REPORT OF THE WORKING GROUP TO REVIEW THE INTERNAL CONTROL AND INSPECTION/AUDIT SYSTEM IN BANKS

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CHAPTER-I

INTRODUCTION

1.1.1 The need to review the existing system of internal control, inspection and audit in banks has been acutely felt on account o the following factors:

(i) Over a period of time, existing systems and procedures have come under strain because of multiplicity of factors particularly massive expansion of branches and consequent phenomenal growth of business causing lengthening of lines of command and control.

(ii) However, in consonance with such rapid changes both in complexion and quantum of bank work and work situations, books of instructions , manuals of instructions etc., have not been revised/updated or added at all in many of the banks or to the required extent.

1.1.2 An effective internal control mechanism helps outside agencies, such as statutory auditors and RBI inspectors who are required to audit/inspect the banks. With the new approach of RBI on bank supervision through off-site monitoring based on reliable data and feed-back in addition to on-site inspection, strengthening of the internal control and inspection/audit function within the banks has assumed an added importance and greater urgency.

Background for setting up of the Working Group

1.2 A meeting of the General Managers in-charge of Inspection and Vigilance of nine public sector banks was convened on January 1, 1995 to take stock of the steps taken for streamlining internal control, inspection etc., and also to give suggestions for further improvement. The discussions brought out a number of areas as detailed below where action was required to improve internal control and inspection/audit system in banks.

(i) Constraints faced by banks in implementing directions/ instructions issued by Reserve Bank of India from time to time on internal control and inspection/audit.

(ii) Increasing trend in non-performing assets, frauds, misuse and abuse of authority in banks, arrears in inter branch reconciliation, deficiencies in house keeping including balancing of books, reconciliation of clearing differences and monitoring of advances.

(iii) Rise in misuse of the payment system in banks, as revealed by recent Reserve Bank of India inspections

(iv) The present quality of staff posted to the Inspection Department in many banks is not up to the standard. Ways and means to be explored to encourage talented staff to come forward to accept inspection assignment.

(v) The accountability of inspectors for their failure to report serious irregularities requires immediate attention of banks.

(vi) It is seen that internal audits are often treated in a routine manner in many banks by neglect of compliance obligations; resultantly, year after year repetitive audit objections are raised in respect of the same branch/area of functioning.

vii) Effective internal audit is required to be conducted by persons having special skills and understanding of the bank's working procedures expected to be possessed by bank's staff and external auditors which are generally lacking particularly in the latter case. Banks must progressively reduce, if not, eliminate dependence on external assistance for internal audit functions. They have to develop their own inspecting staff.

(viii) Lack of adequate training mechanism/facilities for the internal inspection/audit staff to inspect/audit branches/other offices under computerised environment as well as the new areas of activities undertaken by banking system.

(ix) Unsatisfactory quality of the concurrent audit carried out by internal auditors/external firm of chartered accountants. Ways and means to be formulated to improve their quality and effectiveness.

(x) Manual of instructions and inspection manual are neither updated periodically nor new activities are included therein.

(xi) Slow progress in rectification of deficiencies observed in the working of branch/office during the internal inspection/audit and the role of controlling offices in monitoring the internal inspection which is a major weak link in the control system.

(xii) The inspection formats used in banks may require a review in order to sharply focus attention of the bank management and controlling offices to the deficiencies and the operational weaknesses in working of branches/offices so that they can be addressed through timely intervention of senior officers and initiation of corrective steps.

(xiii) Automation of bank branches is being done on an increased scale and hence it is necessary to equip the Inspection Department to audit branches under the computerised environment.

(xiv) Problem areas/deficiencies in the functioning of overseas branches as well as subsidiaries of banks require to be identified during the audit of banks.

(xv) Rating system adopted by various banks requires to be looked into so as to ensure fair assessment of the working of the branch/office.

