

Why Branch Audit?

**Common Man's Concern –
Protecting stability of
financial sector**



Significance of Financial Sector

	Rs. Lakh Crores
GDP 2010-11 at market prices	78.77
Business Size of Banks	125
% to GDP	158%
Market Cap of the BSE stocks (as of date)	27.34
Revenue Receipts as per Budget 2011-12	7.89
Defense Budget for 2011-12	1.64
Income from Banks	5.24
Bank's income as a % of Revenue Receipts as per Budget 2011-12	66%

CBS does not obviate need for branch audit

Branch audit not required

- Centralised system
- Completely parameter controlled
- Regional Processing Centres
- No discretion at branches
- No loans at branches
- No jewel loan / other securities verification / storage at branches
- No inspection of assets by branches
- No TOD / commission charges / waiver at branches
- Branches only do document collection and forwarding
- No Documents maintained at branch
- KYC verification centralised

Branch audit is required

- Centralised system
- Parameters can be overridden
- Branch as a Processing Centre
- Branch has discretion
- Branch can give loans
- Jewels against loans are verified and stored at branch
- Inspection of assets is done by branch
- Branch has powers for TOD / commission charges / waivers
- Branch handles all documents
- Branch retains all documents
- KYC done at branch

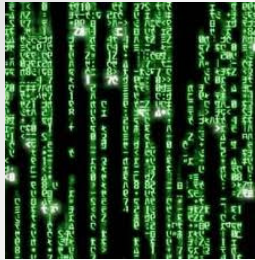
- If branches are only ATMs then, maybe there is no need for a branch audit • 3

CBS Environment...

- CBS only centralises the database...
- It may also centralise parametric controls, largely (for uniformity and standardisation)
- However, audit covers not only CBS data
 - It requires various other ingredients, which are handled and processed by the branches
 - KYC documents and verification
 - Loan documentation
 - Correspondences with customers
 - Physical custody of pledged items – such as Jewels
 - Back papers for inputs into CBS system
- Large number of other transactions which
- are not fully handled in CBS

Audit forms an opinion not
only on Data but, on
various aspects...

CBS can't meet all requirements for audit



Data



Documents



Analysis



**Pledged
Jewels**



**Party's Stock
verification**



**Site
inspection**



KYC check

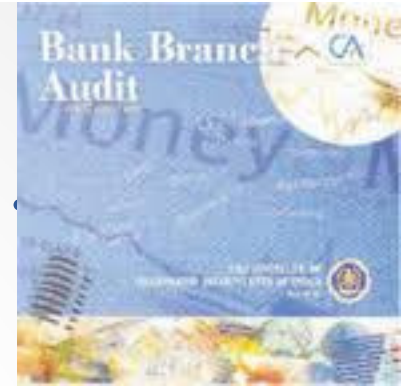


**Discretionary
powers**



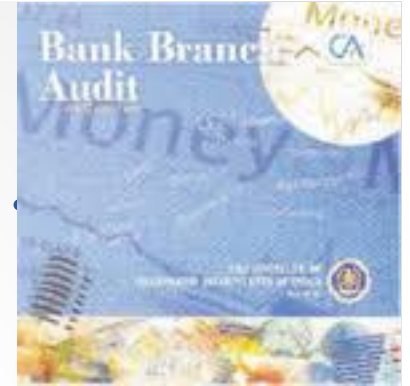
**Security
Documents**

What's verifiable only at Branches...



