E-Book

CENTRAL AUDIT OF BANKS….. BEYOND A TRUE AND FAIR VIEW

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

Southern India Regional Council

Chennai

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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FOREWORD

This e-book provides in-depth knowledge on the topic of Corporate Social Responsibility detailing the meaning, specific provisions/compliances under the regulations to comply with the legal requirements which the corporates are mandated. It also provides insights on the accounting and recognition aspects, penal implications on non-compliances, requirements of Audit and responsibility of auditors towards CSR activities, reporting/disclosure requirements and tax benefits for CSR activities.

The author has also provided the relevant templates/format for Annual reporting of CSR activities and other Annexures/provisions relevant to determine the activities which could be eligible for CSR, companies for whom the same is mandatory, etc.

This e-book, one in a series of member centric publications planned by SIRC, aims to serve as a Handbook and Guide for the professionals who intend to gain knowledge on the subject of Corporate Social Responsibility.

This e-book gives a guidance to the professionals on Central Audit of Banks.

On behalf of SIRC, I wish to place our sincere gratitude and appreciation to CA.P M Veeramani, for sharing his rich experience and expertise on the Central Bank Audits amongst our members through this e-book. I also take the privilege of thanking CA. M K Sridhar for reviewing the basic draft of e-book and adding value to the substance of the e-book.

Comments and suggestions on the e-book are welcome at sirc@icai.in

CA.K.JALAPATHI
Chairman, SIRC of ICAI

CONTENT

INTRODUCTION

The Central Statutory audit of banks, which used to be an extension of the branch audit along with few certificates like compliance with SLR/CRR, has moved forward over the last few years. The audit report which used a fairly simple one of less than a page with very few assertions has now developed into a big document running into several pages with several assertions and a separate annexure on internal financial controls. Besides certification of the financial statements, the central auditors are now required to look into and report on various micro level details relating to banking operations, control systems which has made the central audit of banks into a specialised audit requiring special skills and knowledge in banking operations, RBI regulations besides IT expertise. The skill sets required for the central audit is completely different from the branch audits as more and more assurances are expected of the central auditors by RBI, SEBI (in case of listed banks) besides company law compliances (in case of private banks)

This attempt is to look into the changes which have happened over the period of time and what is the current scenario

A. Changes in the Audit Report

A comparative chart of the audit report for 2007-08 and 2009-10 is given below. We do not see any perceptible changes in the assertions and opinion given in the audit report.

2007-08	2009-10
Subject to the limitations of the audit indicated in paragraph 1 above and as required by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and subject also to the limitations of disclosure required therein, we report that:	Subject to the limitations of the audit indicated in paragraph 1 above and as required by Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and subject to the limitations of disclosure required therein, we report that:
The Balance Sheet and the Profit & Loss Account have been drawn up in Forms "A" and "B" respectively of the Third Schedule to the Banking Regulations Act, 1949	The Balance Sheet and the Profit and Loss Account have been drawn up in Forms A' and B' respectively of the Third Schedule to the Banking Regulation Act, 1949.
In our opinion, the Balance Sheet, Profit & Loss Account and Cash Flow Statement comply with the applicable Accounting Standards.	In our opinion and to the best of our information and according to the explanations given to us and as shown by the books of the bank maintained in accordance with the generally accepted accounting principles in India:
The Balance Sheet, **read with the notes thereon** is a full and fair Balance Sheet containing all the necessary particulars, is properly drawn up so as to exhibit a true and fair view of the state of affairs of the Bank as at 31st March 2008 in conformity	The Balance Sheet **read with the notes thereon and significant accounting policies** is a full and fair Balance Sheet containing the necessary particulars, and is properly drawn up so as to exhibit a true and fair view of the affairs of the Bank as at 31st

with accounting principles generally accepted in India	March, 2010
The Profit & Loss Account, read with the notes thereon shows a true balance of Profit, in conformity with accounting principles generally accepted in India, for the year covered by the account	The Profit and Loss Account read with the notes thereon and significant accounting policies shows a true balance of the Profit for the year ended 31st March, 2010.
The Cash Flow Statement gives a true and fair view of the cash flows for the year ended on that date.	The Cash Flow Statement gives a true and fair view of the cash flows for the year ended 31st March, 2010.
We have obtained all the information and explanations, which to the best of our knowledge and belief, were necessary for the purposes of our audit and have found them to be satisfactory	We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit and have found them to be satisfactory
The transactions of the Bank, which have come to our notice, have been within the powers of the Bank.	The transactions of the Bank which have come to our notice have been within the powers of the Bank.
The returns received from the Offices and Branches of the Bank have been found adequate for the purposes of our audit.	The returns received from the offices and branches of the Bank have generally been found adequate for the purposes of our audit.

