

**REPORT OF THE WORKING GROUP
TO REVIEW
THE ORGANISATIONAL SET-UP
OF THE INSPECTION DEPARTMENT
AND
METHODOLOGY OF INSPECTIONS ETC.**

**RESERVE BANK OF INDIA
CENTRAL OFFICE
MUMBAI**

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EXECUTIVE SUMMARY

1.0. Introductory

1.1 A Working Group was set up under the Chairmanship of Shri B.S. Sharma, presently Executive Director, to undertake a review of, and make recommendations regarding, the Organisational Set-up of the Inspection Department (including staffing pattern) and Methodology of Inspection and Coverage of Areas, etc. While attending to this task, the Working Group has taken into account the valuable views and suggestions received from certain CGMs in-charge of Offices/Departments, as also the information and material received from a few well-known foreign Central Banks.

2.0. General observations regarding the Role and Objectives etc. of the Inspection and Audit Function

2.1 An effective internal control system is critical for the management and monitoring of banking operations and helps in achieving the goals and objectives of the Organisation, building up of reliable financial and managerial information base and optimising performance levels. The main objectives of internal control process have been categorised as: (a) efficiency and effectiveness and operations, and (b) compliance with applicable laws and regulations. According to the "Inter Agency Policy Statement on the Internal Audit Function and its Outsourcing" brought out by the Federal Reserve

System, "Effective internal control is a foundation for the safe and sound operation of a banking institution and when properly structured and conducted, provides vital information about weaknesses in the system so that management can take prompt remedial action."

The Inspection and Audit Sub-Committee of the Central Board, constituted in 1992 by the Board, has been functioning as an Advisory Body and reviewing the Inspection and Audit Reports and their compliance, besides giving a sharper focus to the internal audit and inspection exercises. Such apex level monitoring by the Bank's Board of Directors truly reflects the great importance accorded to Inspection and Audit function and augurs well for monitoring the high standards of performance and efficiency of this national level institution.

3.0 Types of Inspections and Audit, Periodicity thereof and Coverage of Areas, etc.

3.1 The following Inspections/Audits are conducted by the Inspection Department : (a) Systems and Staffing Inspection, (b) Annual Inspection, (c) Performance/Management Audit and (d) Special Assignments (Special Studies/Investigations at the instance of the Top Management).

During inspections, great deal of emphasis is attached to matters like general administration and discipline, security

arrangements, house-keeping, customer service, economy in expenditure, upkeep of the premises and records management. Staff requirements are assessed on the basis of the workload and output indicators fixed by the Bank. There are a few common observations having a bearing on matters like deployment of Leave/Trainee Reserves, Punctuality and Attendance, Discipline and Vigilance, Economy in Expenditure, House-keeping, Record Management, Customer Service, Security Arrangements, Supervision and Control and Operational Deficiencies which generally find place in almost all Inspection Reports.

Inspection Reports provide fairly accurate profiles of Offices/Departments and form eyes and ears of the Top Management. Against the backdrop of a changing scenario in the financial sector reforms, there is a need for changing the focus of the Inspection/Audit from mundane/routine matters to the Management Audit because of the emphasis placed by the Bank on the role and functions of CGMs/GMs in-charge of Regional Offices by redesignating them as Regional Director, and greater delegation of powers to them to dispose of matters at the local level. The Message and Thinking of the Top Management should percolate down, especially among those entrusted with the inspection and audit management. Several items of Inspection/Audit Review should be excluded from the purview of the Inspection and may be looked into by the Regional/Central Audit

Cells (RACs/CACs) on sample basis. There is a high degree of probability that the findings based on a randomly generated sample selection can be generalised for various transactions. The RACs/CACs may be strengthened suitably by placing them under the charge of DGM (in place of AGM) with Gr. 'B' Officers (instead of Gr. 'A' Officers) working in the Team. Inspection should, on the other hand, concentrate only on these high risk-prone areas where major irregularities/deficiencies have been highlighted by the RACs/CACs. Besides, it should pay greater attention to the Management Audit and other crucial areas as also new emerging areas, where risk to the Bank is higher. The basic objective of Management Audit should be to evaluate managerial practices and managerial actions on the basis of certain objective standards to ensure optimum utilisation of the available resources and infrastructure.

3.2 The Working Group has taken a look at the system of assessing various kinds of risks faced by certain Central Banks and the controls and audits operated by them. Any control against loss has a cost. It has, therefore, been emphasised that the strongest and most expensive controls should be directed at the most risky operations. Inspection and Audit Resources, accordingly, need to be directed primarily at the systems where the risks are high.

3.3 The Working Group has suggested that on the analogy of the system prevailing in some of the Central Banks, Inspection

Department may devise a system to maintain a Risk Data-base for Regional Offices and for each Central Office Department separately as a means of ranking audits in terms of the risks they address. To concretise and implement the suggested methodology, a Workshop may be held to facilitate brain-storming sessions, with involvement of an expert in this field.

3.4 As per the practice in some of the Central Banks, a "Control Self-Assessment Audit" may be conducted particularly by the sensitive Departments which are prone to great risks, with the help of the Inspecting Officers/Auditors.

3.5 Electronic Information Systems and the use of Information technology have risks that must be effectively controlled in order to avoid disruptions to business and potential losses. This area needs to be given added attention during Inspection/Audit.

3.6 Whenever specialists activities are to be inspected/audited, there will be need for multi-disciplinary audit teams. For this purpose, Inspection Department may consider constituting a panel of suitable Officers who are conversant with back-up, compliance and Computer system, as also Officers from ECD/DBS who are experienced in inspecting dealing rooms of commercial banks.

3.7 Due to the proposed dilution of the areas of Inspection/Audit and exclusion of routine/mundane matters, the frequency of

inspections could be improved and each office inspected once in a year and a Central Office Department once in two years or so.

4.0 Format of the Inspection Report

4.1 It is important to present the Inspection findings in a cogent, concise, focused and pithy manner, conducive to prompt decision-making and meaningful outcome.

4.2 The Inspection should define their priorities separately for each Department/Office, depending on the major areas of work handled and peculiar features, if any, of that Office/Department and lay more emphasis on what has actually been achieved in those areas, with greater objectivity. The Reports on Specialised Departments should primarily focus on the operational areas of specialisation. Overlaps in Inspection and Audit Reports could be avoided. The focus in the Inspection Report should be on rectification of systemic defects. It should be fair and objective with stress on “fact-finding” rather than “fault-finding” mission. It should combine critical evaluation as well as positive and constructive aspects, achievements as well as irregularities and serious shortcomings.

5.0 Compliance with the Inspection/ Audit Report

5.1 The Inspection and Audit Sub-Committee of the Central Board has been closely reviewing the compliance of Inspection and Audit Reports at periodical intervals. Besides, the EDs’ Committee has also been monitoring implementation of outstanding paragraphs.

Concerted efforts need to be made and pressure exerted on Officers/Departments so that there is no let-up in the progress of follow-up. Further, what is important is quality of compliance and hence, a well experienced Officer should be entrusted with the task of monitoring compliance on a regular basis.

6.0 Review of Organisational Set-up and Staffing Pattern etc.

6.1 The calibre, capacity and competencies of the Officers posted to the Inspection Department and RACs/CACs are not always found to be of a high calibre or exceptional quality. Generally, there appears to be somewhat reluctance on the part of Officers to work in Inspection Department/RAC, maybe because of frequent tours involved.

6.2 In order to raise the quality of inspection, the Bank should ensure posting of energetic officers of high calibre, integrity and experience, there being also need for infusion of fresh blood with new ideas for overhauling the existing systems and procedures which have become outdated against the fast-changing scenario of high customer expectations and technological advancement.

6.3 Selections for posts to the Inspection Department may be done by a Committee consisting of ED in-charge of Inspection, ED (Administration) and CGM, Inspection Department. The Officers posted to Inspection Department/RACs/CACs may be paid a Special Allowance equal to the Faculty Allowance.

6.4 The HRDD/Training Division may identify appropriate training programmes for sharpening the skills of Inspecting Officers, and giving them preference in deputation to foreign training programmes. Specially tailor-made programmes may also be arranged, besides repeating the Programme to enable Inspecting Officers to conduct inspections under computerised environment.

6.5 For raising the quality of inspections and making them objective and meaningful, the posts of GMs heading Inspection Teams may be upgraded to CGM (i.e. Gr. 'F'), those of AGMs (Gr. 'C') of RACs/CACs to DGMs (Gr. 'D') and base-level i.e. S.O. Gr. 'A' to Gr. 'B'. As a consequence, the post of CGM (Gr. 'F') may be upgraded to ED's status or, if for any reason this is not feasible, on par with Principal Adviser (F+).

6.6 Two more RACs with two units each may be set up, one at Ahmedabad and the other at Bangalore by suitably regrouping the jurisdiction of RACs.

7.0 Miscellaneous/Other Incidental Matters

7.1 The Inspection Department may convene, on annual basis, a Conference of Inspecting Officers attached to Inspection Department/RACs/CACs for exchange of views/experiences to which the Top Management may be invited to give directions/advice, as also Statutory Auditors for promoting better understanding and coordination.

7.2 An Inspection/ Audit Manual may be brought out for use of the Inspecting Officers.

7.3 The Inspection Department may prepare a Data-base/Profile on each Office/Department having a bearing on important aspects like financial discipline, staff discipline, Industrial Relations, Customer Service and upkeep of premises, based on the last three years' Inspection/ Audit Reports.

CHAPTER - I
INTRODUCTORY

1.1 At the Ninth Meeting of the Inspection and Audit Sub-Committee of the Central Board held on 18th October 1995 at Thiruvananthapuram, in the context of the discussions on the Executive Summary of the Inspection Report on Ahmedabad Office, one of the Executive Directors had expressed a view that the very system and methodology of inspection needed to be examined as, in his view, the Inspection findings were not objective in nature and mostly routine and repetitive. The Chairman of the Inspection and Audit Sub-Committee, Shri Vipin Malik and Deputy Governor, Shri S.P. Talwar, had disagreed with this view and expressed their general/broad satisfaction over the overall functioning of the Inspection Department and also the quality/coverage of the Inspection Reports. DG(SPT) had, however, suggested that the following steps be taken for further improving the quality of Inspection Reports and proper presentation of the findings before the Sub-Committee :-

- (a) In addition to the Executive Summary of the Inspection Reports, all the major action paragraphs of the Inspection Reports may be listed out in serial order and the gist of compliance received from the Offices/Central Office Departments be furnished against each of them in a tabular form.
- (b) A small Group may be formed to review the coverage of inspections and Organisational Set-up of the Inspection Department.

1.2 The above suggestions were endorsed by the Chairman, Shri Malik who desired that action might be initiated on these points.

1.3 Accordingly, a small Working Group under the Chairmanship of Shri B.S. Sharma, then Chief General Manager, DAPM (now Executive Director) was set up, with Sarvashri M.K. Bandopadhyaya, then Principal, BTC, (now CGM, Inspection Department), S.R. Mittal, then CGM, Nagpur, (now CGM, DIT), H. Natarajan, the then CGM, IDM Cell (since retired on 31.1.1997) as Members, and K.S. Rao, GM, Inspection Department as Member-Secretary. The Terms of Reference of the Working Group were as under :-

To undertake a review of and make recommendations regarding :-

1) Organisational set-up

Present Organisational Set-up of the Inspection Department - its effectiveness - staffing pattern - need for change, if any.

2) Methods of working

Types of Inspection - periodicity thereof - Composition of teams
time-frame for inspections - need for change, if any.

3) Coverage of areas

Present position - its adequacy or otherwise and need for change or expansion.

4) Format of Inspection Report.

5) Any other matter which may be of relevance/incidental to the above terms of reference.