Constitution of the Working Group

1.3.1 Against this backdrop, the Reserve Bank of India has constituted a Working Group to review the internal control and inspection and audit system in banks under the Chairmanship of Shri Rashid Jilani, Chairman and Managing Director, Punjab National Bank(Annexure I). The other members of the Group are Sarvashri Uday.M.Chitale, Chartered Accountant, K.N.Gupta, Chartered Accountant, G.H.Deolalkar, Director, National Institute of Bank Management, Pune and K.C.Chowdhary, Executive Director, Central Bank of India. Shri V. Sethumadhavan, Addl.Chief Officer was the Member-Secretary. On his retirement, Shri G.P.Muniappan, Addl. Chief General Manager, Reserve Bank of India acted as Member-Secretary.

1.3.2 The overall objective of the Working Group is to examine the efficacy and adequacy of the internal control system in banks and suggest improvements in the system.

Terms of reference of the Working Group are as under:

1.4.1 The Group will review :

(i) set up of the internal inspection and audit departments in banks - computerisation of Inspection Department.

(ii) Inspection - scope and coverage, periodicity, criteria for selection of branches, format for reporting, different types of inspections, inspections/audit of service branches, administrative offices/controlling offices, whether inspections and vigilance should be under the charge of same executive or should be separated.

(iii) staffing of inspection department - selection system, incentives, training, etc.

(iv) system of follow-up and compliance of inspection reports.

(v) system and criteria regarding rating of branches and monitoring of poorly and unsatisfactorily rated branches.

(vi) system of reporting and follow-up of very serious irregularities observed during inspection - system of fixing accountability on inspectors for failure to detect and report serious irregularities.

(vii) concurrent audit - functioning of the system, follow-up and its impact on fraud prevention and detection.

(viii) inspection and control of subsidiaries of banks.

(ix) computer/ALPMS audit - training of officers in computer audit.

(x) inspection/audit of overseas branches.

(xi) role of external auditors in strengthening internal control system in banks.

(xii) Surveillance over new deposit accounts opened.

1.4.2 Deputy Governor, Shri S.P. Talwar met the Members of the Group during the first meeting held at Bombay on February 23, 1995. He mentioned that with the setting up of the Board for Financial Supervision, it was envisaged that Reserve Bank of India's supervisory role would considerably widen to cover not only commercial banks but also financial institutions and non-banking financial companies. In view of this, the new approach to supervision should have a broader view of the functioning of various institutions. He observed that there were four elements of supervision viz., bank's Board of Directors, inspection by RBI, internal inspection/audit and long form audit report of the statutory auditors. With a view to strengthening these elements, RBI had recently constituted two Working Groups, one to review the on-site inspection by the Reserve Bank of India under the chairmanship of Shri S. Padmanabhan and this Group headed by Shri Rashid Jilani to review the internal control and inspection/audit system in banks. Deputy Governor further observed that basically banks should have to supervise themselves and RBI had only a sort of remote control over them. However, it was observed that the internal control system in banks had got diluted to a large extent over the period and it left much scope for improvement. New prudential norms introduced by Reserve Bank of India had revealed that there were gaps in credit monitoring, funds management etc., by banks. Further, irregularities were observed in the investment transactions of banks and they had failed to supervise their subsidiaries effectively and consequently the latter had not shown desired results.

1.4.3 Deputy Governor mentioned that the overall objective of the Group would be to suggest measures to strengthen the internal inspection/audit system in banks. He also observed that it was Reserve Bank's experience that with the introduction of prudential accounting norms, the public sector banks were alive to the new situation and were concerned with their non-performing advances and were by and large, following the RBI guidelines. However, the private sector banks, their main objective being profitability, did not strictly follow the prudential norms/systems and many deviations were noticed. Therefore, he suggested that the Group should also take into account the systems in private sector banks in formulating their views.

Methodology adopted by the Group

1.5.1 In the first meeting of the Group held on February 23, 1995 at Bombay, it was decided to send out a questionnaire to all public sector banks, foreign banks and large private sector banks to elicit information from them in regard to the internal inspection/audit. The Chairmen/CEOs of banks were also requested to look into the information furnished in the questionnaire by the concerned departments personally before forwarding the same to Reserve Bank of India. They were also requested to give their views on sensitive issues separately. Responses to the questionnaire were received from 20 public sector banks, 12 private sector banks and 11 foreign banks. The names of the banks which responded to the questionnaire are given in Annexure II. Out of these, replies received from 15 public sector banks, 3 private sector banks and 5 foreign banks(names indicated in Annexure III) were examined by the Group. Details of the questionnaire and summary of views of select banks prepared on the basis of their replies are given in Annexure IV.

