



# CAIIB PAPER-1

## Module-D Unit-2

### **Advanced Bank Management (ABM)**



## CAIIB Paper 1 (ABM) Module D Unit 2 - Compliance Audit

### Introduction

- The users of the financial statements need information about the financial position and performance of the bank in making economic decisions.
- They are interested in its liquidity and solvency and the risks related to the assets and liabilities recognized on its balance sheet and to its off balance sheet items.
- In the interest of full and complete disclosure, some very useful information is better provided, or can only be provided, by notes to the financial statements.
- The use of notes and supplementary information acts as means to explain and document certain items which are either presented in the financial statements or otherwise affect the financial position and performance of the reporting enterprise.
- Recently, a lot of attention has been paid to the issue of market discipline in the banking sector.
- Market discipline, however, works only if market participants have access to timely and reliable information, which enables them to assess banks' activities and the risks inherent in these activities.
- Enabling market discipline may have several benefits.
- Market discipline has been given due importance under Basel II framework on capital adequacy by recognizing it as one of its three pillars.
- Several Banks are listed in stock exchanges and shares of such banks' shares are freely tradable in the stock market.
- The protection of investors' interest in such listed banks is very important and calls for more transparency in the matter of disclosures in the accounts of the banks
- Stockholders + Depositors = Stakeholders.
- This equality says it all.
- Before the enactment of the Banking Regulation Act, the provisions relating to banking companies were administered **through Part XA of the Indian Companies Act, 1956.**
- The statement of objects and reasons for forming a separate Act, inter alia, provides that while the primary objective of the company law is to safeguard the interest of the stockholder, that of banking legislation should be the protection of the interest of the depositor.

***The current disclosure requirements for banks are spelt out mainly in the following statutes/regulations/standards:***

- The Banking Regulation Act
- The Companies Act, 2013
- The Companies Rules, 2014
- Indian Accounting Standards
- RBI Guidelines for Disclosures in Financial Statements
- RBI Guidelines for Basel III Requirements.

For the sake of uniformity in the financial statements of banks, RBI has advised that a summary of '**Significant Account Policies**' - **Schedule 17**

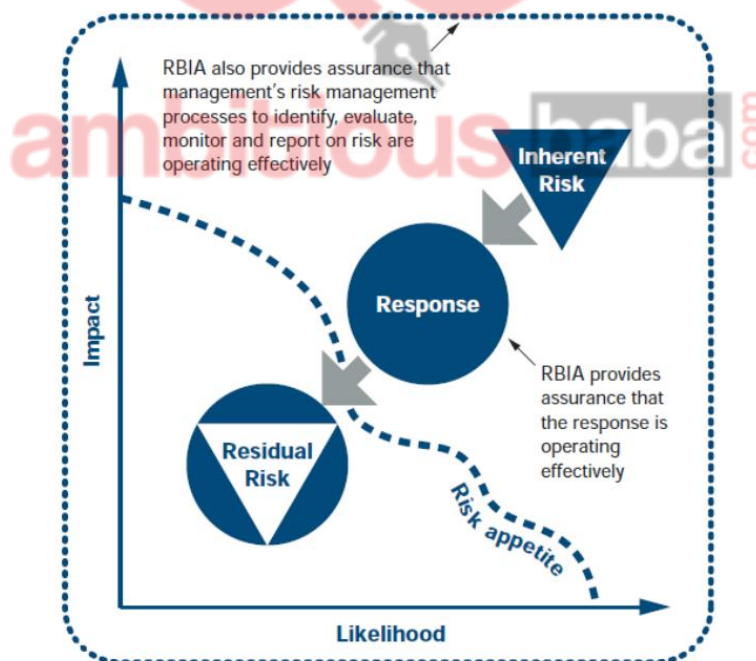
'**Notes to Accounts**' should be shown - **Schedule 18**

### **Role Of Risk Based Internal Audit (RBIA) And Inspection**

- Definition –The Institute of Internal Auditors defines risk based internal auditing (RBIA) as a methodology that links internal auditing to an organisation's overall risk management framework.
- RBIA allows internal audit to provide assurance to the board that risk management processes are managing risks effectively, in relation to the risks appetite.
- RBIA is not about auditing risks but about auditing the management of risk.

*Its focus is on the processes applied by the management team:*

- ✓ The responses to individual risks, and
- ✓ The processes used to assess risks, to decide on the responses to them, to monitor the responses and to report to the board



All banks shall adopt the Risk based Internal Audit approach in line with the RBI requirements for conduct of audit.

