

Financial services risk insights

Long form audit report: Implications on
bank governance Volume I

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Background

The Indian economy has been experiencing two specific problems. Weakening corporate balance sheets and bank balance sheets along with the COVID-19 pandemic has only accelerated the pace of decay. The spike in the number of banking frauds, which is also highlighted in the RBI Annual Report for the period 2019-20, is an indication of the rising vulnerabilities of the financial system. The regulators have been focusing their effort in addressing these vulnerabilities by empowering governance functions within different banks to meet the increased expectations. This regulation around revamping the structure of the long form audit report (LFAR) is an attempt to enhance the governance around the aspects covered in the LFAR and increase the accountability of the banks' management.

The same LFAR format has been in existence for close to 18 years and this regulation makes the format contemporary to incorporate the current complexities of the banking system. While the mandate and scope of the audit will be as per the revised format, the statutory auditor can consider material additions with specific justifications and prior approval of the bank's audit committee. Also, copy of the LFAR is to be forwarded to the Senior Supervisory Manager (SSM) in the Department of Supervision, RBI within 60 days of submission by the statutory auditors. The statutory auditors through the LFAR are expected to comment on a whole range of themes within the banking environment. The banks would need to mirror the effective monitoring of the same themes within their governance functions for a smooth conclusion of the statutory audit.



Understanding key themes

As the focus will be on the effectiveness of the governance functions, such as compliance, risk management and internal audit, banks will have to focus on the following to help statutory auditors perform an independent reviews:

Quality assurance review by the banks around the effectiveness of their governance functions, such as compliance, risk management and internal audit, will help statutory auditors assess the effectiveness of the same.



Banks should carry out a strategic risk assessment exercise to identify risks applicable to them, over and above the operational risk assessment exercises already conducted by them.



Assess control culture, amongst other things, to determine the audit strategy for the bank. Risk culture reviews could essentially serve as a useful alternative.



Effectiveness of the entire credit life cycle by generating concurrent audit reports covering all control effectiveness aspects from origination to collection/recovery in the credit domain, could help determine the effectiveness of the credit function. It might be useful for banks to align the asks from a credit risk standpoint to the concurrent audit report. A mapping of the LFAR requirements to the concurrent audit report should be done.



Requirements around market risk are already covered as a part of treasury concurrent audit and may continue to serve as a good alternative to assess the effectiveness of the market risk function of the bank.



Governance functions, such as risk, compliance and audit, are expected to demonstrate comprehensive coverage of all the risks within the organisation to form an independent view. There is an enhanced focus on risk and compliance cultures. Banks would need to have specific thematic reviews around the same.



Effective fraud management framework developed by the organisation, with a defined set of criteria and approved by the board. The framework should also be subject to an annual review to enhance the set of criteria based on the changing products/services. This could help the statutory auditors understand the efforts made by the bank to manage frauds.



Focus on know your customer and anti-money laundering will continue and the concurrent audit reports may serve as good alternatives for the same.



Data integrity is an important area of focus. The audit plans of the banks would need to be augmented to specifically conduct audits around the same.



While requirements around capital adequacy and Internal Capital Adequacy and Assessment Procedures (ICAAP) are also mentioned, they are more important to assess the solvency of the bank. This would continue to be an area of focus and banks should continue to do what they have been doing, going forward as well.



Strong cyber security oversight framework would be the focus given the IT and cyber security risks around digitalisation of businesses. Banks would need to conduct a comprehensive review of the cyber security framework to provide inputs to the statutory auditors for providing assurance.



Oversight over outsourced activities has been added in the framework for LFAR that banks already have been deeply invested in. They should continue to provide the vendor audit reports to the statutory auditors, for providing assurance about outsourced processes through the LFAR.





Additionally, there is a focus on certain aspects below, which are also covered and included in the banks concurrent audit scope areas. Wherever they are not included, banks should focus on revising the scope of work. It would be worthwhile for banks to conduct a mapping of the concurrent audit scope of work and LFAR.



Reconciliation, balancing of books and write offs of unreconciled entries



Suspense account monitoring



Cash and other security items monitoring



Off-balance sheet exposure monitoring



Conduct risk assessment especially around complaints and mis-selling



Oversight mechanism over the subsidiaries/ joint ventures/associates of the bank



Compliance with Depositor Education and Awareness Fund (DEAF) norms



All accounting and provision related aspects

From a branch perspective, the same themes as captured above have been re-iterated in the RBI guidelines. This is to ensure that all the banks adhere to the requirements irrespective of the level of decentralisation.

Conclusion

The document attempts to set out the key new aspects that the banks need to factor in for providing stronger evidences to statutory auditors, as they provide assurance through the LFAR. It would be worthwhile for banks to undertake a

mapping exercise of the LFAR requirements with their internal risk management, compliance, audit and the concurrent audit plans to ensure that all the LFAR asks are addressed through the governance forums.

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References

- RBI Circular – Long Form Audit Report – Review dated September 05, 2020
- Authors Analysis basis experience in the Governance, Risk Management and Compliance function in the Banking domain

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