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A.1 From 2010-11

Financial year 2010-11 saw a significant change in the audit report. The audit report was divided into sections like Management responsibility, auditor's responsibility, audit opinion and report on the legal and other regulatory requirements.

A.1.1 *Management Responsibility*

The audit report brought out what were the responsibilities of the management in respect of the financial statements. It was asserted that the management was responsible for the preparation of these financial statements in accordance with the Banking Regulation Act, 1949. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of the financial statements that are free from material misstatements, whether due to fraud or error

A.1.2 *Auditors responsibility*

The assertions on the auditors responsibility were that the auditors is only required to express an opinion on the financial statements based on his audit, which is carried out in *accordance with the auditing standards issued by ICAI from time to time . The auditing standards mandated that the auditors complied with the ethical requirements , planned and performed the audit to obtain reasonable assurance about whether the financial statements were free from material misstatements.*

A.1.3 ***Matters leading to forming opinion***

The report went on to further explain the audit procedure, obtaining audit evidence on the the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the bank's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by the management, as well as evaluating the overall presentation of the financial statements

The paragraph ended with the auditors forming a belief that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

A.1.4 ***Audit opinion***

The report was further divided into different paragraphs with one on the auditors opinion on the financial statements and then a positive assertion on certain facts. The audit opinion on the balance sheet, profit and loss account and cash flow statements also asserted that the financial statements gave:

- *the information required by the Banking Regulation Act*
- *in the manner so required*
- *was in conformity with generally accepted accounting princples*
- *gave a true and fair view of the balance sheet*
- *profit / loss for the year and*
- *cash flows for the year*

A.1.5 ***Confirmation on certain facts***

The audit report gave confirmation on the following points regarding financial statements:

1. *The Balance Sheet and the Profit & Loss Account have been drawn up in Forms "A"and "B"respectively of the Third Schedule to the Banking Regulations Act, 1949.*
2. *The auditor had obtained all the information and explanations, were necessary for the purposes of audit and have found them to be satisfactory.*
3. *The transactions of the Bank have been within the powers of the Bank.*
4. *he returns received from the Offices and Branches of the Bank have been found adequate for the purposes of our audit.*
5. *The financial statements consisting of Balance Sheet, Profit and Loss account and Cash flow statement complied with the applicable Accounting Standards.*

A.2 Changes from Financial Year 2018-19

Financial Year 2018-19, while retaining all the reporting requirements, further witnessed several significant ***additions*** *in the audit report consisting of positive assertion on Key Audit Matters, disclaimer on information other than financial statements and audit report besides the management and auditors responsibilities being brought out more elaborately.*

A.2.1 Key Audit Matters

Key Audit Matters represented , the most significant matters in the audit of the financial statements . The auditor had to explain in summary the key areas of audit, in his professional judgment and how they were addressed in the course of the audit. In other words, the auditor was required to give a positive assertion with supporting reasons how he was satisfied in respect of the key audit matters.

A.2.2 Other Information in Annual Report

The annual report contained several other key information apart from the financial statements and audit report which could influence the investor and hence another disclaimer was included in the audit report that the Bank's Board of Directors were responsible for :

- *Pillar III disclosure under Capital Adequacy Framework*
- *Corporate Governance Report*
- *Directors Report*

The auditor responsibility is only to read the other information and consider whether such information is materially inconsistent with the financial statements and unless the auditor is of the opinion that there is something to be reported on, the responsibility ends with the audit report

A.2.3 Management Responsibilities

While the earlier report contained the responsibility of the management in general, the modification affirmed that such responsibility shall be not with the management but also with those charged with governance . While Management comprises of officers and others who also perform senior managerial functions Those charged with Governance (TWEG) are persons entrusted with the supervision , control and direction of an entity. The management responsibilities narrated in the audit report includes:

- ✓ *Preparation of financial statements to show a true and fair view of financial position including compliance with accounting principles, accounting standards, regulatory guidelines issued by Reserve Bank of India*
- ✓ *Maintenance of accounting records in accordance with required statutory provisions*
- ✓ *Safe Guarding of assets of the bank and for preventing /detecting frauds and other irregularities*
- ✓ *selection and application of appropriate accounting policies;*
- ✓ *making judgments and estimates that are reasonable and prudent;*

- ✓ *design, implementation and maintenance of adequate internal financial controls and ensuring that were operating effectively for ensuring the accuracy and completeness of the accounting records*
- ✓ *In preparing the financial statements, management is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting*

A.2.4 Auditor's Responsibilities

The auditors responsibilities are also spelt out in detail to include :

- ✓ *Obtain reasonable assurance that the financial statements are free from material misstatement*
- ✓ *Explaining that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists.*
- ✓ *Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error,*
- ✓ *Design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.*
- ✓ *Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.*
- ✓ *Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the bank's ability to continue as a going concern, as on the date of the audit report Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.*
- ✓ *Audit report is based on the materiality*
- ✓ *Communicating the planned scope and timing of the audit, significant audit findings including deficiencies in internal control identified during the audit*
- ✓ *Ensuring of ethical standards and maintenance of independence*
- ✓ *Decide not to make public disclosure through audit report where adverse consequences of such disclosure would reasonably be expected to outweigh the public interest benefits on account of such information*

]A.3 Changes in 2019-20 – for public sector banks

Reserve Bank of India vide its Letter No DOS.ARG. No. 6270 / 08.91.001 / 2019-20 dated March 17,2020 added the following further points to be reported (some of which turned out to be repetition)

a) that the Financial Statements comply with the Accounting Standards issued by ICAI, to the extent they are not inconsistent with the accounting policies prescribed by the RBI.

b) that there are no observations or comments on financial transactions or matters which have any adverse effect on the functioning of the bank.

c) that on the basis of the written representations received from the directors as on 31st March, 2021, none of the directors is disqualified as on 31st March, 2021 from being appointed as a director in terms of Section 164 (2) of the Companies Act, 2013. (this reporting has brought out divergent views with some auditors taking the view that the clause was not applicable to public sector banks as they are not governed by companies act)

d) that there are no qualifications, reservations or adverse remarks relating to maintenance of accounts and other matters connected therewith

A.4 Further change from 2020-21

Financial year 2020-21 added one more requirement for the auditors to comment on the adequacy and operating effectiveness of the Bank's internal financial controls over financial reporting . As required by ICAI , the report on this area is to be furnished as an annexure to the audit report which turns out to be another report covering the responsibilities of management, auditor , explaining the meaning of internal financial controls and explaining the limitations of the audit and finally reporting on the adequacy and effectiveness.

B. Regulatory provisions to be complied with

B.1 Income Recognition and Asset Classification Norms

The concept of NPA is introduced by Reserve Bank of India to reflect a bank's actual financial health in its balance sheet and as per the recommendations made by the Narasimham committee, which studied the prevailing financial system, identified its shortcomings and weaknesses and made suggestions and recommendations in line with internationally accepted norms. Based on the recommendations of the Committee on "Financial System Reforms", the Reserve Bank of India evolved prudential norms on Income recognition ,Asset classification and Provisioning and issued revised instructions to banks in April 1992. The income recognition on Advances and Investments provisioning were to be made on the basis of the classification of assets into different categories. The norms have been implemented by banks from the financial year ended March 1998. The Reserve Bank of India periodically issued various circulars for the amendments to the norms and annual master circular was also brought out up to July 2015 separate for Advances and Investments.

The compliance of the norms , though begins at the branch audit level, the finalisation of the same takes place at the Head Office only

B.2 Inter-branch Accounts- Provisioning for net debit balance

All connected inter-office accounts , including inland and foreign branches of the bank should be aggregated and the net balances, whether in debit / credit only should be shown as a separate item in the balance sheet. This represents mostly items in transit and unadjusted items and required to be reconciled regularly and reconciled entries need to be eliminated from the reconciliation statement. With the computerisation the reconciliation is today mostly done by the system but manual intervention may be required to eliminate unreconciled entries which may have arisen due to errors . Banks are required to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts and make provision equivalent to 100 percent of the aggregate net debit under all categories, if they are outstanding beyond the prescribed limits.