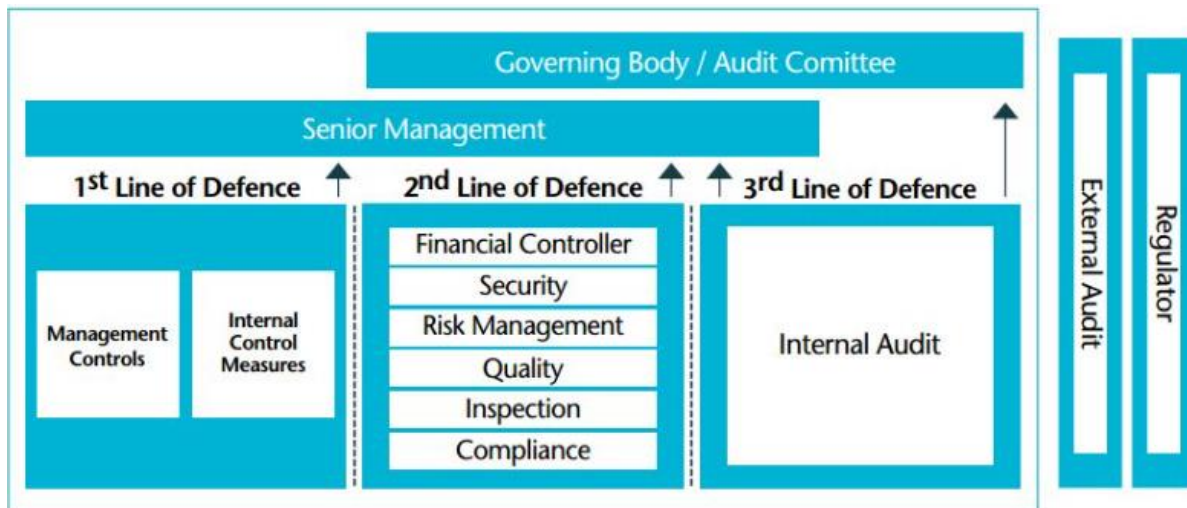
The objective of internal audit at the Bank is to examine the Bank's internal control environment including systems, procedures, governance, etc., and provide an assurance that these are adequate to mitigate risks.

**Objective:**

- ✓ Review potential inherent risks processes and controls instituted by the first and second line of defence to mitigate them.
- ✓ Review the systems to ensure compliance with legal and regulatory requirements.
- ✓ Identify deficiencies in control environment and monitor closure of action items
- ✓ Provide assurance to the Board and top management about the adequacy and effectiveness of the risk management and control framework in the Bank's operations.
- ✓ To strengthen controls and checks to enhance efficiency in the Bank's operations;
- ✓ To ensure that the instructions and various internal policy guidelines from time to time are adhered to;
- ✓ To verify whether there is any dereliction of duty on the part of any of the employees;
- ✓ To verify whether there is any transgression of power at various operational levels;
- ✓ To examine the working of the branch/access points from the point of view of vulnerability and susceptibility to frauds and suggest measures to prevent the same;
- ✓ To help in adhering to prescribed systems and procedures, prevention or timely detection and rectification of lapses/irregularities;

**Line Of Defence Risk:**

- The Board of Directors and Senior Management of financial entities have the primary responsibility to approve a suitable business strategy and ensure prudent risk management in accordance with the risk bearing capacity.
- The governance & assurance functions have to act as strong internal lines of defense.
- RBI has focused on strengthening these internal defenses by uploading the supervisory instructions.



### Principles Relevant to the Internal Audit Function Principle

- **Principle 1:** An effective internal audit function provides independent assurance to the board of directors/ its committee and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, thereby helping the board and senior management to protect their organisation and its reputation.
- **Principle 2:** The bank's internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.
- **Principle 3:** Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank's internal audit function.
- **Principle 4:** Internal auditors must act with integrity.
- **Principle 5:** Banks should have an internal audit policy that articulates the purpose, standing and authority of the internal audit function within the bank in a manner that promotes an effective internal audit function.
- **Principle 6:** Every activity (including outsourced activities) and every entity of the banking group should fall within the overall scope of the internal audit function.
- **Principle 7:** The scope of the internal audit function's activities should ensure adequate coverage of matters of regulatory interest within the audit plan
- **Principle 8:** Banks should have a permanent internal audit function. While some audit assignments may be performed using external experts, responsibility still lies with the internal audit function.
- **Principle 9:** The Audit Committee of the Board should oversee the bank's internal audit function.
- **Principle 10:** The Board and/or Audit Committee should oversee the internal audit function on all matters related to the performance of its mandate as described in the internal audit policy.

