

ICAI J.B. Nagar Study Circle

Intensive Internal Audit - Banking Case Studies

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Topics

- About Risk Based Auditing
- Banking - Typical Sector Issues
- Bank Audit Focus & Operating Controls
- Case Studies
 - Audit of Revenue Systems & Procedures
 - Investigation

01 About Risk Based Auditing

True or False

1. Crisis cannot come next week, my schedule is full

True or False

2. We can audit 100%

True or False

3. We add value to clients in all audit engagements

True or False

4. Clients hope for the best and prepare for the worst

True or False

5. By preparing risk registers clients have managed all the enterprise risks



“Risk is a part of God's game, alike for men and nations.”

“Risk comes from not knowing what you're doing”

- Warren Buffet

“Victory awaits him who has everything in order -
luck people call it.

Defeat is certain for him who has neglected to take the
necessary precautions in time; this is called bad luck”

- Roald Amundsen, The South Pole
[Amundsen's team conquered The South Pole in 1911]

Risk Management is gradually being referenced in all international standards

- Risk is the combination of the probability of an event and its consequences
- The main aim of any activity in an organisation should be to achieve the objectives of the organisation and audit assist the organisation to achieve its objectives. There is a growing recognition that there exists a strong linkage between effective Risk assessment and effective audit coverage and thereby achievement of superior business results.
- Extensive use by auditors to intelligently cover the audit universe as 100% reperformance of business process is not possible. A “WHAT CAN GO WRONG ANALYSIS” prior to field work will provide focus and judgement to the auditor on where to deploy his resources.
- Risk Management is the only science at our disposal to deal with business uncertainties

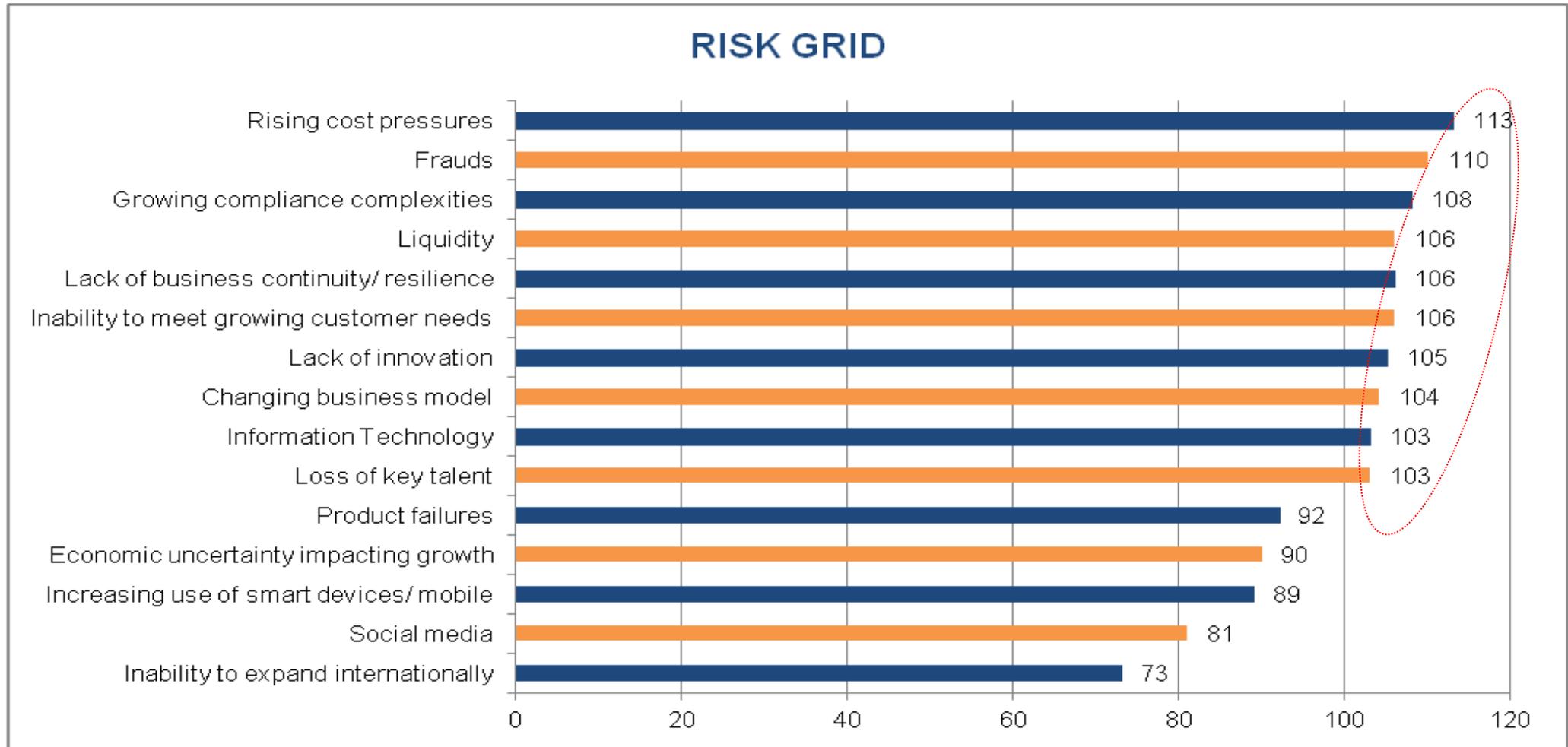
Risk Assessment – wide use and applicability