1.4 Owing to various reasons, including pre-occupation of some of the members, the Working Group could not meet. That apart, there were changes in the posting of some of the members as indicated in brackets above. Further, one of the members, Shri H. Natarajan had, as stated, retired from the Bank's service on 31st January 1997. He was replaced by Shri K.L. Khetarpaul, Addl. CGM, DBS, (MRO). Also, because of the pre-occupation of Shri K.S. Rao with conduct of inspections etc., his services could not be spared and he was replaced by Shri S.M. Khot, AGM, DAPM.

1.5 Changes in the composition of the Working Group apart, at that juncture, deliberations were already on, on the insightful and thought-provoking Paper titled "RBI - Towards Organisational Regeneration - A New Approach", prepared by DG(SPT). Thereafter, a Steering Committee under the Chairmanship of Shri V. Subrahmanyam, Executive Director was formed to examine the modalities of bringing about change in the functional, organisational and attitudinal behaviour in the Bank. One of the major items raised both in DG's Paper and the Steering Committee's terms of reference related to reorganisation of certain Departments, including the Inspection Department.

Against the backdrop of these developments, it was considered appropriate to await the recommendations of the Steering Committee, particularly those having a bearing on the reorganisation and

functions of the Inspection Department and other related areas. The Working Group's work, accordingly, gained momentum after the recommendations of the Steering Committee became available.

Methodology adopted

1.6 The Working Group met on 7th June 1997 and broadly deliberated upon the issues involved and its approach with specific reference to its Terms of Reference. The Chairman, thereafter, addressed D.O.DAPM.No. 189/17.21.00/97-98 dated 20th September 1997 to certain CGMs in-charge of Regional Offices and Central Office Departments (copy reproduced in Annexure I) eliciting their views and suggestions/recommendations with reference to Group's Terms of Reference. Similar letters were also addressed to certain well-known foreign Central Banks calling for information regarding the Organisational Set-up of their Internal Audit and Control machinery, methodology of inspections etc. The Working Group was happy to receive valuable views and suggestions from the concerned CGMs in-charge of Offices/Departments as also useful material from the foreign Central Banks. The Working Group has taken into account these suggestions and the material while formulating its views/recommendations.

Structure of the Report

1.7 The Report deals with each of the items of the Terms of Reference and contains seven Chapters, including Chapter V on

Compliance with Inspection/ Audit Reports although this item does not specifically figure in the Terms of Reference. Executive Summary containing main observations/ recommendations of the Working Group have been given at the beginning of the Report. At the end of the Report, a Summary of Recommendations has been given.

Acknowledgements

1.8 We express our sincere gratitude to the Bank for giving us an opportunity to address ourselves to this key and vital function, so as to strengthen the efficacy of the Inspection and in turn improve the efficiency and performance of this premier national banking institution. We also thank the concerned CGMs in-charge of Offices/Departments for responding to our enquiry and offering their valuable views and suggestions. We also gratefully acknowledge the prompt response received from the foreign Central Banks concerned who forwarded to us useful and informative material relating to their Audit and Inspection Set-up and Methodology of Inspection, etc.

Our thanks are also due to the officials of the Inspection Department who furnished the required information and material to us, readily, as also to Shri S.P. Chandorkar, Assistant Manager, DAPM for his able assistance, as also to the Secretariat of Executive Director (Shri B.S. Sharma), in particular, Smt. D.J. Noronha, Stenographer for typing the Report of the Group.

We would also like to place on record our sincere appreciation for the commendable services rendered by Shri S.M. Khot, Member-Secretary, to facilitate Group's work. He displayed zeal, dedication and resourcefulness and made valuable contributions to the Group's deliberations, besides ably assisting it in drafting the Report.

CHAPTER - II

General Observations regarding the Role and Objectives etc. of the Inspection and Audit Function

2.1 An effective internal control system is critical for the management and monitoring of banking operations. Such a system helps in achieving the goals and objectives of the organisation, optimises performance levels and helps in building up reliable financial and managerial information base. Internal control mechanism also helps to ensure that the bank will comply with the provisions of laws, various regulations, policies and procedures and facilitates risk management.

2.2 The Basle Committee on Banking Supervision,* while focusing on the increasing importance of sound internal controls, has evolved certain Principles for evaluating Internal Control Systems. One of the principles which is relevant to our area of study reads as under :

“There should be an effective and comprehensive internal audit of the internal control system carried out by appropriately trained and competent staff. The internal audit function, as part of the monitoring of the system of internal controls, should report directly to the board of directors or its audit committee, and to senior management”.

.....

* A Committee of Banking Supervisory Authorities constituted by the Central Bank Governors of the Group of Ten countries in 1975.

2.3 The internal control consists of four inter-related elements :

1. Management oversight and the control culture ;
2. Control activities ;
3. Information and communication, and
4. Monitoring activities.

The effective functioning of these elements is essential to achieving a bank's operational, information and compliance objectives.

2.4 The main objectives of internal control process have been categorised as follows :

1. Efficiency and effectiveness of operations. (Operational objectives) and
2. Compliance with applicable laws and regulations. (Compliance objectives).

1. Operational objectives for internal control pertain to the effectiveness and efficiency of the bank in using its assets and other resources and protecting the bank from losses. The internal control process seeks to ensure that personnel throughout the organisation are working to achieve its objectives in a straightforward manner, without unintended or excessive cost or placing other interests (such as an employee's, vendor's or customer's interest) before those of the bank.

2. Compliance objectives ensure that all banking business is conducted in compliance with applicable laws and regulations, supervisory requirements, and internal policies and procedures. This

objective must be met in order to protect the bank's franchise and reputation.

2.5 We have also come across "Inter-Agency Policy Statement on the Internal Audit Function and its Outsourcing" brought out, inter alia, by the Board of Governors of the Federal Reserve System, which sets out some characteristics of sound practices for the internal function. It is worth taking a note of undernoted observations.

"Effective internal control is a foundation for the safe and sound operation of a banking institution. An important element of an effective internal control system is an internal audit function. When properly structured and conducted, internal audit provides directions to senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action."

2.6 The role and objectives of Internal Audit have been clearly defined in the Central Banks of some of the countries. In this context, Chapter 6 titled "Audit Practices : Internal Audit" from the Document "Central Bank Audit Practices: SIGMA Papers No. 24, containing useful statistics in this area is reproduced in Annexure II. The Study relates to the Internal Audit Practices in the Central Banks in Germany, Ireland, the Netherlands and Sweden.

2.7 Talking specifically about the Reserve Bank, the Inspection Department was set up coinciding with the establishment of the Bank in April 1935 with the following objectives :

- (i) To assess in clear terms the achieved and achievable performance of the Offices/branches and Central Office Departments with the available resources.
- (ii) To suggest appropriate improvements so that performance level could be revised further.
- (iii) To critically analyse and assess the staff requirements on the basis of work-load.
- (iv) To give proper feedback to the Top Management on the performance of Offices and Central Office Departments.

2.8 With a view to covering the inspections and audit of Offices/Branches as well as Central Office Departments, a two-tier system of inspection and the financial audit was introduced, as under :

- (i) (a) Systems and Staffing Inspection of Central Office Departments and offices/branches.
(b) Systems (Annual) Inspection of offices/branches.
- (ii) Financial Audit (Voucher/Book-keeping audit) by Central/Regional Audit Cells.

2.9 The Inspection Department functions under the direct supervision of the Chief General Manager (CGM), an officer in Gr`F`. Functionally, the Department is sub-divided into the following units :

- (i) Inspection Teams - 3, each headed by a General Manager, an Officer in Gr. `E`
- (ii) Headquarters Unit consisting of Implementation, Planning and Audit Coordination Cells headed by the General Manager.

- (iii) Central Audit Cells - 2 units, (since a third unit has been sanctioned) each headed by the Assistant General Manager, an Officer in Gr. 'C'.
- (iv) Regional Audit Cells - five each for Banking and Issue units, each headed by an Assistant General Manager.

2.10 It is gratifying to note that the Inspection and Audit Sub-Committee of the Central Board, constituted in 1992 by the Central Board of the Reserve Bank, has been functioning as an Advisory Body and reviewing the Inspection and Audit Reports and their compliance, besides giving a sharper focus to the internal audit and inspection exercises, all aimed at improving productivity and efficiency of the Bank. The Committee at present consists of four members of the Central Board nominated by Governor, the Deputy Governor and the Executive Director, in-charge of the Inspection Department, the Executive Director in-charge of the Department of Administration and Personnel Management, with CGM, Inspection Department as Member-Secretary. Apex level monitoring by the Board of Directors of the Bank truly reflects the great importance accorded to Inspection and Audit function within the Bank and augurs well for maintaining the high standards of performance and efficiency of this national level institution.

CHAPTER - III

Types of Inspections and Audit, Periodicity thereof and Coverage of Areas, etc.

3.1 The following types of Inspections/ Audit are conducted by the Inspection Department.

(a) Systems and Staffing Inspection

The objective of this Inspection is to periodically review the systems and work-load on the staff and offer suggestions for further streamlining the procedures, to promote systemic efficiency and optimise utilisation of staff so as to meet heavy and diverse nature of responsibilities devolved on the Bank in fast-changing economic scenario. More specifically, the systems and staffing inspection covers the following areas :

- i) Whether the procedure laid down in the Manuals, Books of Instructions and Central Office instructions issued from time to time is being followed ;
- ii) Whether the budget estimates are properly drawn up and quarterly/half-yearly reviews undertaken and also whether due attention is given to effecting economy and cost control aspects etc.
- iii) Reviewing the security arrangements, arrears of work, quality of supervision, customer service, punctuality and discipline, and to suggest improvements. Fraud- prone areas and defalcation are addressed.
- iv) Reviewing the basis of division of work amongst various departments/sections with a view to re-arranging duties and responsibility of the staff for equitable and judicious distribution of work ;

- v) Assessing the staff strength of the office/department with reference to the actual volume of work devolving on the Office/Department.

(b) **Annual Inspection**

This aims at examining whether the work in the Regional Offices is carried out according to the prescribed procedures/instructions without any deviations/aberrations, to exercise a check over the administrative procedures followed by the offices so that irregular practices, if any, are detected and rectified early, and to report on the health of the concerned office. These inspections are carried out at an interval of 12 to 18 months. The Systems and Staffing Inspections and the Systems (Annual) Inspections are carried out alternatively. Central Office Departments are not subjected to separate Annual Inspections.

(c) **Performance/Management Audit**

This seeks to evaluate the efficiency of the management of a Regional Office in house-keeping, customer service and proper projection of the Bank and is undertaken during the final phase of the Systems and Staffing Inspections.

(d) **Special Assignments**

Inspections apart, the Inspection Department conducts Special Studies/Investigations at the instance of the Top Management/Heads of the Central Office Departments.

3.2 In the course of Inspections, the Inspection Teams furnish to the CGM/Officer-in-charge of Office/Department concerned its findings in a draft form for perusal and comments, if any. If the Office/Department has no comments, it is required to explicitly indicate so in writing and return the draft. If any of the observations contained in the draft are not acceptable, there is a provision for discussion with the Inspection Team but in the event of differences, the comments of the Office/Department duly approved by the CGM/Officer-in-charge are required to be given to the Inspection Team and such comments, together with the counter comments, if any, of the Inspection team are incorporated in the final report. The CGM, Inspection Department, towards the end of every inspection pays a brief visit to the Officer/Department under Inspection for discussions with the CGM/Officer-in-charge and other officials on important observations and his own assessment. A Salient Features Note which is essentially a summary of the findings of the Inspection is prepared by the concerned GM, in-charge of Inspection Team, which together with the observations of the CGM/Officer-in-charge, Inspection Department, is submitted to the ED/DG/Governor for information with a copy to the CGM/Officer-in-charge of the Office/Department concerned.

