- Understand business criticality of data to the entity under audit
- Assess the Risk inherent to CIS to the FR and Audit Objectives
- Follow the data path and how it works through the Application Interface, identify key controls
- Audit procedures for testing Design and Operating Effectiveness involve:
  - Testing for internal controls enforced by Application
  - Testing for effectiveness of security controls in Applications
  - Testing for significant anti-fraud controls

Useful ICAI/RBI Guidance

- Technical Guide on Bank Audit 2022
- Technical Guide on Audit of Internal Financial Controls in case of Public Sector Banks
- SA 315 - Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- SA 230 - Audit Documentation
- SA 265 - Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
- SA 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report
- Concurrent Audit Manual - IASB
- RBI Master Circular - Prudential norms on IRAC and Provisioning dt 1 Oct, 2021 | Clarifications thereof Nov 12, 2021

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Was the Auditor Negligent?

PNB fraud: RBI initiates special audit of PSBs with focus on trade finance

PTI | Up

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In addition, the RBI has asked all banks for details of the banks had pre-approved credit limits or kept

Learning from Investigation:

- **1200 LOUs by Gokulnath Shetty 2011-2017**
- **SWIFT not integrated with CBS**
- **SWIFT-CBS Recon not done**
- **Contingent Liability not accounted**
- **Bill/LOU expiry not tracked – Greening**
- **Lapses in corporate governance**
- **Monitoring and compliance failure**
- **AIRs ignored! 50% persisting/unresponded**
- **46 persons indicted, no one knew of lapses over years?!**
- **Shetty served at same position for 7 years against max. of 3!**
- **Shetty used late night personal Yahoo mail for 'Txn Recon'!**
- **Import and Export for YE March 2017 at $3.3 billion, 50% > last 2 years**
- **Concurrent audit failure**
- **Care: Recovery Branch Proceedings, status of suit, security etc**

Planning - Critical to Effective Audit

- As you receive your Appointment, you should be ready with engagement letter to branch and with specific requirements to be sent to you: eg.
  - Locations (link/extension branches),
  - Applications (CBS and Others) - Integration? , Digital Banking Channels, Clearing & Settlement Systems, Outsourced functions,
  - Previous Year Auditors, Discuss and Obtain NOC
  - Current year BS & PL (funded and non funded O/S.)
  - List of Audit and non audit returns
  - Previous year BS & PL, Audit Report, LFAR, MOC, Audit Reports
  - CBS and other software in use
  - list of large advances as per new definition
  - list of exception reports
- Readiness for using CBS for AUdit

Transaction Audit - Key Considerations

- How CBS and other applications work?
  - Masters (Standing Data)
    - Eg. Products, GL Codes
    - Eg. Customer, Employee, Loan, Type of charges, TDS etc.
    - Eg. computations logic - Interest Table , Finance Charges Table, Penal Interest Table, Sequence of set off of repayments
    - Eg. Sector, Security, Guarantee etc.
    - Parameters Master
    - Eg. Workflow, Maker-Checker-Authoriser
  - Transaction Records

Internal Controls in CBS Branch

- System Driven Internal Controls
  - Business Rules (Credit Policy) embedded in CBS/Apps
  - Powers (DOA) configured within CBS/Apps
  - Maker-Checker Controls configured within CBS/Apps
  - MIS for Decision making and monitoring generated from CBS/Apps/External systems
  - Exception Reports for Monitoring/Early Warning generated from CBS/Apps