1.5.2 In the first meeting of the Group, it was also decided that views of the Chairmen/CEOs of banks on certain aspects of vigilance arrangement and inspection/audit system might be separately called for. Accordingly, information/views were called for from the CMD of all public sector banks on the following aspects of vigilance arrangement/accountability of inspecting officers:

a) whether vigilance and inspection/audit should be manned by different General Managers - reasons for their views.

b) If vigilance and inspection/audit are to be brought under two different departments, how their coordination could be ensured.

c) System obtaining in the bank regarding fixing up of accountability on inspectors/auditors for their failure to detect and report serious irregularities during inspection.

1.5.3 Views of banks on the above aspects of vigilance were also examined by the Group and its recommendations in this regard are included under vigilance arrangements in the banks discussed in the report.

Scheme of the Report

1.6 The report is divided into 12 chapters as under:

Chapter 1 :- Introduction.

The need/background for setting of the Working Group; constitution of the Working Group; terms of reference; methodology adopted; scheme of report; details of meetings held and acknowledgement.

Chapter 2:- Inspection/audit system prevailing in banking sector

Administrative set up of internal inspection and audit departments in banks; independence of inspection/audit functionaries; coordination between inspection and operational departments at Zonal/Regional Office level; overlapping in the role and responsibility of inspection functionaries at Zonal and Head Office level; extent of computerisation of inspection in Inspection and Audit Department; vigilance arrangements; coordination between vigilance and inspection/audit and fixing accountability of inspectors.

chapter 3:- Staffing of Inspection and Audit Department.

Qualities of an inspecting officer; approach and attitude of an inspecting officer; procedure and criteria for selection and posting of officers to Inspection and Audit Department; prescribed tenure of service in the Inspection Department; financial and other incentives to inspectors/auditors and training of inspectors/auditors.

Chapter 4 :- Scope and coverage of inspection/audit.

Objectives of internal inspection/audit; scope of internal audit; scope of inspection; different types of inspection/audit; relationship between internal inspection/audit and external audit; elements of inspection; manual of instructions on inspection/audit; composition of inspection/audit team; duration of inspection/audit of branches; frequency of inspection; inspection report format; inspection of Zonal/Regional Offices and Head Office Departments; quality of inspection; inspection/audit of overseas branches; new activities undertaken by banks and their control and check list for inspectors/auditors.

Chapter 5:- System and criteria regarding rating of branches.

Parameters for rating; methods of rating and suggestion to improve rating exercise.

Chapter 6:- Concurrent Audit

Role of a concurrent auditor; scope and coverage of concurrent audit, coverage and selection of branches; coverage of activities; agency to conduct concurrent audit; reporting system and rectification of irregularities/deficiencies; remuneration to the external concurrent auditors and accountability of external concurrent auditors.

Chapter 7:- Follow-up and compliance of inspection reports.

Time frame for rectification/compliance; closure of inspection report file; quality of rectification of irregularities and follow-up of inspection/audit reports; Audit Committee and its role in follow-up; reporting of serious irregularities and staff accountability.

Chapter 8:- Inspection and control of subsidiaries of banks.

Need for inspection/audit of subsidiaries by parent banks; Group's view on inspection/audit of subsidiaries by the parent banks and other forms of corporate control over subsidiaries.

Chapter 9:- Computer Audit

Need and scope of computer audit; tasks of computer auditors; approach to EDP audit; control measures for EDP applications; methods of EDP auditing; computer abuses and frauds and role of security; engagement of outside service angencies for EDP processing and system software development and suggestions of the Working Group.