- 1 COSO – ERM Framework, COBIT IT Governance Framework, ISO Standards
- 2 Supreme Audit Institutions, Regulatory bodies, Assurance and audit bodies, etc
- 3 Governments and public bodies for major projects
- 4 Financial institutions, banks and financial service companies
- 5 Management and measurement technique for quantification of risk
- 6 Project companies, infrastructure companies, etc
- 7 Extensive use by auditors to intelligently cover the audit universe as 100% reperformance of business process is not possible. A “**WHAT CAN GO WRONG ANALYSIS**” prior to field work will provide focus and judgement to the auditor on where to deploy his resources.

Significance of Risk Based Supervision

- The philosophy of risk-based supervision is built around evaluation of risks and identification of incipient problems for ensuring that the individual banks initiate corrective action much before the problems could undermine their safety and soundness. Under a compliance based approach, supervisory activities focus on the financial position of the supervised entities at a given point in time (stock). Risk-Based Supervision (RBS) on the other hand is a dynamic process (flow) where the emphasis is more on understanding and anticipating the possible risks the supervised entity will be facing when executing its business plan going beyond its current financial situation. For example, under the RBS approach, the supervisor while considering the bank's plan to introduce new products would focus more on the effects on the bank's capital if the initiatives were unsuccessful or, even, too successful! Compliance focuses more on whether the bank currently has sufficient capital and follows the rules that, it is assumed, are sufficient to ensure the objectives of supervision are met. In that sense, RBS can be said to be more preventive and forward looking as well.
- The RBS approach is also consistent with the international best practice standards such as Basel II and the Basel Core Principles. For instance, Basel II requires banks to design and implement effective risk management systems. The Committee has noted following benefits of a risk focused approach for supervision of banks:
 - Improved understanding of the risk profiles of banks, their business and of the quality of management;
 - **Early identification of emerging risks at individual banks and on a sectoral basis i.e. the risk contagion;**
 - Enable to indicate the direction of risks, possible to anticipate future scenarios and hence a forward-looking capability to initiate supervisory measures where needed;
 - Optimum utilisation of the supervisory resources with a greater focus on material risks and risk management processes at banks.