Parameter Audit - RBI Clarifications

- Clear specification of due date/repayment date should be reflected in loan master and schedule configuration (RBI direction dt. 12Nov21 - due not later than 31 Dec 21
- NPA/SMA classification should be part of day end process and reflect the calender date and not date of day end run irrespective of size of exposure
- SMA classification to be by CBS applied to all loans including retail loans
- Check NPA logic for CC/OD - (a) O/s. > Sanction/DP (b) O/s. < Sanction/DP but no credits for 90 days (c) O/s. <Sanction/DP+ credits do not cover interest
- Upgradation of NPA to standard only if **entire arrears are serviced**
- Classification of SMA/NPA - If due date of a loan account is March 31, 2021, and full dues are not received before the day-end process is run for this date, the date of overdue shall be March 31, 2021. If it continues to remain overdue, then this account shall get tagged as SMA-1 upon running day-end process on April 30, 2021 i.e. upon completion of 30 days of being continuously overdue. Accordingly, the date of SMA-1 classification for that account shall be April 30, 2021.
- borrower accounts shall be flagged as overdue by the lending institutions as part of their day-end processes for the due date, **irrespective of the time of running such processes**

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Advances & CBS

- Appraisal Controls & Exception Analysis – Flow Analysis
- Account Profile data
- Parameters
  - Global
  - Branch Level
  - Account Level
- NPA/SMA Flagging
  - DC Driven – CBS. If not, raise observation in LFAR
- IRAC Classification
  - DC Driven – CBS. If not, raise observation in LFAR
- Provisioning
  - Manual Security Valuation, Provisioning apparently automated!

NPA Automation

- RBI direction dated 14Sep2020 mandated Automation of NPA and Provisioning within CBS not later than 31 December 2021
- Ensure no manual intervention / over-ride in the system based asset classification process
- If exceptional circumstance every manual intervention that overrides System classification must be supported by at least two level authorisation.
- The branch auditor should obtain the exceptional report containing the log of instances and ensure the same. Report in LFAR
- Day end process and manual interventions are generally at branch level
- operations; the branch auditor is to ensure compliance of the said circular. Auditors should note that the above circular is applicable from June 2021.

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LFAR 2020-21 - Advances - Critical Issues

- Potential Error/Fraud Aspects
  - Multiple Customer IDs, Marking of Borrower Group
  - Customer Credit Score in CBS (Important for Quick Mortality Identification)
  - Term Sheet/ Margin/Moratorium/EMI etc.
  - Sanction Date/ Drawing Power/ Security Value
  - Interest - Eligible Rate(Credit Rating), Value Date (Para 5(1)(b) of LFAR)
  - Penal Interest/Charges - Triggers
  - Rephasement (OTE-SME, COVID) - By Which Authority
  - Review/Renewal
  - Fictitious Credits through Office A/c., Inter-branch, Clearing control etc.
  - Devolved Bills in Office Account

LFAR 2020-21 - High Risk Parameters

- Potential Error/Fraud Aspects
  - Stock/Debtor/Creditor/WIP/Audited Accounts entry in CBS
  - Project Loans
  - Asset Classification
  - Quick Mortality Cases to be identified by Auditor

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Key Aspects to note

- IFCoFR for Public Sector Banks mandatory from Financial Year 2020-21
- IFCoFR applicable to all banking companies under Company Law
- Does Branch Auditor have a role in IFCoFR?
- What aspects to consider?

Reporting

- Reporting to CSA Mandatory through LFAR:
  - **internal control issues (Parameter Config, Integration etc.)**
  - **Specific Comments on Advances - highlight system exceptions if any**
  - **Specific failure of processes and controls (IT Dependent, by-pass)**
- Ensure reporting on
  - Internal controls - Be specific with examples rather than generic *'controls found to be weak'*
  - Clearly highlight the system weaknesses that have impacted/can potentially impact financial reporting and bring attention to CSA
    - Eg Application, Configuration, Interfaces, Migration, IT Infrastructure, poor controls with potential forfraud etc.

LFAR 2021 - Books & Records

- 2.(a) Books and Records - Whether there are any software / systems (manual or otherwise) used at the branch which are not integrated with the CBS? If yes, give details thereof.
- (b)(i) Adverse features in IS Audit Reports
- (b)(ii) Generating and verifying and actioning on exceptions reports
- (b) (iv) Manual intervention outside CBS/Apps
- (b) (v) Audit to comment on data integrity (including data entry, checking correctness/integrity of data, no back ended strategies etc.) which is used for MIS at HO / CO level. (Also 6(a)

Systems Risks – Planning Considerations
Branch Financials
Trial Balance
Schedules & Returns
Chart of Accounts
Channels & P&S
CBS
Non-CBS
Internal Controls?
Recon
Recon
Other Considerations
Fraud Hit Accounts
Attacked Systems
Migration
Internal Controls?
Internal Controls?
Internal Controls?