- Key inputs into the CBS
 - Some of the key parameters into the CBS is entered at the branch and can be verified only with documents at the branch
- Security documents
 - Such as unissued / stubs of issued deposit receipts
 - Cheque books
 - DD / MT / Bankers Cheques
- Government business carried out by the bank and reconciliations related to the same
- Verification of LC Bills and documents through bank
- Validity / proper maintenance of loan documents
- Sundry Assets / Sundry Liabilities- an area of concern
- KYC documents
-

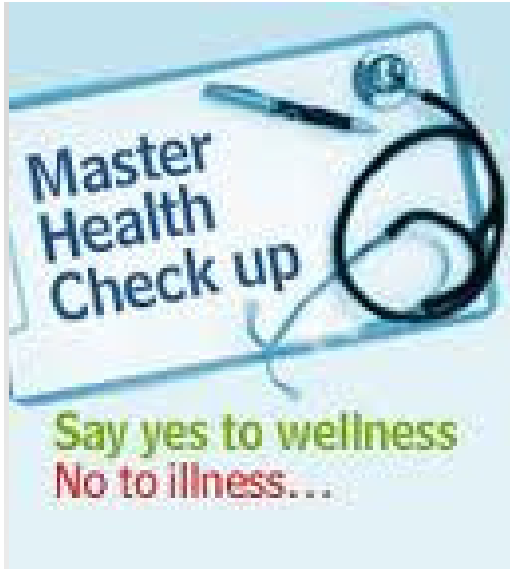
What's verifiable only at Branches...



- Exercise of Delegated authority by the branch manager
 - Especially where override of normal parameters in the CBS is provided (for waiver of charges, interest rate variation, TOD etc.,)
- NPA computation is not automated – in all cases, it's managed using stand alone systems and then fed back into the CBS; Also, need for checks on
 - Input of security valuation
 - Physical existence of the security
 - Validity of other information such as DICGC claim etc.,
- End use of loans
- Loan Account review by the branch
- Jewel loan security pledged
- Payment from dormant accounts

Audit under centralised and de-centralised approach

SN	Centralised Audit	Compared to Branch Audit	Impact on Audit Quality & Conclusions
1	Extent of coverage of transactions		
	Very few sample coverage and a lot of reliance on controls	Emphasis on detailed verification Advances covered in detail	Basis of conclusion is on review of very few transactions Audit Quality impact : -
2	Process changes		
	Invariably not fully covered	Covered through detailed circulars and audit tests	Could lead to very limited understanding by auditors Audit Quality impact : -
3	Diminishing Audit Cycles and ability to complete audit tests on time		
	Very high pressure on auditors	Work is distributed	---
4	Ability to Value Add		
	Very Limited as most of audit time spent on fin. Stats.	Significant Value add possible due to coverage and LFAR	---



SA is a Master Health Check

- LFAR covering about 90- 100 question of about 15 key areas centered around internal controls need to be verified and reported
- This has over the years improved the branch controls substantially
- Part of the fees is towards this additional work
- **This is the only comprehensive master health check for the branches covering financials, operations, transactions etc.,**

Deterrent effect of an Audit...

- Inspection is internal to the system
- External auditors bring in independence
- **The fact that there is an external audit itself has a significant deterrence effect...**
- Increasing concurrent audit coverage would actually increase the overall costs to the banks
- Audit also creates awareness amongst staff on legal requirements such as TDS etc.,
-

Companies Act requires audit of branches

- Section 228 deals with Branch Audit
 - Essentially 227 and 228 expect Branches to be covered by audit by the auditor of the company or by a specific branch auditor so appointed
 - The rules **do not** provide for automatic **exemption for banks**, though for companies engaged in manufacturing, trading etc., if the branch accounts for less than 2% of the turnover, the same is exempted
- This clearly indicates the special significance of bank branch audit considered under the Companies Act also

What 25% not being covered means?

- 25% of Business not being covered means, INR 25 Lakh Crores not covered!
- This is 3 times the Indian Revenue Budget Receipts for 2011-12!
- Over 15 times the defense budget spend
- Can we say that this is not material for not being covered by audit...
 - Beware of PILs...