3.3 During inspections, great deal of emphasis is attached to matters like general administration and discipline, security

arrangements, house-keeping, customer service, economy in expenditure, up-keep of the premises and records management. Attempts are made to identify the reasons for deviation from the prescribed procedure, and suggestions for improvement are offered so as to ensure adherence to the laid-down procedures. Wherever necessary, amendments in the existing procedure are also suggested. Staff requirements are assessed on the basis of the work-load and output indicators fixed by the Bank.

3.4 A few common observations which generally find place in almost all Inspection Reports are briefly mentioned below :

1. **Staff**

- (i) Judicious deployment of leave/trainee reserve and floating staff between different Departments/Sections/Divisions is not being ensured, thereby adversely affecting the work in other Departments/Sections/Divisions.
- (ii) Review of temporary posts for their continuance or otherwise is not submitted to Central Office in time.
- (iii) Day-to-day promotions and daily-wage staff engagement are not need-based.

2. **Punctuality and Discipline**

- (i) Review of bad leave record is not attended diligently ;
- (ii) Cases of unauthorised absence are not dealt within reasonable time ;
- (iii) Due attention is not bestowed on timely attendance of staff ;
- (iv) Wearing of liveries by Class IV employees is not strictly enforced.

3. Discipline and Vigilance

- (i) Inordinate delays in disposal of disciplinary cases ;
- (ii) Random scrutiny of TA/HA bills by the CGM/Officer-in-charge is not undertaken periodically ;
- (iii) Points and places identified as susceptible to corruption are not visited regularly by the Branch Vigilance Officer.

4. Economy in Expenditure

- (i) Effective steps are not taken to contain the overtime.
- (ii) Expenditure on stationery and telephone is on the high side.
- (iii) Banknet and speech network are put to minimum use on account of non-functioning/breakdown in the service etc.

5. House-keeping

- (i) Various registers prescribed by Central Office under Manual provisions are not maintained satisfactorily ;
- (ii) Large number of entries in Sundry Deposits and Suspense Accounts Registers and reconciliation of balances in these accounts with those in the General Ledger leaves scope for improvement;
- (iii) List of outstanding letters are not compiled for submission to the CGMs/Officer-in-charge/Heads of the Department. This effective tool of internal checks is not being used in many departments/offices ;
- (iv) Reconciliation of various advances is in arrears;
- (v) Maintenance of service sheets, housing loan account sheets, LFC sheets, leaves scope for improvement;
- (vi) Submission of monthly work certificate to the CGM/Officer-in-charge has been reduced to a mere formality. It does not serve the required purpose of control mechanism.

6. Record Management

- (i) Record Management in the Central Office Departments/ Regional Offices has not been given due importance. Procedure delineated in General Administration Manual

for transfer of uncurrent records to the Record Room and destruction of records after expiry of preservation period is not being followed ;

- (ii) In most of the Offices/Departments the current/uncurrent records are kept in sectional almirahs/open space rendering the retrieval of records a difficult task.

7. Customer Service

- (i) Public counter in most of the offices do not commence functioning at the prescribed business hours ;
- (ii) Restrictive practice in accepting tenders from customers has adversely affected the customer service rendered in the Bank ;
- (iii) Time schedule prescribed in para 46 of PDO Manual for various transactions in Government securities is not adhered to ;
- (iv) Undue delay in disposal of customers' complaints has been noticed in some offices. Even acknowledgements/interim replies are not issued.
- (v) Recommendations of the Internal Committee on Customer Service in regard to installation of electronic token indicator and display of name plates, option to customers to receive receipted challan by post, use of signature retrieval system etc. have not been implemented by many offices.

8. Security Arrangements

Certain deficiencies like feeble sound of alarm hooters, very short duration of alarm sound, non-reinforcement of sentries, non-observance of battle position by sentries on guard duty, malfunctioning of hot line etc. are noticed in some of the Regional Offices.

9. Supervision and Control

Though the Branch Level Management Committee (BLMC) meetings are held regularly almost by all the Central Office

Departments/Offices, its effectiveness as managerial tool is not pronounced.

10. Operational deficiencies

- (i) Daily statements relating to the RBI General Account transactions and the relative schedules are not being submitted promptly ;
- (ii) Maintenance of specimen signature cards is perfunctory ;
- (iii) The follow-up of compliance by public sector banks on the inspection of Government business handled by them is not effective.
- (iv) Government loans are not balanced at the prescribed intervals in PDO ;
- (v) Maintenance/repairs of residential/office premises is unsatisfactory ;
- (vi) There has been backlog of inspections in all the departments like DBS, UBD and ECD ;
- (vii) Various prescribed statements are not being submitted to Central Office Departments within the time frame. Data collection, compilation and submission of data requires toning up ;
- (viii) Regional Offices have not been monitoring timely receipts of statutory returns from various banks including co-operative banks. This results into delay in scrutiny of returns and effective follow-up action in case of defaults in maintenance of cash reserve ratio and liquid assets ;
- (ix) Reconciliation of currency chest balances is in arrears ;
- (x) Surprise checks by the GM/DGM, Issue Department/ GM/DGM, Banking Department are not effective

3.5 No doubt, Inspection Reports provide fairly accurate profiles of the Offices/Departments and serve as a tool in the hands of the CGMs/GMs concerned of Central Office Departments/Offices, and

also form eyes and ears of the Top Management. However, over the years, the need has been recognised for reducing the size of the Reports by deleting certain items and minor irregularities etc. which are pointed out and left to be monitored by the CGMs/Officers-in-charge themselves. At the same time, there are more crucial and emerging areas which would need to be inspected and covered in the Inspection Reports.

3.6 The above matter had recently come up for discussions during one of the CGMs' Conferences and the following observations were made by some of the CGMs:-

- (i) The size of the Inspection Report needs to be reduced by :
 - (a) avoiding overlaps between Audit and Inspection Reports and making a clear-cut demarcation between the two, and
 - (b) avoiding multiplicity of paragraphs on the common features of different departments of the same office.
- (ii) Major and minor defects/irregularities may be indicated separately. Further, all issues requiring personal attention of CGMs/GMs in-charge should be grouped together.
- (iii) Some of the irregularities noticed could be sorted out during the course of inspection itself, which then need not form part of the Inspection Report.
- (iv) Focus in Inspection Reports should be on positive aspects as well.
- (v) Follow-up of certain paragraphs where a policy decision by Central Office Department is involved need not be pursued with Offices. Also, compliance with certain types of irregularities may be left to the CGMs/GMs in-charge themselves.

(vi) Inspection may be more of a Management Audit and done objectively, keeping in view the constraints like shortage of staff, etc. faced by offices.

(vii) Inspection Reports should indicate the progress of removal of restrictive practices and analyse the factors responsible for increase in the overtime. Greater attention may also be paid to the areas like systems and procedures, delegation of powers, etc. Further, a summary of functioning of an office, highlighting its achievements and comments on extra-ordinary problems, if any, faced by it should be brought out in the Report.

3.7 The Working Group shares the view-points expressed by the CGMs/GMs in-charge, as above. It feels that against the backdrop of a changing scenario in the financial sector reforms, there is a need for changing the focus of the Inspection/Audit. Among other things, a significant shift in the focus of Inspection is warranted from mundane/routine matters to the Management Audit because of the emphasis placed by the Bank on the role and functions of CGMs/GMs in-charge of Bank's Regional Offices. The Deputy Governor (Shri Jagdish Capoor) has, in Circular DAPM.No. 53/16.16.00/98-99 dated 23rd July 1998, set out various arrangements to enable CGMs/GMs in-charge of Regional Offices to assume overall charge of all the Departments at their Centres and be an active player in the decision-making process relating to important developments concerning the Bank in their regions. As a further measure to enable them to discharge their multifarious responsibilities in an effective and efficient manner and project proper image of the Bank, it has also been decided to redesignate them as "Regional Director" after screening by

the Committee of Deputy Governors. In keeping with the new designation, the incumbent will be responsible for ensuring effective discharge of the RBI's responsibility as a Central Banker in his region, besides efficient and smooth functioning of his office. In this process, he will be maintaining liaison with various functionaries of the State Governments as also explaining Bank's policies to the local authorities, bankers, financial institutions, Chambers of Commerce and Industries, etc. Among areas of particular emphasis will be -

- (a) Rural Credit
- (b) Non-Banking Financial Companies
- (c) Urban Banks
- (d) Customer service to the members of the public.

In short, CGM/GM heading a Regional Office should assume total charge of various Departments at his Centre.

3.8 In keeping with this enlarged role envisaged for the CGMs/GMs in-charge of Regional Offices, the Bank is already seized of delegating further administrative and financial powers to them. It is significant to note that with a view to reducing delays on scrutiny of Bills etc. and diverting staff to pressure points and new emerging areas, the Bank has simplified the rules by placing several schemes on "declaration basis". DAPM in their circular No. G.21/254/17.05.17/97-98 dated 21st October 1997 (copy reproduced in Annexure III) have also clarified that cases arising out of extension of facilities/amenities/perks in the areas of Educational Allowance, Conveyance Allowance, Halting Allowance, Reimbursement of Hotel expenses,

Book Grant etc. may be disposed of at the local level, keeping in view the spirit underlying the Central Office instructions, if necessary, by marking the cases to CGM/GM in-charge. Furthermore, the Steering Committee on Rationalisation and Simplification of Rules and Procedures, under the Chairmanship of Executive Director (Shri Sharma), have also made a number of recommendations for making systems and procedures compatible with the changing work environment based on greater use of upgraded tools and techniques in the Organisation.

3.9 It is desirable that the above Message and thinking of the Top Management should percolate down, especially among those entrusted with the inspection and audit work. In our view, several items of Inspection/Audit Review pertaining to facilities/perks to staff should be excluded from the purview of the Inspection. These may be looked into by the Regional/ Central Audit Cells on sample basis, to check proper use of these facilities/perks. The above approach will be in alignment with the trend towards a randomly generated sample selection, since there is a high degree of probability that the findings of such samples can be generalised for various transactions. The Regional/Central Audit Cells may be strengthened suitably by placing them under the charge of DGM (in place of AGM) with Gr.`B` Officer instead of Gr.`A` working in the team by upgrading the post. The Inspection Team conducting the Systems

Inspection should, based on the reports submitted by the RACs/CACs, concentrate on only those high-risk prone areas where major irregularities/deficiencies have been highlighted by the RACs/CACs. Diluted and divested of this routine but time-consuming exercise, the Inspection Team conducting Annual and Staffing Inspection will, thus, be better placed to pay greater attention to the Management Audit and other crucial areas as also new emerging areas where risk to the Bank is higher. The basic objective of the Management Audit should be to evaluate managerial practices and managerial actions on the basis of certain objective standards to ensure optimum utilisation of the available resources and infrastructure.

3.10 In this context, the Working Group has taken the opportunity to have a look at the system of assessing various kinds of risks faced by certain Central Banks and the controls and audits operated by them. It is observed that in the case of Central Banks, the loss of money and reputation are the most significant risks faced by them. A set of secondary risks could include -

- | | |
|---------------------------|---------------------------------------|
| - Fraud | - Breach of the law |
| - Error | - Loss of data |
| - Theft | - Loss of assets |
| - Poor judgement | - Failure of counterparties. |
| - Poor strategic planning | - Insufficient management information |
| - Ineffective support for | - Computer viruses computer systems |

3.11 No single type of risk is unequivocally more important than any other. The measurement of risk is difficult. However, one of the methods suggested for each system in the bank (foreign exchange operations, gold custody, pay-roll and so on) is by way of answers to the following questions :

- Is it a central activity of the bank ?
- Would an error/loss damage the bank's reputation ?
- Would an error/loss commit an offence in law ?
- Would an error/loss have a material effect on the bank's accounts?
- What is the quality of controls in the system ?
- How mature is the system ?
- Is there a history of error/loss ?
- What is the quality of management and staff operating the system ?