The New Business Risk Normal



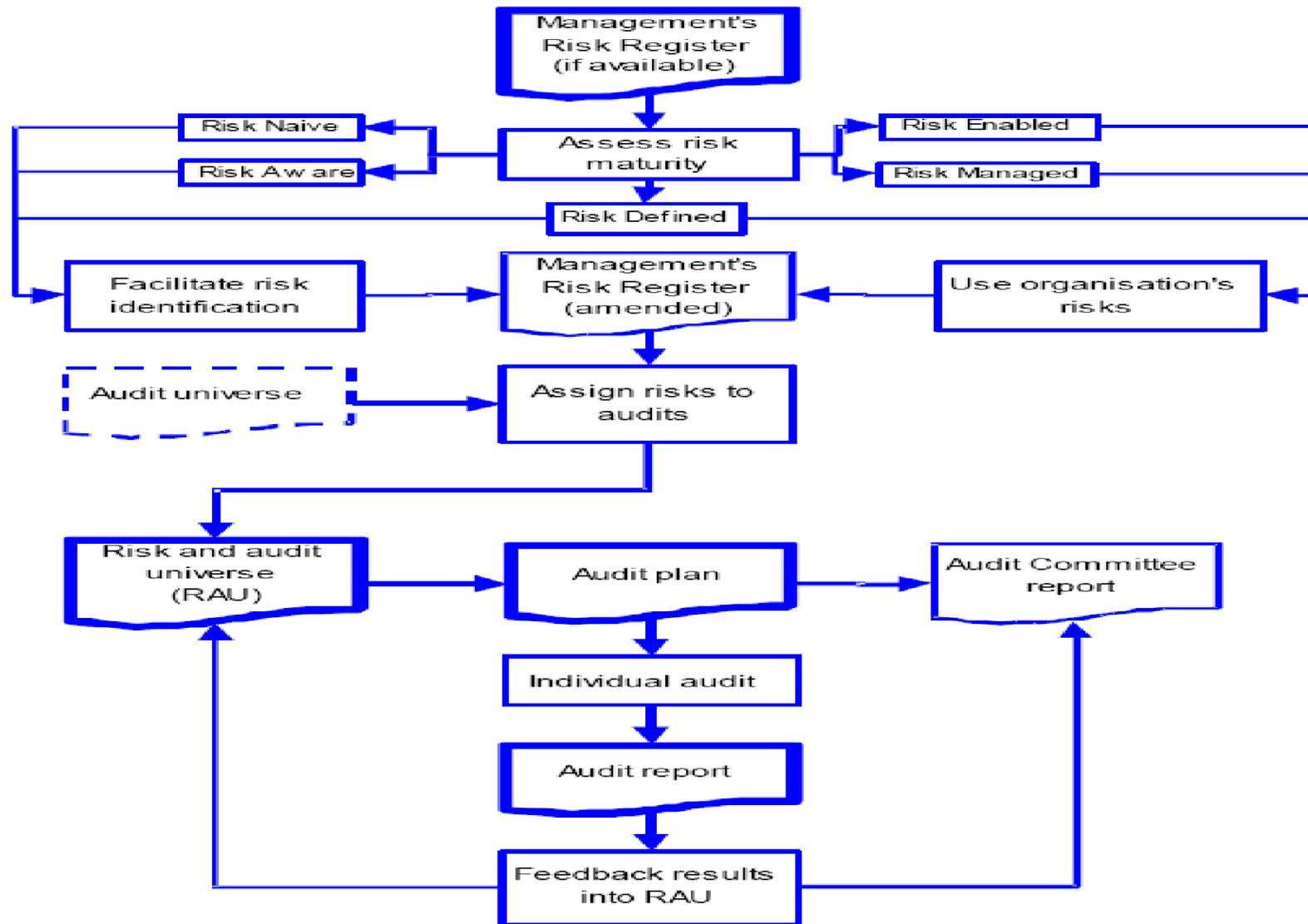
Source IIA Bombay Research Foundation Survey on Measuring the Impact of IA in uncertain times

Risk Management - avoid the common mistakes



- Your risk portfolio should be comprehensive but concise
- Monitor your risk portfolio and undertake root cause analysis for sticky risks
- Update the risk portfolio as business is dynamic
- Go for a simple and easy to use model. It is proven that complex models are not effective and difficult to implement.
- Don't make the mistake of predicting black swan events nobody can except God.