Branches unaudited in various PSU Banks

Particulars	SBI Nos.	BOI Nos.	CENTRAL Nos.
Branches unaudited	2187	674	623
Branches audited	11463	2840	3105
% branches unaudited in number	16	19	17

Business details of unaudited branches- PSU banks

Particulars	SBI % of total business	BOI % of total business	CENTRAL % of total business
Advances	0.67	1.23	0.80
Deposits	2.60	2.43	3.83
Interest Income	0.86	0.97	1.02
Interest expense	4.16	2.48	3.28

Materiality

- Internationally accepted standard on materiality
- AASB 1031 on Materiality, reads as follows....
 - a) an amount which is equal to or greater than 10 percent of the appropriate base amount may be **presumed to be material unless there is evidence or convincing argument to the contrary**; and
 - b) an amount which is equal to or less than 5 percent of the appropriate base amount may be presumed not to be material unless there is evidence, or convincing argument, to the contrary.

Thus clearly the value of advances etc. at unaudited branches of PSU banks is not material.



Materiality in the context of audit opinion

- The proposed plan will not only leave 25% of the loans out of audit sampling
 - But, a much larger slice of deposits and also a significant portion of other operations
- By sheer Pareto analysis, 25% of value would translate to maybe 70 +% of volumes, which will not be covered!
- Also, there is a risk of certain sectors being completely left out!
 - Such as Agriculture, Coffee Plantations
- Similarly, certain regions may be completely left out!

Audit Costs - Are they so significant?

	PSU Banks	Old gen Pvt	New gen Pvt
Number of banks considered	20	12	6
Number of branches	62,065	4,474	6,385
Business Size (Loans, Deposit and Investments) – Rs. Lakh Crores	88.63	5.19	16.69
Business per branch – Rs. Crores	142.80	116.07	261.35
Audit Fees – Rs. Crores	595	21.52	7.52
Total Income – Rs. Crores	407,806	25,107	90,577
Interest Expense to Income	55.73%	56.24%	46.37%
Other Opex to income	19.85%	21.63%	24.05%
Provisions and Contingencies to income	13.40%	10.80%	13.47%
Net Profit to income	10.88%	11.24%	16.11%
Audit Fees to Income	0.15%	0.09%	0.01%
Est. Mandays / branch	13	11	1
Cost of Audit to Business Size	0.007%	0.004%	0.0005%

Should RBI look at better performance measures rather than audit cost?

- If the Business per branch can be increased to Pvt Sector bank levels, the overall business size of PSU Banks will go up by Rs.36 Lakh Crores (a 40% jump!!)
 - A 83% growth if on par with the business per branch of New Gen Pvt Banks
- If Interest expenses match with Pvt Sector, then net profit will go up by about ~ Rs.19,000 Crores! (a 5% higher NP!)
- Rs.25,000 crores if compared with New Gen Pvt Banks

Private Sector Banks have more cases of frauds...

Source: DNA Newspaper report based on an RTI application

- Fraud cases reported in the Year – 2010-11
- ICICI and HSBC – 13,067
- Private Banks including foreign banks – about 15,000 cases
- **PSU Banks including SBI and its subsidiaries – 3,700 cases**
- **SBI alone reported – 784 cases**