Each question can be weighted, depending on the importance. Then each question can be scored, say, on a scale of one to three. The score is multiplied by the weight, and then all the weighted scores are added up. The result is the 'risk score' for the system. Comparisons of these scores for different systems will help the auditors to direct their resources effectively: other things being equal, systems rated with the highest scores should receive the most attention. Examples of how different systems may be risk-ranked to determine where audit resources should be directed are given below :

**EXAMPLES OF HOW DIFFERENT SYSTEMS MAY BE
RISK-RANKED TO DETERMINE WHERE AUDIT
RESOURCES SHOULD BE DIRECTED**

| All scores are on a scale 0-3 | | | | | | | |
|--|--------|----------------|----------------|---|----------------|---|----------------|
| | Weight | PAYROLL SYSTEM | | CONTINGENCY PLANS FOR COMPUTER NETWORKS | | MANAGEMENT OF FOREIGN EXCHANGE RESERVES | |
| | | Score | Weighted Score | Score | Weighted Score | Score | Weighted Score |
| Is this a central activity of the Bank? If yes, score 3. | 15 | 0 | 0 | 2 | 30 | 3 | 45 |
| Would an error or loss damage the Bank's reputation? If yes, score 3. | 15 | 1 | 15 | 3 | 45 | 3 | 45 |
| Would an error or loss commit an offence in law? If yes, score 3. | 15 | 2 | 30 | 0 | 0 | 3 | 45 |
| Would an error/loss have a material effect on the Bank's accounts? If yes, score 3. | 15 | 0 | 0 | 3 | 45 | 3 | 45 |
| What is the quality of controls in the system? If poor, score 3. | 10 | 1 | 10 | 1 | 10 | 0 | 0 |
| How mature is the system? If new, score 3. | 5 | 3 | 15 | 3 | 15 | 1 | 5 |
| Is there a history of error/loss? If yes, score 3. | 10 | 1 | 10 | 1 | 10 | 0 | 0 |
| What is the quality of management and staff operating the system? If poor, score 3. | 10 | 1 | 10 | 1 | 10 | 1 | 10 |
| WEIGHTED TOTALS | | | 90 | | 165 | | 195 |

It is clear from this example that the most risky system is the management of foreign exchange reserves, followed closely by the contingency plans for computer networks. Audit resources need to be directed more towards these systems rather than the less risky payroll system. If this process is repeated across all the Bank's systems, it will provide the basis for a programme of audits for the year

3.12 In order to control the risks, different types of controls are exercised by the Central Banks, such as controls over valuables (video surveillance of vaults or strong rooms, joint custody of keys to valuables), controls over staff (adequate experience and training), controls over Processing (proper delegation of authority) and controls over Computers (uninterrupted power supply for critical systems, physical controls over access to computer rooms, etc.) Any control against loss has a cost. It has, therefore, been emphasised that the strongest and most expensive controls should be directed at the most risky operations. For example, the likelihood of a member of staff making an inflated expenses claim may be fairly high, but the monetary loss may be low. On the other hand, the likelihood of a payment message generated by the bank being intercepted and altered is probably low, but the monetary loss to the bank could be substantial. In this, the decision of where to place expensive controls depends on an assessment of both the likelihood of a risk happening as well as the materiality of the loss if it did. Inspection and Audit Resources, therefore, need to be directed primarily at the systems where the risks are high.

3.13 A Paper titled "Central Bank Audit Practices" (known as SIGMA Papers No. 24), contains a study of internal and external audit practices in Central Banks in four countries, viz., Ireland, Netherlands, Germany and Sweden. In the Central Banks in Germany and Ireland,

the primary focus is on areas identified as having the highest financial risk based on an assessment of materiality, potential for error or loss, and the reputation of the Bank. In Netherlands, the Bank's most sensitive Departments have Internal Control Sections which work closely together with the Internal Audit Department. In Sweden, the primary focus is on accounting and internal control, especially in connection with valuables, information and systems security. Incidentally, the Federal Reserve System in the U.S.A. has developed Risk Analysis Methodology which consists of the Risk Analysis Model, Risk Analysis Questionnaire, Risk Calculation Sheet and Frequency Model.

3.14 The Working Group suggests that on the analogy of the system prevailing in some of the Central Banks, as mentioned above, the Inspection Department may devise a system to maintain a Risk Database, both for Regional Offices as a whole and for each of their Departments separately in view of different functions performed by them, as a means of ranking audits in terms of the risks they address. This will ensure that appropriate resources are given to the Inspection Team dealing with the highest risk areas; in other words, the inspection/audit priority should adequately reflect the degree of risk to the Bank. The guidelines evolved by the Inspection Department, in consultation with the Departments concerned, for use of the

Inspecting Officers may be reviewed and revised in view of the changes suggested above.

3.15. The Working Group realises that to concretise and implement the above methodology will need a dialogue with the CGMs/Officers-in-charge of Offices/Departments. For this purpose, a Workshop may be held to facilitate brain-storming Sessions, with involvement of an expert in this field.

Control Self-Assessment Audit

3.16 There appears to be a practice in some of the Central Banks for conduct of a "Control Self-Assessment Audit," particularly by the sensitive Departments themselves which are prone to great risks, with the help of the Inspecting Officers/Auditors. Such a Control Self-Assessment Audit facilitates a review of controls at frequent intervals and reinforces the efforts of the regular inspection/audit machinery and presents a better control environment when they visit there. The aim of Control Self-Assessment Audit is to enable the Departments to give themselves a regular Health-check to assess :

- (a) the key risks in their area ;
- (b) the financial implications of each risk ;
- (c) the steps being taken to control the risks ; and
- (d) the steps being taken to ensure that the controls work.

A suggestion more or less to the above effect has been made by Mumbai Office indicating that Offices may be permitted to approach

the Inspection Department directly or through the respective Central Office Department for conduct of Special Audit/Inspection of particular areas where an urgent need is felt for the purpose.

**Inspection/Audit of Computer/
Electronic Data- Processing etc.**

3.17 During the last few years, the Bank has embarked on a Programme of Computerisation of its operations on a very significant scale. Besides, it has taken long strides in developing Management Information System through increasing resort to Communication Systems. It has also acquired a number of Personal Computers. Electronic Information Systems and the use of information technology have risks that must be effectively controlled in order to avoid disruptions to business and potential losses. Controls over Information Systems and Technology should include both general and application controls. General controls are controls over the Computer System (i.e. Mainframe and end-use terminals) and ensure its continued proper operations (e.g. back-up and recovery procedures, software development and acquisition policies, maintenance procedures, and access security controls). Without adequate controls over information systems and technology, including systems that are under development, the Bank could experience the loss of data and programmes due to inadequate physical and electronic security arrangements, equipment or systems failures, and inadequate back-up

and recovery procedures. This area needs to be given added attention during the course of Inspection and Audit.

Composition of Inspection Teams

3.18 Skills required for conduct of inspection and audit depend upon the mandate in terms of the scope and objectives of the inspection/audit to be conducted . Generally speaking, the range of skills will have to include experience in Banking, Finance, Accountancy, Management, Computer Systems, Foreign Exchange and Trading. Wherever specialist activities are to be inspected/ audited, there will be need for multi-disciplinary audit teams. The DEIO have made a suggestion that there could be a system of *ad hoc* staffing to improve inspection of specialised Departments like DEIO. For this purpose, the Inspection Department may consider constituting a panel of suitable officers who are conversant with back-up, compliance and computer system, as also of officers from ECD or DBS who are experienced in inspecting Dealing Rooms of commercial banks. The Officers presently attached to the Department being inspected or those who had worked there during the period covered by inspection should not, however, be associated with the inspection.

Time-frame for Inspections/Audit

3.19 It is not possible for us to suggest any definite time-frame for Inspection/Audit as much will depend upon the size of the Office/ Department, the nature and volume of financial operations, the level

of efficiency of the office, the efficacy of the Control Mechanism obtaining there and so on. It is desirable to have some measure of flexibility in this matter. Due to the proposed dilution of the areas of Inspection/Audit and exclusion of routine/mundane matters which can be left to be sorted out by CGMs/GMs in-charge and their monitoring by the Branch Management Committee and shift of focus on areas of greater risk, and other crucial matters, the Inspection/Audit Team should be able to complete their tasks within shorter periods. Consequently, the frequency of inspections could be improved and each office inspected once in a year and a Central Office Department once in two years or so.

3.20 In this context, DEIO have suggested that snap inspections to verify compliance of Inspection Reports, on the analogy of veracity verification of commercial bank compliance done in DBS, be introduced. Such inspections need to be short for one/two days, to ensure compliance with major observations only. We endorse this suggestion.

CHAPTER - IV

Format of the Inspection Report

4.1 As has been observed by us elsewhere, the Inspection Reports are generally elaborate documents providing a certain profile of an Office/Department. We are aware that in recent times, a great deal of time and care are taken in the preparation of the Reports. Each Report is presented with an Executive Summary and a Summary of Recommendations. A Salient Features Note with the CGM, Inspection Department's comments is submitted to the Top Management highlighting major findings of the inspection.

4.2 No doubt, sometimes Inspection Reports tend to be stereotype and repetitive maybe, because of the fact that much of what it contains is technical and also that the tasks are often repeated at each Inspection. We need hardly emphasise the importance of presenting the Inspection findings in a cogent, concise and pithy manner, conducive to prompt decision-making and meaningful outcome.

4.3 One of the observations made by Mumbai Office is that while compiling the Inspection Report pertaining to Operational Departments like Issue, DAD, PDO etc., deficiencies in maintenance and infrastructural facilities, which are extraneous to operational aspects, are accorded undue prominence to the neglect of the core activities of the Department inspected. This not only adds to the bulk

of the Report but also the relative paragraphs remain outstanding for a long time against the operational Departments, giving a distorted picture of the operational efficiency of that Department. It has, therefore, been opined that paragraphs relating to the deficiencies/suggestions for lay-out, furniture and fixtures, improvement in infrastructure facilities etc. be included in the Chapter devoted to the Estate Department for immediate follow-up action. The Working Group agrees to this suggestion.

4.4 The Working Group has also received the following further suggestions :

- (a) At the end of each Chapter in the Inspection Report, a summary of major irregularities/deficiencies be appended.
- (b) The Inspection Department should avoid making general statements like, "A large number of entries are lying unreconciled in RBI General Account" or "A number of entries are outstanding in Sundry Deposits Accounts/Suspense Account. Offices may take corrective action to clear the backlog." Instead, it will be helpful if the Inspection team goes into the reasons for delays and bottlenecks, if any.
- (c) The Inspection Team should be realistic while making suggestions and those which are difficult to implement because of known constraints or are not likely to result in improving efficiency/productivity need not be made; these are unnecessarily shown as outstanding in successive Inspection Reports.
- (d) The Inspection should define their priorities separately for each Department/Office, depending on the major areas of work handled and peculiar features, if any, of that Office/Department and lay more stress on what was expected and what has actually been achieved in those areas, with greater objectivity. The Reports on Specialised Departments should primarily focus on the operational areas of specialisation. Routine administrative deficiencies, such as

those concerning leave, training, budget, subscriptions to newspapers/journals, overtime, stationery etc. can be covered in the half-yearly audit reports. This is how overlaps in Inspection and Audit Reports could be avoided. Further, areas like level of computerisation, availability of Programmers, the level of development of software in-house could be areas to be looked into by the Inspection Department. Inspection Team could also comment whether programmes developed meet the needs of the Department.