Chapter 10 :- Frauds in Banks

Nature and types of frauds; causes for perpetration of frauds; analysis of fraud prone areas; preventive vigilance and the role of inspectors/auditors; staff accountability and penal action and reporting of frauds.

Chapter 11 :- Emerging areas of concern in banking business
Capital adequacy norms; prudential norms for income recognition, asset classification and provisioning; NPA management, Investment portfolio; stockinvest scheme; operations of NRE A/c.; reconciliation of inter-branch accounts; reconciliation of Nostro balances.

Chapter 12 :- Recommendations of the Working Group.

Details of meetings held

1.7 Details of the Working Group meetings held are furnished in Annexure V to this report.

Acknowledgements

1.8.1 The Working Group is thankful to banks which responded to questionnaire and furnished valuable information on various aspects of their internal control and inspection/audit system. It also expresses its gratitude to the guidance given by Deputy Governor (Shri S.P. Talwar), Executive Director (Shri D.S.Ramachandra Raju) and Chief General Manager(Shri A.M.M.Sarma) regarding the aspects to be covered in the report. The Working Group would also like to record its deep appreciation of invaluable role played by Shri V. Sethumadhavan, Additional Chief Officer(since retired) and Shri G.P.Muniappan, Additional Chief

General Manager as Member Secretary whose knowledge and painstaking efforts could make it possible for the Group to finalise the report and in time.

1.8.2 The Group has made use of the book entitled "Guidelines for internal bank inspection" brought out by Bankers Training College, Bombay and Inspection and Audit Manual of State Bank of India.

1.8.3 The Group also places on record the excellent assistance provided by S/S K.R. Ananda, Asst. General Manager, Dept. of Supervision, Reserve Bank of India, Central Office, Bombay, S.D. Pawaskar, Deputy Chief Officer, Central Bank of India, Audit and Inspection Dept., Bombay, P.P. Pinto, Officer, Staff Admn. Department, Central Bank of India, Bombay and K. Prakash, Officer, Inspection Dept., Punjab National Bank, Bombay.

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CHAPTER II

INSPECTION/AUDIT SYSTEM PREVAILING IN BANKING SECTOR

Administrative set-up of Inspection and Audit Department in banks

2.1.1 It is observed that all the banks which have been taken up for study by the Group have well laid down system of inspection/audit. In almost all these banks, at the apex corporate level, the Inspection and Audit Department is headed by General Manager (Inspection & Audit). In many banks he also holds the additional charge of Chief Vigilance Officer. General Manager is assisted by a team consisting of Deputy General Manager, Assistant General Manager, other hierarchy of officers. The complement of staff generally commensurate with the scale of operations and number of branches to be inspected. The Inspection and Audit Department at the Head Office usually deals with the following areas:

(i) Policy formulations in respect of matters dealing with programming of inspection/audit assignments;

(ii) Overseeing and co-ordinating the inspection/audit and its subsequent follow-up by functionaries at branch/controlling offices;

(iii) Placing of grave and serious irregularities/instances of frauds surfaced during the course of inspection/audit before senior executives/Audit Committee of the Board (ACB);

(iv) Effecting appropriate changes in the existing systems and procedures to plug the lacunae/loopholes; usually this is done by issuing instructions to the branches and inspection/audit personnel; and

(v) Control over cost and arranging training of inspection/audit staff.

2.1.2 Modalities of conducting inspection/audit differ from bank to bank. Some banks(including some major public sector banks) have a centralised set-up whereas other follow decentralised functioning. Most of the private sector banks and banks having smaller number of branches have preferred the centralised structure. Banks with greater number of branches and larger geographical spread have opted for decentralised set-up. In decentralised set-up, the inspection/audit work is carried out by personnel posted at Zonal/Regional Audit Offices/Inspectorates. These Audit Offices/Inspectorates function as an extended arm of Central Audit and Inspection Department and are usually headed by officers of Scale V/IV rank and these offices are in no way under the control of regional/zonal functionaries.