- **Principle 11:** The Head of Internal Audit is responsible for ensuring that the internal audit function complies with sound internal auditing standards and with a relevant code of ethics (integrity, objectivity, confidentiality and competency).
- **Principle 12:** The internal audit function should independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes created by the business units and support functions and provide assurance on these systems and processes.
- **Principle 13:** The bank's board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate, effective and efficient internal control system and, accordingly, the board should support the internal audit function in discharging its duties effectively.
- **Principle 14:** Regardless of whether experts are hired on contractual basis for internal audit purpose, the board of directors remains ultimately responsible for the internal audit function.
- **Principle 15:** To facilitate a consistent approach to internal audit across all the banks within a banking organisation, the board of directors of each bank within a banking group or holding company structure should ensure that either:
  - ✓ Every banks has its own internal audit function, which should be accountable to the bank's board and should report to the banking group or holding company's head of internal audit; or
  - ✓ the banking group or holding company's internal audit function performs internal audit activities of sufficient scope at the bank to enable the board to satisfy its fiduciary and legal responsibilities.
- **Principle 16:** The bank should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

### **Assurance over Fraud Risk Controls**

Every year crores of rupees are lost to frauds. Often fraud occurs because of poorly designed controls and weak governance undermining the organisation's processes.

- Organisations should have robust internal control procedures to limit the risk of fraud, and internal audit's role is to assess the controls.
- The risk of fraud should be included in the audit plan and each audit assignment to evaluate the adequacy of anti-fraud controls.
- The Head Internal Audit should consider how the risk of fraud is managed across the organisation and assess the fraud risk exposure periodically.

***Operationally, internal audit should have sufficient knowledge of fraud to:***

- Identify red flags indicating fraud may have been committed
- Understand the characteristics of fraud and the techniques used to commit fraud, and the various fraud schemes and scenarios.
- Evaluate the indicators of fraud and decide whether further action is necessary or whether an investigation should be recommended.
- Evaluate the effectiveness of controls to prevent or detect fraud.

### ***Internal auditors should not investigate fraud:***

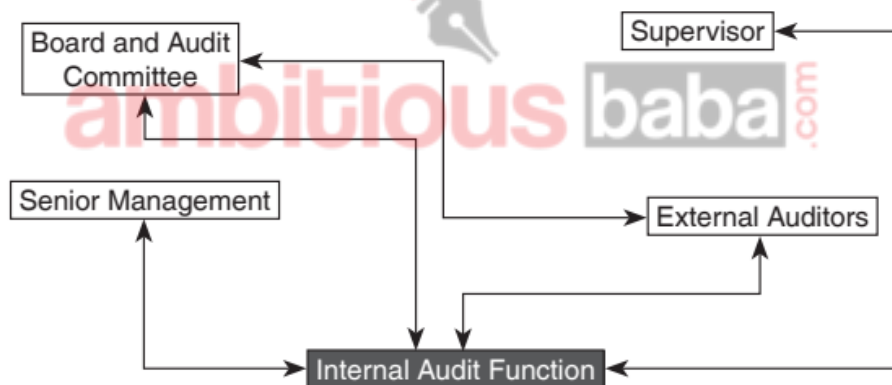
- Unless they have the specific experience and expertise required to do so.
- Conflict of interest should also be avoided, as internal audit is also tasked with evaluation of fraud control framework.

**Formulate and document appropriate** plans for each assignment, including the assignment's objectives, scope, timing, and resource allocation.

- The overall approach of the audit should be risk based (Risk Based Internal Audit – RBIA)
- The conduct of the internal audit should be supervised by the HIA to ensure that objectives are achieved, quality is assured, and staff is developed
- Compliance should be monitored, and sustenance of compliance should be an integral part of reporting to the Board/ACB.
- All pending and high risk and medium risk should be reported to the Board/ACB in order to highlight key areas in which risk mitigation has not been undertaken despite risk identification
- If the internal audit reveals that bank management has accepted a level of risk that may be unacceptable to the bank, the HIA should discuss the matter with senior management. If the issue is not resolved, it may be escalated to Board/Committee.

## Risk Based Internal Audit

Internal Audit Function – Linkages



### **Roles and Responsibilities**

#### **Board of Directors:**

- The Board of Directors of the Bank shall have overall responsibility to ensure internal audit function is properly positioned, staffed and resourced so that it can carry out the assigned duty independently, objectively and effectively.

- It should respect and promote the independence of the internal audit function by ensuring that internal audit reports are provided to the board or its audit committee without management filtering and that the internal auditors have direct access to the board or the board's Audit Committee.
- The Board shall delegate its powers for the conduct of internal audits, implementation of an internal audit framework and review of policies/processes/systems/controls and the review of the effectiveness of implementation of an internal audit framework to the Audit Committee of the Board.