- (e) The focus in the Inspection Reports should be on rectification of systemic defects. Paragraphs describing the working of the Departments/Sections and background information can be avoided since both the Department inspected and the Inspection Department which are users of the Reports, are in any case aware of this information. This will make the Report leaner and more focused facilitating easier follow-up.

4.4 We are inclined to go along with the above suggestions and recommend that these may be acted upon by the Inspection Department.

4.5 Chennai Office has suggested that the findings of each Department may be summarised in a docket at the end of each Department's Report covering various aspects like good features, house-keeping, customer service, major findings, compliance with earlier inspection findings, procedural/minor irregularities, Inspection recommendations etc.

4.6 While we do not wish to prescribe any format, as such, for the Inspection Report, a few general observations may be in order :

- (a) The Inspection Report is the outcome of the inspection of an office/ a department and hence reflects the quality of various portfolios handled by it.

(b) The Inspection Report should be fair and objective with stress on “fact-finding” rather than “fault-finding” mission.

(c) It should be presented in clear, concise, systematic and convincing manner.

(d) The Report should combine critical evaluation as well as positive and constructive aspects. It should highlight achievements as well as irregularities and serious shortcomings. The facts should be reported accurately.

(e) In the training programmes tailor-made for the Inspecting Officers, a Session may be included on drafting of the Report.

4.7 With the suggestions and recommendations made by us for changing the focus of the Inspection by excluding certain areas of minor/routine nature from the purview of inspection, the Inspection Reports may become sleek, free from tediousness and focus on the issues covered during inspections.

CHAPTER - V

Compliance with the Inspection/Audit Report

5.1 The terms of reference of the Working Group do not specifically include item regarding compliance with the Inspection/ Audit Reports although follow-up of Inspection/ Audit Reports is very essential for removing irregularities/tightening up procedures and taking corrective action, so as to improve the functioning of an Office/Department.

5.2 As per the existing instructions, Regional Offices/Central Office Departments are required to furnish compliance to the Inspection Department within the time- frame indicated below :

- | | |
|---|---|
| (a) Compliance with a substantial portion of the Report | - Within one month from the date of submission of the Report |
| (b) Second or subsequent compliance with the remaining paragraphs | -At the end of each month (to reach Inspection Department by the 20th of the succeeding month). |
| (c) Cent per cent compliance | Within three months after submission of the Report. |

5.3 All Offices/Departments have to ensure that irregularities having financial implications are complied with within a period of one month. Audit Cells submit to the Inspection Department a quarterly progress report on compliance of Audit Reports by Offices/Departments.

5.4 The Implementation Cell of the Inspection Department monitors the follow-up of Inspection Reports and reviews the position on monthly and quarterly basis. As regards Audit Reports, the Audit Co-ordination Cell of the Inspection Department takes up with the concerned Offices/Departments any serious deficiencies/lapses brought out in the audit reports.

5.5 The Working Group notes with satisfaction that the Inspection and Audit Sub-Committee of the Central Board, set up with the approval of the Committee of the Central Board (CCB) at its meeting held on 21st October 1992, closely reviews the compliance of Inspection and Audit Reports at periodical intervals, besides attempting to give a sharper focus to the internal audit and inspection exercises and tailoring them towards the objective of maximising the productivity and efficiency. The Sub-Committee has also been inviting other Top Executives (Deputy Governors and Executive Directors) to the meeting. Ever since its first meeting held at Calcutta on 21st January 1993, the Sub-Committee has met 22 times, the last being on 12th August 1998 at Mumbai.

5.6 The Working Group is happy to note that in pursuance of a decision taken at the Senior Management Committee Meeting held on 16th February 1995, the Executive Directors' Committee has been set up consisting of Executive Director (Administration), Executive Director in-charge of Inspection Department, Principal Chief General

Manager, DAPM and CGM, Inspection Department. The Executive Directors' Committee reviews major outstanding paragraphs from the Inspection Reports due for placing before the Inspection and Audit Sub-Committee, in the presence of the CGM/GM in-charge of the Office/Department concerned. In the case of Central Office Departments, the Executive Director in-charge of the Department concerned is also invited to attend the meeting. The Executive Directors' Committee has reportedly held 29 meetings till 10th September 1998. We have been informed that with a view to dispensing of a maximum number of outstanding paragraphs, the CGM, Inspection Department has been authorised by the Executive Directors' Committee to visit, depending upon the needs, the concerned offices for discussing the matter with CGMs/GMs in-charge.

5.7 In view of the significant measures, as above, already taken by the Bank, the Working Group does not consider it necessary to go further into this area except observing that concerted efforts need be made and pressure exerted on the Offices/Departments so that there is no let-up in the progress of follow-up. Further, what is important is quality of compliance and not its percentage, as such. Hence, an Officer well experienced should be entrusted the task of monitoring compliance on a regular basis.

CHAPTER - VI

Review of Organisational Set-up and Staffing Pattern etc.

6.1 By virtue of its role and responsibility as a body to ensure compliance by Regional Offices and Central Office Departments with Bank's rules, procedures, and manual provisions etc., the Inspection Department occupies a pivotal position in the Bank's Organisational Set-up. It is essentially concerned with controlling risks to the Bank's reputation and finances, and bringing about improvement in the Bank's efficiency and productivity. In pursuance of this avowed objective, the Inspection Department, which is headed by the CGM in Gr.`F`, attends to its core functions through different Units, as under :

(i) **Inspection Unit**

It consists of three Inspection Teams each led by a Gr.`E` Officer, with complement of one/two Gr.`C` Officers, four to six Gr.`B` Officers and a few workmen staff.

(ii) **Headquarters Unit**

This unit comprises Implementation Cell, Audit Coordination Cell, Planning Cell and Administration Cell and attends to variety of functions.

(iii) **Audit Cells**

There are two units of Central Audit Cells (since a third unit has been sanctioned) to conduct audit of Central Office Departments

and five Regional Audit Cells each with a separate team for the Banking and Issue Departments to conduct financial audit, as per the following jurisdiction :-

| <u>RAC at</u> | <u>Jurisdiction of Office</u> |
|---------------|--|
| Mumbai | Ahmedabad, Mumbai, Byculla, Nagpur Panaji. |
| Calcutta | Bhubaneswar, Calcutta (including DNBS), Guwahati and Patna. |
| Kanpur | Bhopal, Kanpur and Lucknow |
| Chennai | Banglore, Chennai, Staff College, Chennai, Hyderabad, Kochi and Thiruvananthapuram |
| New Delhi | Chandigarh, Jaipur, Jammu, Srinagar and New Delhi. |

These Cells are under the administrative control of the local CGMs but functionally they are attached to the Inspection Department.

6.2 Whereas the scope and coverage of the Systems and Staffing Inspection and Systems Inspection is comprehensive dealing with wide range of Bank's activities, the Audit Cells mainly deal with proper accounting of Income and Expenditure and maintenance of Bank's Books and Registers.

6.3: The staff posted to the Inspection Department and Central/Regional Audit Cells is expected to have adequate experience and thorough knowledge of the working of various Departments. The staff required by the Regional Audit Cells (RAC) is

to be provided by the respective local offices at Mumbai, Calcutta, Kanpur, Chennai and New Delhi. CGMs at these centres have to prepare a panel of officers to be posted to the RAC on an annual basis, keeping in view not only their work experience but also integrity, personal traits and devotion to work. It has to be ensured that any officer posted to RAC does not stay for more than three to five years and Officers' transfers are to be effected within the tolerance limit of 25% of the total strength of RAC. The postings of officers to the Inspection Department in Central Office including Central Audit Cells are arranged by the DAPM generally in consultation with CGM, Inspection Department, having regard to the work experience, integrity and devotion of the Officers concerned..

6.4 In practice, the calibre, capacity and competencies of the Officers posted to the Inspection Department and RACs are not always found to be of a high order or exceptional quality. Generally, there appears to be somewhat reluctance on the part of officers to work in Inspection Department/CAC/RAC maybe because of frequent tours involved.

6.5 The Working Group feels that the quality of Inspection will much depend upon the experience, competencies and integrity of the officers. The Bank, therefore, needs to attach a lot of importance and care while posting of energetic officers of high calibre, integrity, experience etc. to the Inspection Department/RAC. A telling

observation made by one of the Offices is that there is need for infusion of fresh blood with new ideas for overhauling the existing systems and procedures which have become outdated against the fast-changing scenario of high customer expectations and technological advancement. With a view to making the posting to the Inspection Department/RAC really attractive and coveted, we recommend that the Bank may consider taking the following measures :

- (i) Conscious efforts may be made to create a general awareness and impression among the Officers that the Bank attaches considerable importance to the posting of officers to the Inspection Department/RAC. Accordingly, Bank will be selective while posting officers to the Inspection Department/CAC/RAC, by prescribing appropriate suitability criteria and inviting applications from eligible officers on All-India basis. The selections may be made by a Committee consisting of ED in-charge of Inspection Department, ED (Administration) and CGM, Inspection Department.
- (ii) The Officers posted to the Inspection Department/RAC may be paid a Special Allowance equal to the Faculty Allowance admissible to the Members of Faculty attached to the Bank's Training Establishments. The present quantum of the Faculty Allowance is Rs. 400/- p.m. (fixed).
- (iii) The HRDD/Training Division may be requested to identify appropriate training programmes, such as a Seminar on "Internal Audit in a Central Bank" conducted by the Centre for Central Banking Studies of

the Bank of England The Inspecting Officers may also be deputed to the Institute of Chartered Accountants of India Ltd. to get the feel of the current practices being adopted by them for audit/inspection. Further, they may be given preference in the matter of deputation to foreign training programmes.

- (iv) The tenure of posting may continue to be generally three to five years and in exceptional cases, up to seven years.

6.6 The Working Group has received a suggestion from several CGMs to the effect that the three Inspection Teams, which are presently headed by General Managers in Gr. 'E', may appropriately be headed by Gr. 'F' officers. The consideration that has weighed with them in making this suggestion, apparently, is that Regional in-charges and Heads of CO Departments being in Gr. 'F', the General Managers heading the Inspection Teams may find it difficult to be forthright in their assessment or evaluation of the Offices/Department; they may tend to compromise their position by ignoring shortcomings or weaknesses in the working of the Office/Department.

6.7 The Working Group has given considerable thought to the above suggestion and has also taken into account the practice obtaining in foreign Central Banks. Taking all relevant factors into account, the Working Group strongly feels that it will, indeed, be in fitness of things, especially from the viewpoint of raising the quality of inspections and making them objective and meaningful, to upgrade

the posts of GMs heading Inspection Teams to CGM (i.e. Gr. 'F'), those of AGMs (Gr. 'C') of RAC/Central Audit Cells to DGMs (ie.. Gr. 'D') and base-level i.e. S.O. Gr. 'A' to Gr. 'B'.

6.8 As a consequence of the above, there appears to be a case for upgrading the post of CGM in-charge of the Inspection Department to Executive Director. If for any reason this is not found feasible, at least his status may be raised on par with the Principal Adviser('F+') in DEAP/DESACS carrying a Special Allowance of Rs 300/- p.m. Needless to say, this will be without prejudice to the interests of his seniors in other Departments.

6.9 For enhancing the effectiveness of Inspections and sharpening the skills of the Inspecting Officers, it is absolutely essential that they are provided appropriate training at periodical intervals by devising specially tailor-made programmes at the Reserve Bank Staff College, Chennai and/or the BTC. The objective of the training programme should be to improve the competence of the Inspecting Officers and inject professionalism among them. As already suggested, the HRDD/Training Division may be requested to identify suitable training programmes conducted by other institutions like NIBM or foreign Training Programmes for the benefit of the Inspecting Officers. Incidentally, we observe that the Staff College, Chennai had conducted one-week Programme in July 1995 for the Inspecting Officers of the Inspection Department and the RACs to enable them to

conduct inspections under computerised environment in the Bank. Such programmes may have to be repeated to cover Officers posted to the Inspection Department/CAC/RAC.