Flow of Risk Based Internal Audit



02 Banking Sector Issues

Typical issues plaguing banking sector in India

- The amount involved in the frauds reported by the banking sector in India has more than quadrupled from Rs. 2038 crore during 2009-10 to Rs. 8646 crore during 2012-13. Similarly, another report has estimated the losses of the Indian insurance companies at a whopping Rs.30, 401 crore in the year 2011 due to various frauds which have taken place in the life and general insurance segments. The losses work out to about nine per cent of the total estimated size of the insurance industry in 2011. The Libor manipulation scandals, have caused major upheavals in western nations and their impact has been felt not only in the individual institutions or countries but across the global financial system.
- Spectacular change witnessed over the last decade on account of financial innovation, increased globalisation and the growing use of modern technology as service delivery.
- New products and services embedding technological innovations are some of the complexities that the bank supervisors have to increasingly contend with. The exponential growth of the off-balance sheet items and introduction of complex products such as derivatives and securitization has complicated the turf for the supervisors, banks and auditors alike.
- The emergence of financial conglomerates with considerable cross-border and cross-sector activities. Thus, while on the one hand the boundaries between financial sectors have become increasingly blurred, the inter-linkages between various markets have increased on the other.

Typical issues plaguing banking sector in India

A comparative picture of total number of fraud cases and amount involved as on March 31, 2013 for scheduled commercial banks, NBFCs, Urban Cooperative banks, and Financial Institutions is as under:

No. of frauds cases reported by RBI regulated entities

(No. of cases in absolute terms and amount involved in Rs. crore)

Category	No. of Cases	Amount Involved
Commercial Banks	169190	29910.12
NBFCs	935	154.78
UCBs	6345	1057.03
FIs	77	279.08
	176547	31401.01

- The number of deposit accounts in the banks over the last ten years (between end 2002 and end 2012) has gone up from 43.99 crore to 90.32 crore while the number of loan accounts in the same period has also more than doubled from 5.64 crore to 13.08 crore.
- The average number of all transactions that happen every day in the banking system at approximately 10 crore, which is enormous.
- The number of frauds per million banking transactions was about 0.4. Likewise, besides increase in the number of brick and mortar branches, additional service delivery points like ATMs and Point of Sale (POS) terminals have also gone up significantly. While the number of ATM machines has grown from 34789 in March 2008 to 114014 in March 2013, the number of POS terminals has also more than doubled (from 423667 to 845653) during the same period.

Typical issues plaguing banking sector in India

Technology Frauds

- Newer service delivery platforms like mobile, internet and social media, for enhanced efficiency and cost-cutting are now embedded in our lifestyles.
- Several instances of high/low value frauds wherein the fraudsters have employed hostile software programs or malware attacks, phishing, Vishing (voicemail), SMSishing (text messages), Whaling (targeted phishing on High Networth Individuals) techniques apart from stealing confidential data to perpetrate frauds.

KYC/ AML Frauds

- Fudged identities
- Benami/ shell
- Money laundering

Advances related Frauds

- There is considerable delay in declaration of frauds by various banks in cases of consortium/ multiple financing.
- Majority of the credit related frauds are on account of deficient appraisal system, poor post disbursement supervision and inadequate follow up. The absence of an orderly system of information sharing among the lender banks further exacerbates the problem.
- Laxity in post disbursement supervision
- Inadequacy of follow up of advances portfolio by banks is clearly underlined by the fact that majority of the fraud cases come to light only during the recovery process initiated after the accounts have been classified as NPA.
- Title deeds are not genuine or that the borrowers had availed multiple finance against the same property.
- Collusion of professional agencies with the borrowers to fabricate fudged financial statements, inflated security valuation reports, defective search reports for title deeds of mortgaged property, based on which banks have been led to overestimate the funding requirements and security cover for the same.

How banks are different from other corporate entities?

1. Custodian & Bearer of Instrument bearing value
2. Operate on a very high leverage hence vulnerable to economic downturns
3. Changes in fair value
4. Credibility – large funding from small depositors
5. Large volumes
6. Decentralised controls and no human contact
7. Fiduciary responsibility giving rise to breach of trust
8. Memo transactions
9. Highly regulated
10. Clearing systems
11. International settlements

Branch Level:

1. Track and review all high value transactions for adequacy of recording, profilers and approvals
2. Physical count of cash, gold bars, cheques, stationery items, ATM balancing & hot listing
3. Review of daily voucher, expense and journal report
4. Review of TODs, Blocked accounts, stop payment requests, customer instructions
5. Review of customer complaints and resolution
6. Monitoring and closure of early alerts such as 2 or more cheque bounces, cash deposit in dummy accounts, FD redemption in cash, income reversals, insurance policy issuance to third party, aged balances, income reversals, etc
7. Review of financial inclusion drives for priority sector lending and account opening - KYC
8. Review of revenue leakages and accounts where there are deviations against approved rates
9. Nature or irregularities noted in branch advances and not yet rectified along with financial impact

Operating Risk/ Controls - Close and Continuous Auditing

Illustrative

Central Level:

1. Daily and periodical balancing of CMS Clearing, Remittance Clearing, Migration Routing Account, suspense accounts, etc
2. Review of exception reporting and system deviations/ trail of warnings
3. Operating errors in document collection, signature verification, calculation of commission/ revenue, invalid/ expired documents at the stage of account opening or loan approvals, etc
4. Transactions escaping authority limits, client set limits/ client authority set limits
5. Transactions wrongly captured in the system
6. Customer facilities wrongly activated in the system
7. Improper execution of legal documents
8. Client consent from unauthorised sources
9. Miss-out of payment/ redemption instructions
10. Transactions not executed as per client instructions
11. Movement in NPA positions and management assessment on SMA, NPAs.

Operating Risk/ Controls - Close and Continuous Auditing

Illustrative

System Level:

1. Handling of all exceptions by supervisory levels. Generally exceptions are transactions that where system generates a message that the user cannot handle the transaction given the nature of the transaction or there is a warning or error message.
2. The default interest rate code is modified to carrying a higher or lower rate based on adequate approvals.
3. System validations have been implemented to restrict set up of duplicate customer master records.
4. System does not permit reversal of the charges in excess of the original charged.
5. System prevents lien from exceeding the deposit value, it prevents marking of multiple liens against the same deposit, thus preventing the total liens exceeding the deposit account.
6. Access for changes made to the configuration/ parameter settings is restricted to authorized user and require verification from another user.
7. System restricts issuance of excess credit limits such as LC/ BG over and above the master credit limit set up for the customers
8. Interest computation switchovers to be restricted except with approved authorities, automation over manual computations
9. Closure of account restricted unless compliance with mandatory closure and revenue collection formalities
10. System customization to ensure correct NPA classifications as per RBI prudential norms

Vulnerable areas - points of focus for any audit

1. Project lending
 2. Lending against debts/ stocks
 3. Transfer/ fund movement amongst sister concerns
 4. Supplier accounts remitting funds to buyers
 5. Valuation of net worth of borrowers
 6. Frequent limit enhancements/ ad-hoc limits leading to over-trading/ leverage
 7. Cooked books a very common phenomenon
1. Work completion and revenue recognition
 2. Existence and valuation
 3. Reason, volumes and business rationale for such transfers, %age of related party transactions
 4. Tracking suppliers/ related parties
 5. Expert, registered and independent valuers
 6. Monitoring account conduct
 7. Matching with audited copy from auditors

03 Banking Sector Case Studies

03.A Systems & Process Review – Income Recognition

Background

- Systems and procedures review of the income recognition process of a large public sector bank.
- To cover the risk that is posed by the manual intervention that are allowed in all applications. Possibility of any misstatement in financial statement due to auto entries.
- Suggest the possibility of report structures in addition to existing reports to highlight major exception.
- Auto reconciliation process such operating and to check accuracy of the process
- System in place and adopted by the Bank to verify vendor specific checks and balances
- Income Recognition would include:
 - Verification of select accounts in Deposits and Advances to be selected from various products including associated companies
 - For Term Deposit Products, interest calculation on maturity, periodical interest payouts and interest calculation in case of pre-mature payments.
 - For loan Products – verification of interest computation including calculation of penal interest
 - Computation and application of interest, fees and charges for transactions of various types in Trade Finance stream.

