Audit of Banks and Financial Institutions (FI)

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Background

"Banking is such a unique industry where you do not want your competitor to fail."

Banks and Financial Institutions (FIs) play a central role in the economy. They hold savings of public, provide a means of payment for goods & services, finance the development of business and trade.

Therefore, Banks and FIs must command the confidence of the public and those with whom they do business. Thus stability of the banking and financial systems, both nationally and internationally, recognized as a matter of general public interest.

Background

As a result, naturally, <u>stakeholders' expectation from external or statutory auditors of a bank and FI is much higher than audit of another entity</u>.

From local view points, a number of high profile fraud/scam took place in recent years involving a number of Banks and FIs in Bangladesh.

Many such fraud/scams took place due to the absence of robust risk management, internal control and internal audit function in those banks. In some cases, although these functions were present but it failed to operate effectively.

Background

Aftermath of these scams/irregularities, as usual, along with others, criticisms were also directed towards auditors of those banks/FIs.

Unfortunately, many of these criticisms towards auditors were driven by emotion, and not by the fact. As a result, instead of constructive feedback/ criticism that could have assisted auditor to improve their quality, these were turned out to be wholesale abuse and at times finding a scapegoat.

Having said that, it is also imperative to note that as per the local regulations, roles and responsibilities of an auditor of Bank/FI are far greater than what is in place in other countries.

Additional risk factors for Bank /FI audit

- Custody of large amount of monetary items
- Assets that can rapidly change in value
- Operate with high leverage (capital to assets)
- Short term deposit, solvency, liquidity issue
- Complex accounting and IT systems
- Assume significant commitments
- Wide spread of branches and departments
- Highly regulated with strict enforcement
- Cross border involvement and FX issue

Scope of an audit of a Bank/FI

As per the current legislation in place, an auditor of a Bank/FI shall conduct the audit in compliance with the following major requirements:

- Bangladesh Standards on Auditing;

- The Companies Act, 1994;

- The Bank Company Act 1991 (as amended in 2013) for Banks and the Financial Institutions Act, 1993 for FIs;

- Specific regulations issued by Bangladesh Bank (e.g. Prudential Guidelines for Banks and FIs); and

- Bangladesh Securities and Exchange Commission Rules and Regulations (if applicable).

Bangladesh Standards on Auditing (BSA)

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements of the Bank/FI. The procedures selected includes assessment of the risks of material misstatement of the financial statements of the Bank/FI, whether due to fraud or error.

In making those risk assessments, **<u>auditor considers internal control relevant to Bank/FI's preparation of financial statements in order to design audit procedures that are appropriate in circumstances , but not for the purpose of expressing an opinion on the effectiveness of those internal control</u>**.

Bangladesh Standards on Auditing (BSA)

An audit also includes evaluating appropriateness of accounting policies used and reasonableness of accounting estimates.

Based on these, the auditor provides an opinion as to whether, **the financial statements of the Bank/FI give a true and fair view of the financial position of the Bank/FI at year-end and of its financial performance and cash flows for the year then ended in accordance with Bangladesh Financial Reporting Standards (BFRS)**.

It is worthwhile to note that some guidelines of Bangladesh Bank are quite different to BFRS.

The Companies Act 1994

As per Section 213, paragraph 2 of the Companies Act, 1994 an auditor shall, amongst other inquire about the following:

(a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members:

(b) Whether transactions of the company which are represented merely as book-entries are prejudicial to the interests of the company;

The Companies Act 1994

(c) If the company is not an investment company or a banking company, whether any assets of the Company comprising of shares, debentures and other securities, have been sold at a price less than at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account; and

(f) If any shares have been allotted for cash, whether cash has actually been received, and if no cash has actually been so received, whether the position as stated is correct, regular and not misleading.

The Companies Act 1994

As per para 4, the auditor’s report shall state;

(a) whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purposes of his audit;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him; and

(c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

The Bank Company Act 1991

As per Section 39, Para 3 of the Bank Company Act 1991, as amended in 2013, in addition to the requirements of Section 213 of the Companies Act 1994, an auditor of a Bank shall also state the following matters in his/her report:

- Financial statements of the Bank have been drawn up in conformity with prevailing rules, regulations and accounting standards as well as related guidance issued by Bangladesh Bank;
- Adequate provisions have been made for advance and other assets which are in our opinion, doubtful of recovery;

The Bank Company Act 1991

- The records and statements submitted by the branches have been properly maintained and consolidated in the financial statements;
- The information and explanations required by auditors have been received and found satisfactory;
- Capital Adequacy Ratio (CAR) as required by the Bangladesh Bank has been maintained adequately during the year;
- Minimum coverage of risk-weighted assets during the course of audit; and
- Any other matter which need to be brought to the attention of shareholders.