6.10 As far as the RACs are concerned, we recommend that two more Cells with two units each may be created, one at Ahmedabad, and another at Bangalore by suitably regrouping the jurisdiction of the RACs. The setting-up of proposed two additional Cells and regrouping of Offices under the existing Cells can improve the frequency of audits and coverage of additional areas as recommended by us elsewhere in the Report.

Review of Officers' strength of Inspection Department/Regional Audit Cells

6.11 At present, the total strength of Inspection Department in Central Office and Regional Audit Cells is 163 comprising 106 in Class I (Gr. 'F'-1, Gr. 'E' - 4, Gr. 'C' - 19, Gr. 'B' - 22 and Gr. 'A' - 60) and 57 in Class III and Class IV. Of these, total employees strength of five Regional Audit Cells is 79 [53 in Class I - (Gr. 'C' - 10 and S.O. Gr. 'A' - 43) plus 26 in Class III/IV].

6.12 It is interesting to note that the position of Audit staff in a few

selected Central Banks as at December 1994, was as under :

| <u>Central Bank</u> | <u>Audit staff</u> | <u>Total staff</u> | <u>Audit as % of total</u> |
|---------------------|--------------------|--------------------|----------------------------|
| Canada | 37 | 2,137 | 1.7 |
| France | 57 | 16,876 | 0.3 |
| Germany | 36 | 17,142 | 0.2 |
| Italy | 64 | 9,351 | 0.7 |
| Japan | 48 | 6,160 | 0.8 |
| United Kingdom | 31 | 4,072 | 0.8 |
| U.S.A.* | 61 | 4,154 | 1.5 |

*Federal Reserve Bank of New York

The number of internal inspectors/auditors that an organisation needs is very subjective. It depends on the perception of risk in that organisation. The Study of Central Bank Audit Practices indicates that as a rule of thumb, in banking there is one internal auditor for every one hundred bank employees. Small banks, on the other hand, need a higher ratio of auditors to staff. Three auditors are generally seen as a minimum in order to maintain a high quality audit. Considering the total staff strength at about 32,000 of our Bank, the strength of the Inspection Department and Regional Audit Cells, viz., 163, appears reasonable. In any case, the review of the staff strength may be undertaken as per the well-established practice of the Bank.

We, however, reiterate that the posts of Gr. 'C' and Gr. 'A' may be upgraded to Gr 'D' and Gr. 'B' respectively, as recommended in para 6.7 above.

CHAPTER - VII

Miscellaneous/Other Incidental Matters

7.1 In our view, it will be only appropriate that the Inspection Department convenes, on annual basis, a Conference of Officers attached to Inspection Department and Regional Audit Cells for exchange of views and experiences , the undesirable features noticed, the potential risks, the thrust areas, future scenario and challenges etc. The Top Management may be invited to give the benefit of their thinking, guidance and direction to the participants. The forum could also be utilised to arrange inter-face between Statutory Auditors and Inspecting Officers to promote better understanding, coordination and minimise areas of overlaps. One or two experts in the Inspection/ Audit Area could also be invited to address the participants in regard to the advanced techniques of Inspection/ Audit etc. We reiterate that such Conferences should become a regular annual feature.

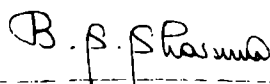
7.2 The Inspection Department has evolved certain guidelines in consultation with the Departments concerned, which are issued to the Inspecting Officers and CACs/RACs. The

Working Group suggests that an Inspection/Audit Manual may be brought out by the Inspection Department for use of the Inspecting Officers. Such Audit Manuals have been brought out by some of the Central Banks. The Audit Manual brought out by the Bank of England could serve as a model for our purpose. Interestingly, the Manual contains the following basic principles of conduct for the Audit staff :

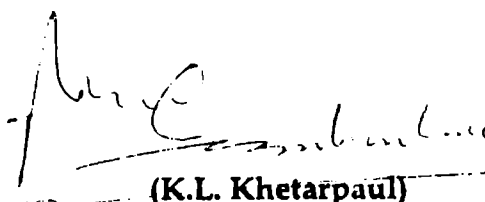
- * You should always think objectively about the risk to the Bank in the system you are auditing. Are the controls adequate ? Are you auditing them in the best way ?
- * You should not act as part of the control of an asset or system you are auditing.
- * You should record and report matters honestly, clearly and concisely, disclosing all relevant facts.
- * You should observe local protocol wherever you are auditing and act in a courteous and responsible manner.
- * You should be aware that the nature of the work might cause some disruption to offices. It is important to keep this to a minimum and adopt an understanding, albeit pragmatic attitude. Internal audit is a service to management.
- * You should declare any personal interest which may make it inappropriate for you to audit in area.
- * As a member of the Audit Division you should not deal in the shares of any financial institution and any dealings in the shares of other institutions must have the prior sanction of the Auditor.

The Manual when prepared should be reviewed and updated periodically to keep pace with the changes taking place from time to time and the need for change in the Inspection Methodology, etc.

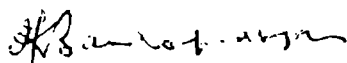
7.3 The Working Group further suggests that based on, say, the last three years' Inspection/Audit Reports, the Inspection Department may prepare a data-base on each Office/ Department having a bearing on important aspects like financial discipline, staff discipline, Industrial Relations, Customer Service, up-keep and maintenance of premises and house-keeping etc. Such data would be of use to the new incumbent of CGM/GM in-charge of the Office/ Department. The data should be updated from time to time.



(B.S. Sharma)
Chairman



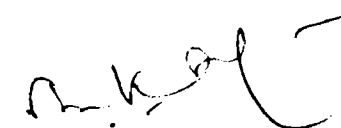
(K.L. Khetarpaul)
Member



(M.K. Bandopadhyaya)
Member



(S.R. Mittal)
Member



(S.M. Khot)
Member-Secretary

Dated : 10th October 1998
Mumbai

SUMMARY OF RECOMMENDATIONS

Against the backdrop of a changing scenario in the financial sector reforms, there is a need for changing the focus of the Inspection/Audit from mundane/routine matters to the Management Audit because of the emphasis placed by Central Office recently on the functions of CGMs/GMs in-charge of Regional Offices . Various suggestions made in CGMs' Conference for indicating progress of removal of restrictive practices, separate indication of major/minor irregularities, focus on positive aspects etc. may be considered. (Paras 3.6 and 3.7).

2. The Message and thinking of the Top Management as reflected through the enlarged role envisaged for the CGMs/GMs in-charge of Regional Offices, and delegation of powers, *inter alia*, to dispose of cases arising out of facilities/amenities/perks extended to employees, as also the recommendations of the Steering Committee on Rationalisation and Simplification of Rules and Procedures should percolate down, especially among those entrusted with the Inspection and Audit work. Several items of Inspection/Audit Review should be excluded from the purview of inspection and these may be looked into by the Regional Audit Cells (RACs) on sample basis to check misuse of facilities/perks. The RACs may be strengthened suitably by

the Inspection Department, in consultation with the Departments concerned, for use of the Inspecting Officers, may be reviewed and revised in the light of these changes (Para 3.14).

6. To concretise and implement the methodology suggested by the Working Group, a Workshop with the participation of CGMs/GMs in-charge of Offices/Departments may be held to facilitate brain-storming sessions, with involvement of an expert in this field. (Para 3.16).

7. In keeping with a practice in some of the foreign Central Banks for conduct of a "Control Self Assessment Audit" particularly by the sensitive Departments themselves which are prone to great risks, with the help of Inspecting Officers/Auditors, similar Control Self-Assessment Audits be conducted to enable Departments to give themselves a regular Health-check to assess the key risks in their area and the efficiency of the controls being exercised by them. (Para 3.16)

8. Area relating to exercising of adequate controls over Information Systems and Technology may be given added attention with a view to ensuring physical and electronic security arrangements to guard against equipment or systems failures, loss of data and inadequate back-up and recovery procedures. (Para 3.17).

9. Whenever specialist activities are to be inspected/audited, there will be need for multi-disciplinary audit teams. For this purpose, the Inspection Department may consider constituting a

Panel of suitable Officers who are conversant with back-up compliance and computer system, as also Officers from ECD and/or DBS who are experienced in inspecting Dealing Rooms of commercial banks (Para 3.18)

10. Due to the proposed dilution of the areas of Inspection/Audit and exclusion of routine/mundane matters which can be left to be sorted out by CGMs/GMs in-charge and their monitoring by the Branch Management Committee and shift of focus on areas of great risk and other crucial matters, the Inspection/Audit Team should be able to complete their tasks within shorter intervals. Consequently, the frequency of inspections could be improved and each office inspected once in two years or so. (Para 3.19)

11. Snap inspections of one/two days may be introduced to verify compliance of Inspection Reports, on the analogy of veracity verification of commercial bank compliance done in DBS. (Para 3.20).

12. Paragraphs relating to the deficiencies/suggestions for lay-out, furniture and fixtures, improvement in infrastructure facilities etc. be included in the Chapter devoted to the Estate Department for immediate follow up action. (Para 4.3)

13. The Inspection Department may act upon the following suggestions :

- (a) At the end of each Chapter in the Inspection Report, a summary of major irregularities/deficiencies be appended.
- (b) The Inspection Department should avoid making general

statements like, "A large number of entries are lying unreconciled in RBI General Account" or "A number of entries are outstanding in Sundry Deposits Accounts/Suspense Account. Offices may take corrective action to clear the backlog." Instead, it will be helpful if the Inspection team goes into the reasons for delays and bottlenecks, if any.

- (c) The Inspection Team should be realistic while making suggestions and those which are difficult to implement because of known constraints or are not likely to result in improving efficiency/productivity need not be made; these are unnecessarily shown as outstanding in successive Inspection Reports
- (d) The Inspection should define their priorities separately for each Department/Office, depending on the major areas of work handled and peculiar features, if any, of that Office/Department and lay more stress on what was expected and what has actually been achieved in those areas, with greater objectivity. The Reports on Specialised Departments should primarily focus on the operational areas of specialisation. Routine administrative deficiencies, such as those concerning leave, training, budget, subscriptions to newspapers/journals, overtime, stationery etc. can be covered in the half-yearly audit reports. This is how overlaps in Inspection and Audit Reports could be avoided. Further, areas like level of computerisation, availability of Programmers, the level of development of software in-house could be areas to be looked into by the Inspection Department. Inspection Team could also comment whether programmes developed meet the needs of the Department.
- (e) The focus in the Inspection Reports should be on rectification of systemic defects. Paragraphs describing the working of the Departments/Sections and background information can be avoided since both the Department inspected and the Inspection Department which are users of the Reports, are in any case aware of this information. This will make the Report leaner and more focused facilitating easier follow-up.
(Para 4.4)

14. Inspection findings may be summarised in a docket at the end of each Department's Report covering various aspects like good

ED in-charge of Inspection Department, ED (Administration) and CGM, Inspection Department.

- (ii) The Officers posted to the Inspection Department/RAC may be paid a Special Allowance equal to the Faculty Allowance admissible to the Members of Faculty attached to the Bank's Training Establishments. The present quantum of the Faculty Allowance is Rs. 400/- p.m. (fixed).
- (iii) The HRDD/Training Division may identify appropriate training programmes, such as a Seminar on "Internal Audit in a Central Bank" conducted by the Centre for Central Banking Studies of the Bank of England. The Inspecting Officers may also be deputed to the Institute of Chartered Accountants of India Ltd. to get the feel of the current practices being adopted by them for audit/inspection. Further, they may be given preference in the matter of deputation to foreign training programmes.
- (iv) The tenure of posting may continue to be generally three to five years and in exceptional cases, up to seven years.