Approach and Methodology

Application & Process walkthroughs:

- Comprehensive walkthrough of all key applications such as CBS, interface files, GL Head Mapping and connected income recognition processes at the Branch and HO income stream walkthroughs, asset classification norms, etc

Preparation of:

- Product functionality notes, product configuration parameters set in the applications, study of various RBI circulars and Bank's policy directives, analysis of financial statements and preparation of materiality parameters for sample testing through re-performance tests and control questionnaires

Verification of:

- Comparison of branch filings with audited reports, re-performing interest, commission, TDS and other calculations, review of NPA bucket movements and upward restoration, etc. the sampling was spread across all branch categories such as metro, urban, semi-rural and rural and also covered all product categories all the key product categories that would have a significant impact on the financial statements of the bank

Observations arising from the review

- Certain percentage of deposit accounts population application of interest did not match with the re-performed results.
- In case of loan and trade finance products there were no application of interest deviations noted.
- System automatically classifies an overdue account into an NPA account when the account is overdue for more than 4 instalments. On verification of NPA Report of C Branch, it was found that some of the overdue accounts having more than 4 instalments overdue were not appearing in the NPA Report. The error was on account of repayment schedule not migrated properly. This was rectified subsequently.
- In few cases, the System has automatically upgraded the status from "Loss assets" to "Standard assets" without any recovery in the account. Further, the system also applied the unserviced interest reversed earlier. However, the system did not charge the interest on month end for the period during which the advance is classified as standard assets. Code changes were made restricting auto upgrade.
- In few housing loan accounts (under same product) sanctioned on the same day, system has charged different rate of interest to these loan accounts. If the same is configured manually at the discretion of the branch, it should be appearing in the "Exception Report For Interest Rates Variation". However, these loan account numbers are not appearing in the said report. The Branch has used discretion in lowering the standard rate.
- A C branch account which was a substandard account was manually changed to standard account on several occasions after system has classified it as an NPA account. Each manual intervention can delay identification of NPA a/c.

Observations arising from the review

- In few cases recovery in NPA account is used towards principal instead of adjusting towards interest outstanding. Also account became standard as on XXXX. However no interest charged for Nov, Dec and January XXXX.
- Under **Inland LC**; add on levy on commitment charges, which is 6% or 12% as applicable based on rating of the borrowers as per circular, is not being charged and collected automatically by the Trade Finance system. We observed that the same was not recovered manually also by the C Branch.
- Recommended that credit rating of the borrowers / customers should be linked to all types charges / commissions as stipulated in the bank's circular and the charges be collected automatically by the System so as to prevent the income leakage.
- As per circular dt XXXX on personal banking segment for revision / rationalization of service charges, issue of cheque book for SB/CA is to be charged Rs.2.5 per leaf. However, on review it was observed that for multiple accounts system applied charges at a flat rate of Re. 1 was charged per leaf instead of Rs. 2.5 as mentioned above.
- As per circular dt. XXXX on personal banking segment, in case of revision / rationalization of service charges for cheques above Rs.1,00,000/; system should charge cheque return charges of Rs.200 on the basis of cheque amount as per circular under reference. However in one case Cheque of Rs. 22,00,000 was returned and system levied charges of only Rs.100 instead of Rs. 200 resulting in loss of income.
- Instances were found where TDS was being computed on compounded basis where it should have on flat interest computations.

03.B Fraud Investigation

Background

- RBI directive to conduct special scrutiny of certain accounts and transactions which were classified as quick mortality case in the RBI inspection.
- The 3 CBC Group of Companies had availed Letter of Credit and Corporate Loan Facilities from the Bank for export and import business of precious metals.
- Under these facilities, they had collectively defaulted on over 50 Crores. Apart from FD's the Bank could recover only 1 Crore.
- The rest of the securities had either no market value; or the charges had not been created at the ROC.
- As security, the company had pledged their Assaying Laboratory worth around 5 Crores. Although the charge was created at the ROC, the machinery was confiscated by the ECGC as they had first right.

Approach and Methodology

Background check:

- Firm and Promoters profiling, Personal interviews, Researching RBI data , Collecting information on default history of promoters and related entities , Purchasing Business Information Reports.