Reconciliations

- Reconciliations – Payments, Clearing/ Settlements
  - Subsidiary-GL Balancing?
  - RTGS/SWIFT/CTS-NACH
  - OLTAS/GSTN/Credit Card
  - ATM Switch Suspense/ATM Cash Suspense
  - IMPS, Wallet Systems/Channel Recon
  - Clearing Suspense
  - All suspense and Parking Accounts
  - Inter Branch- Unmatched SOL Ids
  - ECS Batch
  - Office Account Recon and Analysis
  - NOSTRO/VOSTRO Recon and Analysis

Clearing and Deposits

- Clearing
  - Suspense Accounts
  - Clearing Exceptions – Returns, Errors
  - Clearing
    - Exception and Cheque Returned reports
    - Cases in which Schedule modifications allowed
    - IBD Cheque Numbers
  - ECS
    - Outstanding entries follow up
  - CRA - Reconciliation of Cash covers and Audit Rolls
  - Short/Excess Claims in Office Claims – O/s Entries
  - Bank Reconciliations
  - OCC Dishonour
  - TOD due to Clearing Report

Deposits & Borrowings

- Inter Bank Liabilities
  - Reconciliation
- Demand Deposits
  - SB
  - Demand/Term Deposits
  - Margin Monies
  - Special Schemes
- Inoperative & Dormant Accounts
- Parameters
  - Interest & effective Date
  - KYC & AML
  - SI
  - Lien Marking
- External A/c. Confirmations
- Duplicate Certificate Issues

Contingent Liabilities

- Claims against the bank not acknowledged as debts –***LOUs?***
- Liability – Forward Exchange Contracts
- Guarantees
- Acceptances, Endorsements & Obligations
- Bills for Collection
- Special Issues
  - Outside CBS but involve revenue
  - Crystallisation of Liability – How Accounted?
  - Frauds

Audit Risk Special Considerations

- Multi/Alternate channel Suspense/Recon
  - ATM
  - Credit/Debit/Smart Cards
  - Voice Banking
  - Internet Banking
  - Mobile Banking
- Multi segment branches – Inter segment transactions
- Special business branch risk considerations
- Auditing Treasury Operations and systems
- Auditing Derivatives Operations & systems
- Service Branches/ZO/RO
- H.O Audit considerations

Fraud Modus

- Large Value Frauds Modus:
  - opening current accounts with banks outside the lending consortium without a no-objection certificate from lenders,
  - diversion of funds by borrowers through various means,
  - including through associated/shell companies,
  - lapses in credit,
  - underwriting standards and failing to identify early warning signals.
- Fraud due to the non-integration of the SWIFT system with the CBS.
- money laundering through Prepaid Payment Instruments, KYC norms were made stringent, limits were placed on fund transfers and caps were put on the amount held in wallets.
- SIM Swap Frauds, AnyDesk Mobile Banking Frauds

Documentation – Work Papers

- Digital Workpapers
  - Software Driven or Organised by Folders
  - Version controlled
  - Conforming to AAS
- Some contents:
  - Engagement letter
  - Risk and Controls Assessment Documentation
    - Minutes of Meetings
    - Audit Universe and Walkthrough Observations
    - Record Details of Audit Environment Scope Limitations
  - Audit Program Checklist, Plan, Who did what? Maker-Checker
  - Data identified for analysis and results for analysis
  - Templated Working Papers for all Large advances, Adverse findings with evidence
  - Ensure objective electronic evidence
- All key communication on e-mail, No Whatsapp etc.
- Management Representation Letter
- Record basis of judgment
- LABEL AND BACKUP SECURELY - Out of sight! Out of mind!

Your own Self-realization is the greatest service you can render the world !

Thank You !!!

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