(Para 6.5)

18. In order to raise the quality of inspections and making them objective and meaningful, the posts of GMs heading Inspection Teams be upgraded to CGM (Gr. 'F'), those of AGM (Gr. 'C') of RACs/CACs to DGMs (Gr. 'D') and base level, i.e. S.O. Gr. 'A' to Gr. 'B'. As a consequence of this, the post of CGM in-charge of the Inspection Department should be upgraded to Executive Director or at least on par with the Principal Adviser (F+) carrying a Special allowance of Rs 300 p.m. (Paragraphs 6.7 and 6.8).

19. The Inspecting Officers be provided appropriate training at periodical intervals by devising specially tailor-made programmes at

the RBSC, Chennai, and/or the BTC, to improve their competencies and inject professionalism among them. HRDD/Training Division may identify suitable training programmes conducted by other institutions like NIBM or foreign Training Programmes for the benefit of the Inspecting Officers. The Programme held at RBSC, Chennai to facilitate conduct of inspections under computerised environment in the Bank may be repeated. (Para 6.9).

20. Two more RACs may be created, one at Ahmedabad and another at Bangalore by suitably regrouping jurisdiction of the Cells. (Para 6.10).

21. A review of the staff strength of the Inspection Department may be undertaken as per the well-established practice of the Bank. (Para 6.12)

22. The Inspection Department may convene, on annual basis, a Conference of Officers of Inspection Department and RACs/CACs for exchange of views/experiences, to which the Top Management and Statutory Auditors may be invited. One or two experts in the Inspection/Audit area could also be associated with it to brief the participants about the advanced techniques of Inspection/ Audit. (Para 7.1).

23. An Inspection/ Audit Manual may be brought out for the use of the Inspecting Officers. (Para 7.2).

24. The Inspection Department may develop Data-base on each Office/Department, based on the Inspection findings of the last, say, three years. (Para 7.3)

URGENT

September 20, 1997
Bhadra 29, 1919(Saka)

Dear Shri

Working Group to review the
Organisational Set-up of
Inspection Department and
Methodology of inspection, etc.

The Bank has set up a Working Group with the following composition to review the organisational set-up of the Inspection Department and methodology of inspection, etc. .

- | | |
|---|------------------|
| (1) Shri B.S.Sharma, Chief General Manager, RBI, DAPM, CO, Mumbai. | Chairman |
| (2) Shri M.K.Bandopadhyaya, Chief General Manager, Inspection Department, RBI, CO, Mumbai. | Member |
| (3) Shri S.R.Mittal, Chief General Manager, UBD,RBI, CO, Mumbai. | Member |
| (4) Shri K.L.Khetarpaul, Additional Chief General Manager, Department of Non-Banking Supervision, RBI, CO, Mumbai. | Member |
| (5) Shri S.M.Khot, Assistant General Manager RBI, DAPM, CO, Mumbai. | Member-Secretary |


The terms of reference of the Working Group are given in the Annexure.

2. Considering your long and rich experience in the Bank both in Regional Office/s and Central Office Department/s

the Working Group will like to have the benefit of your valuable views and suggestions/recommendations, with particular reference to the terms of its reference. I enclose for your ready reference a copy of Chapter 6 titled "Inspection and Audit" from the General Administration Manual - Volume I, which gives necessary information regarding the existing organisational set-up of the Inspection Department and the methodology of inspection/audit, etc. I shall, therefore, be glad if you will please favour us with your comments/recommendations, etc. at an early date. Since the Working Group has to submit its Report within a short time-frame, it will be appreciated if your reply reaches us by 4th October 1997.

Looking forward to hearing from you and with kind regards,

Yours sincerely,


(B.S. Sharma)

Encl: As above

**Extracts from the Document titled
"CENTRAL BANK AUDIT PRACTICES"
SIGMA PAPERS; No. 24**

6. AUDIT PRACTICES: INTERNAL AUDIT

46. This chapter describes the internal audit practices of the central banks in the four countries studied and recapitulates the most common and relevant aspects of internal audit, which are presented in more detail under their respective country chapters.

Responsibility for Internal Control

47. The role of the *board of directors* or *central bank council* includes a wide range of policy matters and business activities, duties and functions as specified in the bank act and regulations. In terms of corporate governance, the board is to ensure that there is adequate direction and control in keeping with the relevant statutory provisions for the bank's functions. It has ultimate responsibility and accountability for the system of internal controls that contribute to sound management and administration of the central bank.

48. The role and responsibility of *senior bank management* in various bank acts are clear as to the liability for the proper management and administration of the central bank. These responsibilities translate into the reasonable accuracy of the accounts and the effective and efficient management of resources and safeguarding of assets and other resources under the bank's control.

49. A major duty is to co-ordinate the development and implementation of management policies, practices and controls in order to satisfy their statutory responsibility. To meet its accountability, senior management has established a broad array of management control and accountability tools to report on performance within the central bank. External and internal audits in particular are essential review functions due to their inherent independence.

50. The board is also responsible for budgetary matters and that proper accounts are available for audit. The board has the important role of producing an annual report and relevant financial statements certified by independent external auditors, either by an outside accounting firm or the supreme audit institution.

51. In terms of specific control, some central banks use sub-committees, namely, an investments committee, a remuneration and budget committee, and an audit committee to manage and administer the bank to promote compliance with the bank act. These committees constitute an important element in the governance structure of a central bank. They are generally involved in the organisational structure, lines of authority and accountability of the bank. Review of strategies, plans and performance, budgets and liaison with the external and internal auditors are other important duties.

52. The board of directors and executive management of the central bank are accountable and answerable for their actions in accordance with the role and duties contained in the statutory provisions of the central bank act and regulations. As a result, there is a fundamental need to comply with these legislative requirements.

* Germany, Ireland, the Netherlands and Sweden

Although there are usually no statutory requirements for an internal audit function (except in the case of the Swedish Central Bank), there are obvious reasons for senior management to establish and maintain an internal audit group. Internal audit enforces the overall systems of internal control and therefore adds to the incentives of management and staff to perform in accordance with the bank's objectives and policies and procedures. Also, the presence of an internal audit function enables the internal auditors to limit the extent of audit testing that may be necessary to issue their audit certificate and opinion as required by law.

Internal Control and Internal Audit

We have defined internal control as a process to help the bank achieve its goals and objectives. Internal audit is a special part of the internal control system of the central bank.

Internal audit as an independent assessment provides objective information on the management and cost-effectiveness of business activities and operations, systems and built-in controls, economical and efficient use and protection of resources, integrity of information and reporting, and compliance with legal statutes and organisational policies and procedures (see Institute of Internal Auditors Standards). In the four countries studied here, it is recognised that a successful audit effort must build on:

- endorsement and acceptance of a clear mandate from the board (of directors) and senior management of the bank;
- the organisational status and authority granted the auditors should be sufficient to perform the audit mandate;
- existence of a professional and competent staff to manage and carry out audits in an independent and credible manner;
- the audit programme must be performed according to standards and be flexible and responsive to changing needs of management; and
- the audit results should be used to improve the bank's operations.

56. In terms of *organisational status*, the head of internal audit should report and be directly accountable to the highest level practicable in the bank and/or to the board of directors. This will assist in gaining the respect and co-operation of senior management, and permit the accomplishment of audit responsibilities in an independent and objective manner.

57. Auditors should have *authority* to access all information, records, documents, reports, facilities, sites and equipment that are relevant to their examinations. They are also authorised to interview employees and others to obtain information and explanations.

58. Operational *independence* is also important in that the auditors are not to be involved in developing or implementing policies, processes, systems or procedures which they may be called upon to examine. This does not, however, preclude the *ex-ante* audit of new computer systems under development or major capital construction projects.

59. Audit *standards* exist for both internal and external auditors in the four countries studied. Although these may vary from country to country, they can be classified under general standards, field work and reporting standards. General standards relate to competence, independence and professionalism.

Field standards cover planning, internal controls and evidence, and reporting standards deal with disclosure of audit opinions, and the form and content of audit reports.

60. In terms of *utility* of audit results, audit standards (and the practices in the four countries) address risk assessment and specify the requirement to produce constructive, cost-effective and practical recommendations that help managers meet operational responsibilities and protect their interests by identifying opportunities for improvement. Value-added advice on the design and operation of essential control systems and the elimination of unnecessary controls and practices are also seen as important.

Types of Internal Audit

61. Central bank internal auditors in the four countries studied have the authority to audit all areas of bank activities. The scope and coverage of audits include:

- all parts of the organisation (e.g. central office operating departments, corporate support services, branch offices);
- all types of costs and revenues;
- all types of activities (e.g. procurement systems and procedures; banknote production, issuance, distribution and destruction; payment transactions; lending operations; foreign exchange transactions; trading of securities; accounting and annual accounts; construction activities and major capital investment projects; design, development and operation of computer-based systems).

62. Several audit strategies are found and are used in various ways, sometimes based on a mix of audits carried out on a surprise basis or a pre-announced basis. Surprise audits usually tend to be performed on bank operations that are considered to be high risk and are material in terms of liquidity. This includes highly sensitive business areas, such as money processing, cash payment operations, the custody of cash or vault holdings, banknote production and destruction, foreign exchange and trading transactions.

63. The audit of systems and major construction and procurement projects during the design phase prior to their implementation or completion is another audit strategy. The pay-back to such a strategy is that it is more cost-effective and timely to correct weaknesses in the control design before rather than after implementation, when large quantities of resources have been spent and a strong commitment to a faulty design has been generated. By auditing project management (including planning), costs incurred, control system design reports, management and audit trails at the start of development, the auditors are able to recommend cost savings.

64. A further audit strategy involves the reliance on the existence and quality of work performed by major controlling departments based on the scope of organisational studies and checking at the transaction level. This could significantly reduce the amount of audit work to be carried out by the internal auditors. Using a similar concept of reliance on the quality and effectiveness of the internal audit function, the external auditors can also limit their audit coverage and level of audit testing, particularly at the systems level.

Reporting Relationships

65. Principal reporting relationships of the internal auditors in the four countries studied are with the board of directors, audit committee, senior management and major internal control departments in the central bank. Proper interface is needed to co-ordinate audit effort, and to minimise unnecessary overlap and to avoid duplication of the different control groups.

66. External and internal auditors work closely together in order to have an overall effective audit function to avoid duplication. It should be noted that this co-operation is usually not a legal requirement but based on good professional practice. Exchange of audit plans, co-ordination of planning, and information on results are typically examples found in the four countries studied where a close relation between internal and external audit was visible.

67. Positive and mutually confident working relationships between auditor and those audited are also considered to be of utmost importance for the effective fulfilment of the audit task. The audit time will be shortened and a better exchange of ideas and managerial experience will contribute to successfully meeting the audit objectives. Positive working relationships will gain commitment from senior management of the audited unit to take corrective action on reported weaknesses.

68. Based on satisfactory working relationships, summary reporting back through to senior management, the board of directors or an audit committee is facilitated, more cost-effective and gives positive results.

Audit Resources

69. *Recruitment* of staff varies but typical sources are universities and technical colleges, the chartered accountant community, and from within the central bank itself.

70. *Skills* required depend on the audit mandate in terms of the scope and objectives of the audits to be performed. Generally speaking the range of skills includes experience in management and general audit, computer systems, banking, foreign exchange and trading, engineering, financial accounting and economics. This is due to the specialist activities to be audited and the use of multidisciplinary audit teams.