#### **Audit Committee of the Board:**

- The Audit Committee of the Board shall
- Be chaired by a person who is independent and is not the chair of the board.
- Include members who have experience in audit practices, financial reporting and accounting. Be responsible for framing policy on internal audit and financial reporting, among other things;
- Oversee the financial reporting process; provide oversight of and interact with the bank's internal and external auditors;
- Formulate and recommend to the board for their approval, the appointment, remuneration and dismissal of external auditors;
- Review and approve the audit scope and frequency;
- Receive key audit reports and ensure that senior management at Corporate Office and the Officials working in Branches & other related Offices are taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors and other control functions;
- Oversee the establishment of accounting policies and practices by the bank;
- Review the design and effectiveness of the overall risk governance framework and internal control system.
- Review the annual financial statement of the Bank along with Management Letter which is the letter to the shareholders before it is approved by the Board of Directors;

#### **The role of the audit committee shall also include the following:**

- It should provide direction and oversee the operations of the total audit function in the bank and maintain quality of internal audit and inspection.
- Follow up on the statutory audit of the bank and inspection of the Reserve Bank
- Strengthening housekeeping.
- Fixing accountability of inspecting/auditing officials for failure to detect serious irregularities.
- Periodical review of the accounting policies/internal control systems in the bank with a view to ensuring greater transparency in the bank's accounts.
- Sensitizing the Board about risk prone areas.
- **Review of Risk management measures to mitigate the risk.**

- The audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.
- The audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary

### **Head Internal Audit (HIA)**

- **To bring uniformity in approach followed by the banks, as also to align the expectations on Internal Audit Function with the best practices, RBI advised all banks on January 07, 2021 as under:**

#### **Authority, Stature and Independence:**

- The internal audit function must have sufficient authority, stature, independence and resources within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.
- Accordingly, the Head of Internal Audit (HIA) shall be a senior executive of the bank who shall have the ability to exercise independent judgement.
- The HIA as well as the internal audit function shall have the authority to communicate with any staff member and have access to all records or files that are necessary to carry out the entrusted responsibilities.

#### **Competence:**

- Requisite professional competence, knowledge and experience of each internal auditor is essential for the effectiveness of the bank's internal audit function.
- The desired areas of knowledge and experience may include banking operations, accounting, information technology, data analytics and forensic investigation, among others.
- Banks should ensure that internal audit function has the requisite skills to audit all areas of the bank.

#### **Staff Rotation**

- Except for the entities where the internal audit function is a specialised function and managed by career internal auditors, the Board should prescribe a minimum period of service for staff in the Internal Audit function.
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- The Board may also examine the feasibility of prescribing at least one stint of service in the internal audit function for those staff possessing specialised knowledge useful for the audit function, but who are posted in other departments, so as to have adequate skills for the staff in the Internal Audit function.

#### **Tenor for appointment of Head of Internal Audit:**

- Except for the entities where the internal audit function is a specialised function and managed by career internal auditors, the HIA shall be appointed for a reasonably long period, preferably for a minimum of 3 years.

### Reporting Line:

- The HIA shall directly report to either the Audit Committee of the Board (ACB)/ MD & CEO or Whole Time Director (WTD).
- Should the Board of Directors decide to allow the MD & CEO or a WTD to be the 'reporting authority' of the HIA,
  - ✓ Then the 'reviewing authority' shall be with the ACB
  - ✓ 'Accepting authority' shall be with the Board in matters of performance appraisal of the HIA.
- Further, in such cases, the ACB shall meet the HIA at least once in a quarter, without the presence of the senior management, including the MD & CEO/WTD.
- The HIA shall not have any reporting relationship with the business verticals of the bank and shall not be given any business targets.
- In foreign banks operating in India as branches, the HIA shall report to the internal audit function in the controlling office/head office.

### Remuneration:

- The independence and objectivity of the internal audit function could be undermined if the remuneration of internal audit staff is linked to the financial performance of the business lines for which they exercise audit responsibilities.
- Thus, the remuneration policies should be structured in a way that it avoids creating conflict of interest and compromising audit's independence and objectivity.

### Offsite Audit

- Offsite Audit vertical within the Internal Audit Department for offsite monitoring of certain transactions/ activities at branches/offices/BUs.
- The tasks for offsite monitoring team can be added/modified based on new issues arising and based on feedback from field auditors
- For carrying out these tasks the Team will be provided with read-only access to the MIS databases and other systems to enable them to query the required data using tools like SQL, etc.
- The Offsite Audit Team will support on-field branch banking auditors and Banking Unit auditors with the necessary reports/inputs that may be required.

### Information System (IS) Audit within the Internal Audit Department

- The scope of IS Audit covers all information systems used by the bank in related activities, viz., system planning, organisation, acquisition, implementation, delivery and support to end-users.
- The scope also covers monitoring of implementation in terms of its process effectiveness, input/output controls and accomplishments of system goals.

- The IS Audit scope includes testing on the processes for planning and organizing the information systems activities and the processes for monitoring those activities
- **The Concurrent Audit**, is responsible for satisfactory implementation of the Concurrent Audit system of the Bank, including review and reporting of observations noted during the audit and their timely compliance.
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