Analysis of:

- Pledged securities and their valuations, history enquiry and third party confirmations, L/C Transactions and underlying documents, determine the financial position of the Group Companies

Verification of:

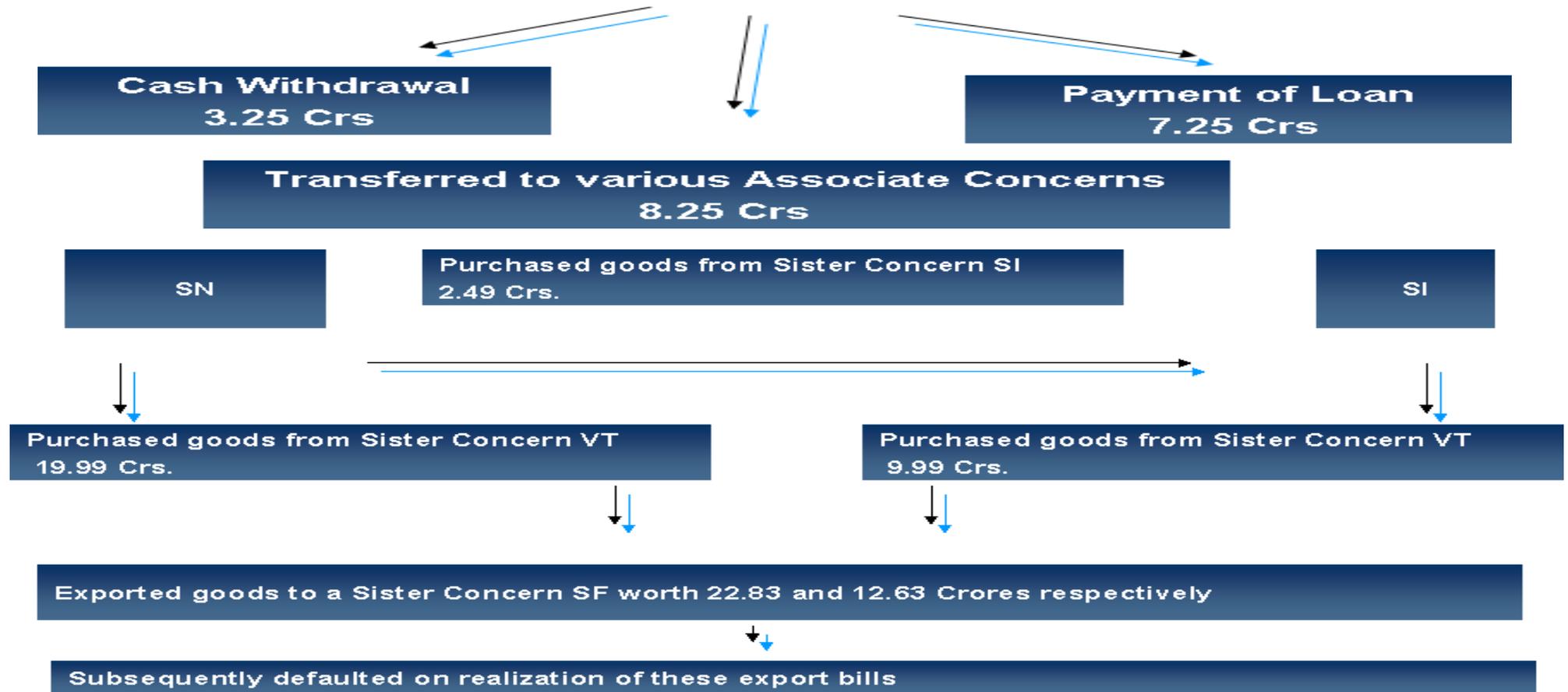
- Account Statements to determine trail of money, Correspondence and credit proposals, Financial Statements, Site visit reports, Board of Directors relationships and resulting conflict of interest situations at the BOD level.

Control Lapses at the Bank

- Confidential reports from existing bankers were not obtained.
- Business information reports of suppliers and customers of entities were not obtained.
- The entities defaulting history with the various banks was not taken seriously
- The necessary charges for the securities pledged was not created at the Registrar of the Company.
- The Bank issued LCs with less than stipulated margin without adequate explanation.
- A holistic view of the group was not taken as an associate company had already defaulted with the Bank and was currently engaged in legal recovery process.

Modus Operandi - Diversion of Funds

- G availed a Corporate loan of Rs. 20 Crores for working capital purposes.



Thank You

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