The Bank Company Act 1991

The following additional reporting requirements have been inserted through amendment in 2013, where an auditor is also suppose to report on:

- **Adequacy of internal audit, internal control and risk management related process**;
- **Any fraud/forgery, irregularities or administrative error or anything harmful for the Bank committed by the officer-staff of the bank or its associated entity came to the attention of the auditor; and**
- **If applicable, whether subsidiary company has been audited and properly consolidated**.

The Bank Company Act 1991

Paragraph 4 of section 39 also requires an auditor of a Bank to report on the following matters immediately to Bangladesh Bank:

- ***Any serious violation of the Bank Company Act 1991***;
- Due to loss, capital of entity came down below 50%;
- ***Any other serious non compliance occurred***, including doubt on repayment of due to creditors; and
- There is doubt whether assets are adequate to meet demand of creditors.

The Financial Institutions Act 1993

As per Section 24, paragraph 6 of the Financial Institutions Act 1993 an auditor shall inform Bangladesh Bank, if

- ***There has been serious violation or non-compliance of the FI Act 1991 or a criminal offence took place due to fraud or dishonesty***;
- Due to loss, capital of entity came down below 50%;
- ***Any other non compliance occurred***, including doubt on repayment of due to creditors; and
- There is doubt whether assets are adequate to meet demand of creditors.

The Financial Institutions Act 1993

As per FID Circular 03 dated 02 March 1999, an auditor of an FI shall also state the following matters in his/her audit report:

- **Financial statements of the FI have been drawn up in conformity with prevailing rules, regulations and accounting standards as well as related guidance issued by Bangladesh Bank;**

- **Whether adequate provisions have been made for advance and other assets which are in auditors opinion, doubtful of recovery;**

- **The records and statements submitted by the branches have been properly maintained and consolidated in the financial statements; and**

The Financial Institutions Act 1993

- **The information and explanations required have been received and found satisfactory.**

The same FID circular also requires an auditor to give ***<u>specific focus and make observation on the following matters</u>***:

- Whether internal control of the FI is in all respect and to prevent fraud-forgery;
- Whether require policy and procedures have been followed for disbursement of loans and leases;
- Whether required instructions of Bangladesh Bank have been followed for classification of loans and leases, provisioning and profit/interest in suspense;

The Financial Institutions Act 1993

- Whether there are any mismatch on maturity of assets and liabilities and its potential impact on liquidity;
- Whether there has been any irregularities adopted to increase profit;
- Whether proper steps have been taken to rectify irregularities highlighted by Bangladesh Bank inspection team.
- Whether various circulars issued from other departments of Bangladesh Bank have been followed properly; and
- Whether internal policies have been properly followed.

Critical matters of the Bank Company Act

Section	Title
10	Disposal of non-banking assets
13	Maintenance of Capital
14	Regulation on authorized, subscribed and paid-up capital and voting rights
14 A	Restriction on holding of shares
14 B	Significant Share holder
15 (9)	Number of director and independent director
15 (10)	Number of directors from individual family
15 AA	Term of Managing Committee
15 B	Role of committee
15 C	Internal Audit and Control
18	Submission of related party information

Critical matters of the Bank Company Act

Section	Title
19	Restriction on commission, brokerage, discount etc. on sale of shares
22	Restrictions on the payment of dividends
23	Restriction on holding directorship
24	Statutory Reserve
25	Maintenance of CRR & SLR
26 A	Holding share of any other company
26 B	General Limitation for credit line
26 C	Transaction with the related person
27	Restriction on loans and advances
28	Restriction on waiver of loans

Critical matters of the Bank Company Act

Section	Title
28	Restriction on waiver of loans
32	Opening or transferring of business center
33	Maintenance of liquid assets
34	Assets in Bangladesh (Loan Deposit Ratio)
35	Unclaimed deposits and valuables
36	Half yearly report
38	Accounts and balance sheet
40	Submission of reports
42	Display of audited balance sheet

Prudential Guidelines for Banks

CAPITAL ADEQUACY OF BANKS
LOAN CLASSIFICATION AND PROVISIONING
SINGLE BORROWER EXPOSURE
RESCHEDULING OF LOANS
LOAN WRITE-OFF
CORPORATE GOVERNANCE IN BANK MANAGEMENT
FORMATION OF BOARD OF DIRECTORS
RESPONSIBILITIES AND AUTHORITIES OF BOARD
RESPONSIBILITIES OF THE CHAIRMAN OF BOARD
FORMATION OF COMMITIES FROM THE BOARD
EXECUTIVE COMMITTEE
AUDIT COMMITTEE
RISK MANAGEMENT COMMITTEE