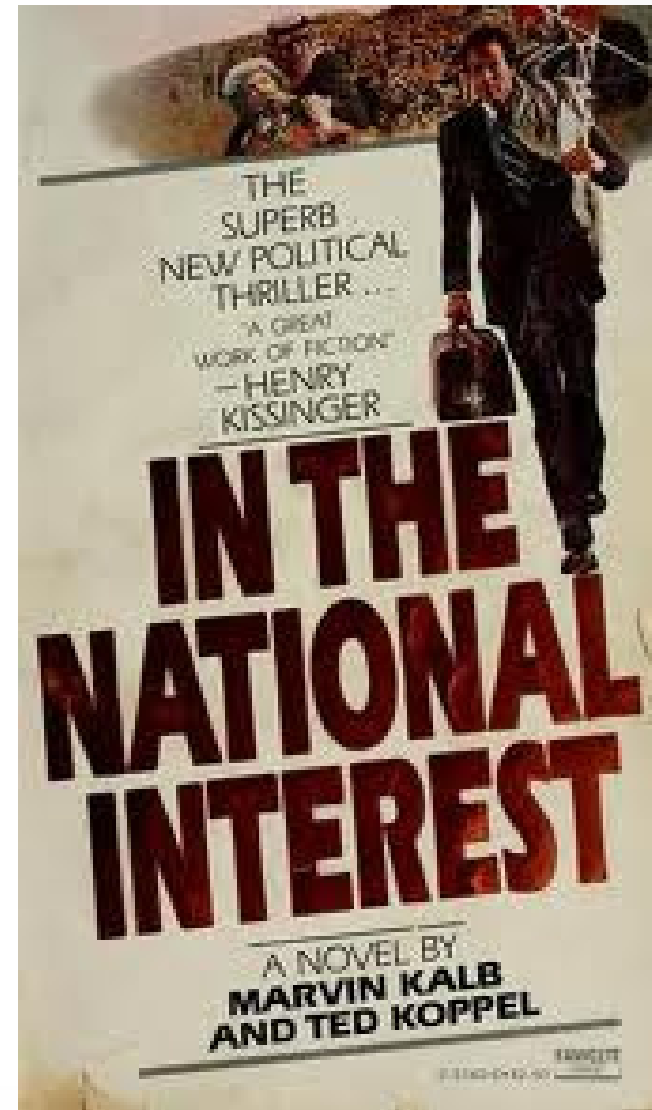
- The trend continues in the current year also
- Upto Sep 2011, ICICI Bank alone (3,304 cases) has over 60% of the 5,319 cases reported

Private Sector Banks have more cases of frauds...

	2007-08	2008-09	2009-10	2010-11
Total Loss – Cr.	1,057			
No. of cases	21,244	23,579	24,788	~ 18,700
Of which, ICICI	10,976	13,221	15,074	13,067
And of HSBC	3,770	3,481	2,741	
And of Citi	1,647	1,182	1,277	
And AMEX	499	703	817	
Way below comes SBI	561	745	545	784

National Interest...

- When Govt is thinking of audit of public spending...are we moving in the wrong direction in respect of such a critical sector?



Can we ignore...



- The large number of frauds in the financial sector...
- GTB, where branches were not audited...
- The reasons for the subprime crisis in the US, with more automation and lesser number of products!
 - ...Primarily because of no concept of branch audits!!

Whither Corporate Governance?



- Who has mooted this...Is there a concept paper?
- Is this just a perception?
- Should this not be discussed at ACB and Boards of all Public Sector Banks
- Also, public opinion solicited
- Before any proposal is considered by RBI
- **If audits are dispensed with, would it not lead to higher risk weightage for unaudited branches?**

•

Can you ignore another Regulator's view?

- Banking Regulation Act
 - Regulator for Banking Operations
- Companies Act
 - Regulation of Companies
 - This provides for audit of all companies – even very small companies (**no exemptions provided**)
- ICAI
 - Regulator of the CA profession for audit
 - This is the regulator who is to give guidance on audit and also regulate the profession
- **ICAI strongly feels that branch audits cannot be dispensed with at this point of time**
- Can RBI ignore the views of this other regulator, whose primary objective is to regulate accounting
- and audit?

Inappropriate move...

- In our opinion, this move arises on account of
- A) Inadequate appreciation of core banking which provides only data
- B) Audit expenditure cannot be compared to any other expenditure – it's an expenditure to guarantee financial sector stability
 - For physical security, RBI has ordered, in all branches closed circuit TVs and Alarm Systems
 - How does this move compare in this context?

Are we not doing exactly the opposite here?

Finally, to Conclude...

- This move is completely incorrect and there is a dire need to continue the bank branch audits at this point of time, in view of
 - Many aspects of the business needing to be audited only at the branch
 - Significance of this sector to the country and its national interest
 - Audit Cost is anyway not a significant issue in the overall context
 - Materiality of the amounts which would not be covered by audit!
- On the other hand, branch audit must be ordered in private sector banks also

Need of the Hour

- We should actually be working together to understand the expectations and improvise audit methodologies to provide financial sector stability