B3 Compliance with Accounting Standards

Commercial Banks shall ensure strict compliance with the Accounting Standards notified as amended from time to time, subject to Directions/Guidelines issued by the Reserve Bank of India. UCBs shall be guided by the announcements of the Institute of Chartered Accountants of India (ICAI) regarding applicability of accounting standards subject to directions/guidelines issued by Reserve Bank of India. Part B of Annexure II of the Master Direction on Financial Statements – Presentation and Disclsoure of Reserve Bank of India dated 30.8.2021 specifies guidance with respect to issues in the application of Accounting Standards for Commercial Banks which shall also apply to co-operative banks. The current master circular substitutes the circulars issued periodically since last two decades.

B 4 Notes on Accounts

Banks shall disclose information as specified by the RBI regulations in the notes to accounts of the financial statements. These disclosures are intended only to supplement and not to replace disclosure requirements under other laws, regulations, or accounting and financial reporting standards . The disclosure items kept on increasing over the period of time and as per latest master circular dated 30.8.2021 , the items to be disclosed runs into around 35 pages, ranging from computation of regulatory capital and Capital to Risk Asset Ratio, various other ratios like Liquidity Coverage Ratio, Net Stable Funding Ratio, business ratios , the computation of each ratio being covered by separate circulars which undergo periodic modifications. The notes on accounts are requires disclosure on investments, NPA and its movements, exposure to specified sectors, managerial remuneration , restructured accounts, top advances, top NPA, Top deposits …etc to name and few. Notes on Accounts are part of financial information certified by the auditors along with Balance Sheet and Profit and Loss Account .

The new disclosure circular has substituted the instructions for compilation of Form A – Format of Balance Sheet and Form B – Format of Profit and Loss Account , which has given rise various interpretations

B 5 Long Form Audit Report (LFAR)

In addition to the financial statements , the central statutory auditors are required to certify a long form audit report (LFAR) covering various operational areas of the bank. The whole bank LFAR format was significantly different from the branch formats. The inputs from the branch audit reports form only a small part of the whole bank LFAR. Reserve Bank of India in September 2020, introduced the new format for LFAR repealing the earlier one which was in force since 2012. The new format requires reporting on various areas which are far beyond the scope of audit of financial transactions. The objectives of the new format as explained by the regulator is as follows:

i. The overall objective of the Long Form Audit Report (LFAR) should be to identify and assess the gaps and vulnerable areas in the business operations, risk management, compliance and the efficacy of internal audit and provide an independent opinion on the same to the Board of the bank and provide their observations.

ii. This may also involve commenting on various risks to which the banks are exposed to like credit, market, operational and liquidity risk and risk management efficacy, assessment of appropriateness of procedures for preparation of supervisory returns, KYC/AML/CFT issues, cyber security, business performance, business strategy including very high growth / high ROE accompanied with high risks, etc.

iii. Some of the matters to be dealt with by the SCA in their LFARs will be based on the LFARs received from the branches. In dealing with such matters, the SCA are expected to exercise their own judgement to make their observations on the basis of review of branch auditors' LFARs.

iv. While deciding their audit strategy, the auditors may factor-in all material issues which are considered critical by looking at the size and complexity of the business operation, business strategy/models, internal controls including the control culture of the bank, structure and complexity of the IT systems, etc.

v. The scope and coverage of Statutory Audit and LFAR will broadly be as per the given format. However, if the SCA feels a need of some material additions, etc. in the scope, this may be done by giving specific justification and with the prior intimation to the Audit Committee of the Board of the bank.

vi. SCA may resort to need based limited transaction testing as hitherto.

vii. In deciding whether a qualification in the main report is necessary, the auditors should use their judgement based on the available evidences / facts and circumstances of each case

B 6 Certificates

As part of the appointment, the central auditors are required to issue certificates on various specific areas stipulated by RBI from time to time. The number of certificates kept on increasing over the period of time and currently it stands at around 20 numbers , so much so, that ICAI has come out with a separate common audit report covering all the certificates. The certificates include compliance with CRR/SLR requirements, compliance with Income Recognition and Asset Classification norms, Exposure norms Large Exposure Frame Work, Unauthorised operations in internal / office accounts, automation of compliance with IRAC norms, computation of MCLR rates, priority sector advances, interest subvention, monitoring of red flagged accounts etc to name a few. There was also a certificate to be given on the cyber security which appears to have been withdrawn currently.