Prudential Guidelines for Banks

APPOINTMENT AND RESPONSIBILITIES OF CEO
APPOINTMENT OF ADVISOR AND CONSULTANT
RESTRICTION ON LENDING TO DIRECTORS
INTEREST RATES ON DEPOSIT AND LENDING
OPERATION OF SPECIAL NOTICE DEPOSIT (SND)
BANK CHARGES
MANAGING CORE RISKS IN BANKING
CREDIT RATING
CREDIT RISK GRADING MANUAL
CONSUMER FINANCING AND S E FINANCING
PROHIBITION ON BANK LOAN FOR LAND PURCHASE
ACCEPTANCE AND PURCHASE OF INLAND BILL
GUIDELINES ON ISLAMIC BANKING

Prudential Guidelines for Banks

MAINTAINING ADEQUATE SECURITY OF LOCKERS
DISCLOSURE REQUIREMENTS FOR BANKS
MAINTENANCE OF DEFFERED TAX ACCOUNTS
PURCHASES OF FIXED ASSETS AND ACQUISITION OF IMMOVABLE PROPERTIES
AVOIDANCE OF HIGH EXPENSE FOR LUXURIOUS VEHICLES AND DECORATION
ESTABLISHMENT OF BUSINESS CENTERS
MEASURES TO ENSURE SAFETY OF THE VAULTS
BANKING SERVICES AT CUSTOMER PREMISES
DURATION OF MATERNITY LEAVE FOR FEMALE BANK EMPLOYEES
AGE LIMIT FOR BANK-JOB APPLICANTS
BANK DEPOSIT INSURANCE SCHEME

Assessment of Risk Management

In addition Bangladesh Bank has also issued guidelines on risk based capital adequacy, stress testing and managing the banking risks in the following six core areas:

Internal Control and Compliance Risk
Foreign Exchange Risk
Credit Risk
Asset Liability Management Risk
Money Laundering Risk
ICT Security Risk

An auditor of a Bank need to review compliance of these guidelines by that Bank.

Effective audit

It is very important to note the fact that the quality of the external auditor's opinion would also be influenced by multiple elements, notable amongst those are the proper observance of various roles and responsibilities of not only external auditors but the following parties as well:

- the Bank's Board of Directors;
-the Bank's Management; and
- the supervisor (i.e. B Bank) and other regulators

Therefore, commitments from all stakeholders required.

Example of overseas audit report - UAE

As required by the UAE Federal Law No. 8 of 1984 (as amended), we further confirm that we have obtained all Information and explanations necessary for our audit, that proper financial records have been kept by the Group, and the contents of the Director's report which relate to these consolidated financial statements are in agreement with the Group's financial records. We are not aware of any violation of the above mentioned Law and the Articles of Association having occurred during the year ended 31 December 2013, which may have had a material adverse effect on the business of the Group or its financial position

Overseas audit report - Germany

In our opinion, based on the findings of our audit, the consolidated financial statements comply in all material respects with IFRSs as adopted by the EU, the supplementary requirements of German commercial law pursuant to § 315a Abs. 1 HGB and full IFRS and give a true and fair view of the net assets and financial position of the Group as of December 31, 2013 as well as the results of operations for the business year then ended, in accordance with these requirements.

Overseas audit report – Germany (cont.)

Report on Management Report

In our opinion, based on the findings of our audit of the consolidated financial statements and group management report, the group management report is consistent with the consolidated financial statements, and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development

Example of overseas audit report - UK

Opinions and conclusions arising from audit

Auditor’s assessment of the risks of material misstatement and response

Application of materiality and an overview of the scope of the audit

How Auditor scoped their audit

Auditor’s opinion on other matters prescribed by the Companies Act 2006 is whether unmodified

Is there anything to report in respect of the matters on auditors is required to report by exception

Conclusion – Quality has a cost

In million	INR	PKR	EUR	USD	USD
Total assets	23,959,816	1,549,659	1,611,400	2,671,318	674,380
Net profit	155,963	16,071	681	17,800	4,200
Audit fee	1,683	25	69	45	14
Audit fee % of total assets	0.007%	0.002%	0.004%	0.002%	0.002%
Audit fee as a % of net profit	1.01%	0.2%	10%	0.25%	0.33%

Conclusion – Quality has a cost

BDT Million	Bank A	Bank B	Bank C	Bank D
Total assets	213,738	153,585	116,300	248,670
Net profit	11,770	1,928	962	3,115
Audit fee	1.1	0.7	1.5	2.9
Audit fee as a % of total assets	0.0005	0.0005	0.0013	0.0012
Audit fee as a % of net profit	0.0093	0.036	0.155	0.093
Applying the lowest % (0.002%) on total assets	4.3	3.1	2.3	5.0
Applying the lowest % (0.2%) on net profit	23.5	3.9	1.9	6.2

Floor Discussions

Questions and Answers Sessions