71. *Training* and professional development of internal auditors usually are a combination of classroom and on-the-job training. This is supplemented by attendance at seminars or conferences to keep abreast of modern audit techniques, etc. Most audit organisations try to provide each auditor with at least two weeks of training per year. In some organisations, there exists a young professionals-to-hire programme, and new recruits are subsequently trained.

72. The *size* and amount of audit resources needed in an organisation varies according to a multiplicity of variables. It is very much dependent on factors, such as nature and complexity of bank activities, organisational structure and extent of decentralisation, audit scope and type of auditing performed, extent of computerisation, quality of existing systems and controls, volume and value of transactions, revenue, expenditures and assets and working relation between external and internal auditors.

73. For indicative purposes only, as a rule of thumb, in banking there is one internal auditor for every one hundred bank employees. Small banks, on the other hand, need a higher ratio of auditors to staff. Three auditors are generally seen as a minimum in order to maintain a high quality audit.

Planning of the Audit

74. The internal audit is typically planned on a multi-year as well as an annual basis. The plans cover selected audit units after deciding on high, medium and lower risk areas. Based on risk assessment, judgement, audit experience, and available audit resources, individual audit assignments are then normally scheduled on a one to three year cycle. The approved audit resources will of course influence the frequency of individual audits. Taking into account risk assessments made as part of the long-term and annual planning process, audit assignments can then be scheduled.

75. To optimise the limited audit resources, some internal audit offices have found it useful to rank in order of priority all potential audit areas. The criteria used to do the *risk assessment* and to schedule the individual types of audits are:

76. *Materiality*. This aspect of risk is a function of how reliable the system of internal controls and procedures in place are considered to be. Quantitatively speaking, the amount of revenues and expenditures, the value of the assets generated, the volume and value of payment transactions are considered to be material. In addition, the auditors also try to take into account the vulnerability to loss through fraud, theft or mismanagement, and the liquidity of cash and other assets managed.

77. *Reputation and image of a central bank* is extremely important in qualitative terms due to their fundamental role in the economy and this aspect has always to be taken into account in planning the audit. A lack of prudence in the implementation of monetary policy, managing foreign exchange reserves, ensuring a safe and efficient inter-bank payment system and the production and issuance of banknotes for the country could result in a loss of credibility in the eyes of the public with the devastating consequences for the country.

78. The *nature and complexity* of the bank operation can bear considerable risk. A specific example is the risk associated with foreign exchange transactions, such as market risk, credit risk, liquidity and processing and manipulation risks. Other areas are securities trading and holdings. Banknote production, issuance and destruction are also sensitive areas.

79. *Other criteria* for selecting which areas should be audited include major changes in systems or organisation, staff turnover, extent of decentralised approval authorities, the degree of computerisation and any known senior management or external auditor concerns.

Performing the Audit

80. The internal audits in the four countries studied follow a similar pattern. The basis of planning an internal audit is risk assessment. This results in identifying preliminary audit scope and objectives. These objectives are usually refined into specific attainable lines of inquiry in order to decide what to emphasise and how to perform the actual audit work.

81. A *detailed planning* phase normally precedes each audit assignment selected for audit. This phase involves obtaining, documenting and reviewing background information related to the bank activities under audit. A preliminary survey is made to assess whether there are any areas where improvements in bank operations are needed, or where significant concerns or risks are suspected. If additional audit work is warranted, the auditors will proceed to a more detailed examination of the major issues identified and the remainder of the control system.

82. The auditors will then proceed to *review the internal control* systems to ensure they are working as intended. To do this, key system controls are identified in terms of economy, efficiency and compliance. Based on the evaluation of the existence and adequacy of these key controls, the auditors determine the level and type of *audit testing* required. The audit testing is done to ensure if the systems and procedures performs as they are specified to do. The testing may include that a sample of actual transactions are followed in detail on how they are processed. Sometimes the auditors also use sets of "hypothetical" transactions to do these kinds of tests. In order to clarify it, a relevant and stable "*audit trail*" exists. Computer audit programs or manual audit guides and/or checklists are used in the analysis of the system, and results in an identification of deficiencies or weaknesses and risks. The cause for the situation and the resultant effects are further investigated and recorded together with appropriate audit evidence to back up all conclusions reached. Audit work has to be orderly and *well documented*.

83. The final phase is *report writing* in order to draft formally the audit observations and recommendations that will end up in the final draft audit report. Before completing the audit report, the auditors will usually obtain, after an oral debriefing of the auditees, written comments or responses to the draft report. This will serve to confirm the factual accuracy of the audit findings and to put the audit issues into a proper managerial perspective.

Audit Tools

84. All bank auditors have access to audit programmes, checklists and internal control questionnaires, covering the various activities of the central bank. This is supplemented in some banks with personal computer access to mainframe information systems of the bank. Such access is useful for auditing, not the least during the planning phase of an audit, or for data collection on different subjects or/for cost analysis.

85. Specific computer tools for auditors that are used are ACL or IDEA audit software, common office automation packages, and various spreadsheets available on the market. ACL or IDEA audit software are widely used by bank auditors for data extraction, sampling and analysis purposes, especially where there are large volumes of transactions. Spreadsheets are also used for analysis. The automation packages are used for purposes of designing graphics and documenting process flows and internal controls.

Follow-up on Audit Recommendations

86. A good audit practice is to follow up on the extent of management action in implementing measures which correct weaknesses identified in audit observations and recommendations. No matter how good the audit report may be, if no action is taken, the systems of internal control will continue to be at risk. It is incumbent upon the key players in the follow-up process to report and validate the status of improvements made as a result of the audit report.

87. As a starting point the auditors usually request a confirmation letter from management describing what actions have been taken following an audit report. In most central banks, the minimum follow-up action of this is a review of the confirmation letter. The letter is reviewed to see that all serious risks are addressed, and information is provided on the action to be taken, the implementation date and the position responsible. This ensures agreement and commitment to make the necessary changes. A letter requesting confirmation of status on progress may be subsequently sent out to management of the entity audited. The scope of the next regular audit would automatically include something on the follow-up of

previous observations. Some banks will regularly do periodic on-site reviews of progress, if the audit findings are serious and warrant urgent attention.

88. Banks will then report the status of actions taken on their audit reports and unresolved issues in an annual report to the board of directors and, where applicable, to the audit committee.

Quality Control

89. In-house supervisory and quality assurance is regularly performed on the quality of each audit itself as well as on each audit report and supporting working papers. The intent is to ensure that sufficient, appropriate and valid audit tests and evidence was gathered to afford a reasonable basis for the audit conclusions. The review of the audit report is essentially of content and form. Quality control varies between audit offices and depends, among other things, on the size of the audit entity but seems always to follow generally accepted audit standards.

90. The report conclusions must be consistent with the terms of reference for the audit assignment. Also, the audit observations must be clear, state causes and effects, and result in practical and cost-effective recommendations.

Evaluation of the Audit Department's Work

91. Apart from the assessment of the internal auditors' work for purposes of reliance by the external auditors (including the SAI), the internal audit department usually produces summary reports on performance of the audit department on an annual basis. Some banks also prepare summary annual reports to the board of directors, bank management and the external auditors for specific matters relating to lending operations and the annual accounts.

92. In addition, correspondence files and working papers and audit reports are available for trend analysis of audit issues. The activity reports sent to board of directors or audit committee members provide performance information on the audit plans in light of approved budget and available resources. Specific information is also provided on the reliance that external auditors were able to place on the internal audit function and any quantifiable cost savings.

Corporate Memory

93. The value of a good management information system for audit planning and follow-up purposes, training and continuity is acknowledged by all bank auditors met. The existence of such a system is also efficient and effective in preparing audit activity reports and year-end reporting on the state of audit, and on the overall performance of internal control systems in the bank.

94. Most bank auditors use time sheets to record and subsequently analyse for future planning purposes. The audits and their results are recorded in detail in PC (personal computer) data files or in a manual filing system (reports, correspondence and working papers).

TELEGRAMS
'RESERVBANK'
TELEPHONE:
2661602

RESERVE BANK OF INDIA
DEPARTMENT OF ADMINISTRATION
AND PERSONNEL MANAGEMENT
CENTRAL OFFICE
SHAHID BHAGAT SINGH ROAD
MUMBAI-400 001

DAPM (PMW) No. G.21/254/17.05.17/97-98

October 21st , 1997
Ashwina 29th , 1919 (Saka)

All Chief General Managers/
General Managers (Officers-in-Charge),
Heads of Central Office Departments/
Principals of Training Establishments
(as per list attached)

Dear Sir,

Delegation and decentralisation - Facilities/Amenities/Perks -
References to Central Office

As you are aware, Central Office have been constantly reviewing the entire gamut of facilities/amenities/perks made available to various categories of staff resulting in increased relaxation in respect of certain facilities as well as further delegation of powers to offices/departments during the last 2/3 years. It is, however, observed that references still continue to be received in DAPM seeking instructions/clarifications in specific cases on subjects like Educational Allowance, Conveyance Allowance, Halting Allowance, Reimbursement of Hotel Expenses, Book Grant, etc., leading to avoidable correspondence and resultant delays in disposal of such cases. An illustrative list of such references received from offices/departments is given in the Annexure.


2. While adequate care is taken by Central Office to make instructions as clear as possible, you will kindly appreciate that it is not possible to take into account all types of situations and prescribe exact norms for dealing with them. It is desirable, therefore, that such cases are disposed of without reference to Central Office, if necessary by marking the case to CGM/GM (O-i-C) of the office/department. It should not be difficult to finalise the decision at office level keeping in view the spirit underlying the Central Office instructions.

..2

If, however, for some reason, it is felt that the decision cannot be taken at the level of CGM/GM (O-i-C), a reference may be made to Central Office, giving the details of the case and the reasons as to why a decision could not be taken at the local level. In such a case, it may please be clearly mentioned that the reference is being made with the approval of CGM/GM (O-i-C).

3. Please acknowledge receipt.

Yours sincerely,



(M.R.Dudani)
General Manager

Encl.: 1

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ANNEXURE :

| <u>Sr.No</u> | <u>Reference made to Central Office</u> | <u>Central Office Observations</u> |
|---------------------|--|--|
| 1. | Educational Allowance:- Delay in submission of the claim. | May be allowed if office/department is satisfied about the reasons for delay in submission of claim. |
| 2. | Conveyance Allowance:- Delay in submission of claim (i.e. beyond 15 th April of the financial year) because of illness of the claimant. | -Do- |
| 3. | Travelling Allowance – Tour (Training):- An officer was deputed for training. Due to the curfew, he had incurred extra expenditure on conveyance. | Such claims may be admitted depending upon the circumstances, at the discretion of the CGM. |
| 4. | Travelling Allowance – Tour – (Payment of conveyance expenses):- Taxi/Auto fare claims were submitted for higher meter reading in certain cases, due to road repairs, diversion of route, etc. | The claim may be admitted if the office /department is satisfied about its genuineness. |
| 5. | Travelling Allowance – Tour (Inspection):- Payment of Halting Allowance/ Reimbursement of lodging and boarding charges on Bandh day, while on tour. | The same may be paid by the office/department after ascertaining the facts regarding the Bandh. |
| 6. | Travelling Allowance (Tour) – Lodging Charges:- An officer had booked a room in a Government Lodge for 3 days as per the tour programme. On the first day itself the office called him back due to exigencies of service. The lodge authorities did not refund advance rent paid by him, as per their rules. The officer claimed lodging charges for 3 days. | Since the officer did not have any alternative, reimbursement of lodging charges may be admitted. |
| 7. | Furnishing of Residence of Officers:- Request for purchase of domestic flourmill. | It is permissible, being a kitchen appliance and covered under Central Office instructions. |