B 7 LODR Regulations

Since most of the banks are also listed in the stock exchanges, the compliance with the Listing and Other Disclosure Regulations (LODR) issued by Securities and Exchange Board of India (SEBI) also needs to ensured by the central auditors especially in the case of quarterly results. These regulations require separate reporting formats of financial statements besides disclosure of various ratios. Though the quarterly reports are "limited review reports on unaudited financial statements" the assurance in the report by the auditors is not significantly different from the year end statements if one looks at the report, which reads as : " Based on our review conducted as above, nothing has come to our attention that causes us to believe that the accompanying statement of unaudited financial results prepared in accordance with applicable accounting standards and other recognized accounting practices and policies has not disclosed the information required to be disclosed in terms of Regulation 52 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 including the manner in which it is to be disclosed, or that it contains any material misstatement or that it has not been prepared in accordance with the relevant prudential norms issued by the Reserve Bank of India in respect of income recognition, asset classification, provisioning and other related matters

Structured Supervisory Mechanism (SSM) Review

The Annual Financial Inspection (AFI) carried out by the Reserve Bank of India after the audit for each financial year end was replaced by Risk Based Supervision system since 2009. Supervision of each bank is assigned to a team of officers of Reserve Bank of India and this review is termed as Structured Supervisory Mechanism. The SSM team interacts on a quarterly basis with the central auditors and highlight the areas / points on which they expect the auditors to go through and revert to them on the compliances. The areas of concern are also shared with the banks in their Risk Mitigation Plans (RMP) based on the Risk Assessment Reports (RAR). The compliances called for are more with regulatory directions apart from Bank Regulations Act and not necessarily on the financial statements alone.

Audit fee

Though the expectations and compliances required from the central auditors increased manifold over a period of time, it is sad to note that the remuneration has not moved either according to the volume of work involved or the risk undertaken. The current schedule of fee for the Central audit of public sector banks is divided into two – (a) Rs.750 per branch for the branch reviewed (other than those audited by CSA) and (b) a scaled fee ranging from Rs.7,06,200 for a bank having balance sheet size up to 50,000 crore to Rs.9,61,400 for bank having balance sheet size of above Rs.5 lakhs crore. The fee for LFAR is a percentage of the statutory audit fee . The fee was last revised in 2013 and in spite of best efforts from ICAI there has been no revision though the audit requirements went up substantially in last three / four years The audit fee for the private sector banks , both at branch audit level and central level are below par. The fee for the limited review reports is only an insignificant percentage of the year end on the ground that it is not an audited statement . It is indeed sad that the boards of the bank , including some of our professional brothers in the board, feel that audit fee is a cost which needs to be pruned . The complaint that there is "no value addition" by the auditors is misplaced when the auditors are not adequately remunerated even for the work done.

Conclusion

In spite of the disappointment on the audit fee front, the central audit of banks continues to be a big challenge and it must be appreciated that the audit firms are discharging their function fairly well. There has been no major instances of deviations in compliance with IRAC norms if one goes by the disclosure in the notes on accounts. There has also not been any reported cases of major failure in the audit The requirements for the public sector banks is considered more for the above study, but the same provisions apply to private sector including unlisted banks as well except for certain concessions in respect of areas not applicable to them. The responsibility of the central auditors have moved from a certification of a true and fair view of financial statements to a much more detailed reporting on various micro level matters, which requires the chartered accountants firms to have trained partners besides audit staff . With the number of public sector banks going down on account of mergers, the opportunity to get the audits have also diminished considerably. But the RBI notification of April 2021, making it mandatory to have joint auditors , based on the balance sheet size is a welcome step. This has resulted in a big churning of the auditors of not only banks, but also NBFC. Thus, the audit firms who are appointed / wish to get appointed as central auditors need to be well trained on a regular basis , not only in audit but also in all banking related matters.

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