2.1.3 The administrative set up under decentralised system is as under:

AGM (Inspection/Audit) H.O.
!
!
Chief Internal Auditors (Scale - V, IV)
!
!
Senior Internal Auditors (Scale - III)
!
!
Internal Auditors (Scale - II)
!
!
Stock Inspection Officer

2.1.4 A typical orginasation chart under the centralised inspection/audit system is as under:

```
                         GM (Inspection)/CVO
                                 !!!
                          DGM (inspection)
                                !!!!!
 ____________________________________________________________________
 !                        !                           !          !
 !                       AGM                         AGM         !
                          !                           !
 ______________________________________________    _______________
 !    !                !                 !     !   !      !       !
 ! CHIEF             CHIEF             CHIEF       !              !
      !                !                 !                !
*Program-     * Establishment      * Reporting &     *Reporting
 ming Cell    * Frauds & Investi-    Monitoring        & Moni-
*Computer       gation             * Customer          toring of
 Audit        * Complaints           Service Cell    (ELB,VLB)
*System                                              *Admn.
 Review                                               Office
*Audit                                                inspection
Committee
*Policy
matters
  !              !                    !
 ______________________________________
                   !
               Sr.Mgrs.
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Programming

2.1.5 Under the centralised inspection/audit system, the programmes of inspection/audit are chalked out at Head Office level. In majority of banks following decentralised system of inspection/audit, programming is done at Zonal level.

Selection

2.1.6 Selection of officers for posting in the inspectorate is done at H.O. level by Personnel Division under both the systems.

Administrative control

2.1.7 Under the centralised inspection/audit system, the inspecting officials are under the direct administrative and functional control of Inspection and Audit Department of Head Office such as placement, performance appraisal and other related matters. However, in decentralised set-up, they come under the administrative control of Zonal Office for administrative matters.

Submission of inspection reports

2.1.8 Under the centralised system of inspection/audit, the inspectors directly submit the reports to the Inspection and Audit Department at Head Office for confirmation of the rating given in the inspection report and follow-up of important issues. Copies of the reports are also sent to Controlling Offices and the branch. Under the decentralised structure the inspecting officials submit all the reports to the local controlling office, for onward transmission of the copies of the reports to the concerned branch/Zonal/Regional Office/ Head Office for rectification, follow-up and monitoring.

Follow-up

2.1.9 Under the both the systems, the follow-up is done at Zonal level, based on the rectification reports submitted by the branch. However, quarterly review/monitoring of serious irregularities is done at Head Office level in some banks, based on the quarterly statement of rectification of serious irregularities, submitted by the Zonal Offices. In both the systems, in the event of grave/ serious irregularity detected during the course of inspection having a vigilance angle, such irregularity is referred to the Chief Vigilance Cell by the Inspection Division. The Group found that except in few banks, time limit has been laid or has been maintained in this regard.

2.1.10 The Group proposes no change in the existing structure of inspection/audit department of the banks. Each bank may continue with the set-up that is suitable for its scale of operations and from the angle of administrative convenience. However, it is essential that following important aspects are ensured under both the systems viz.,

(a) independence of inspection functionaries at Zonal/Regional Office level,

(b) co-ordination between inspection and operational departments at Zonal/Regional Office level,

(c) strict time limit on completing compliance by branch/Zonal /Regional Offices,

(d) Inspection and Audit Department or its Zonal/Regional Audit offices/Inspectorates being vested with authority to confirm acceptance of compliance on each report and authorising its formal closure.

2.1.11 The Zonal Office may have discretion for permitting carry forward of any hard core irregularities if it is satisfied that the same are not rectifiable in a time-bound fashion.

Independence of inspection/audit functionaries

2.2 Independence of inspection functionaries at Zonal/Regional level should be preserved for their effective performance. Zonal/Regional inspection functionaries should have the freedom to report directly to Central Inspection and Audit Department at Head Office. Operational in-charges should not be allowed to interfere with/effect changes in the inspection/audit function. The Group emphasises that independence of inspection directorates must be preserved.

Co-ordination between inspection and operational departments at Zonal/Divisional Office

2.3.1 This co-ordination can be achieved through a variety of ways. Zonal/Regional Audit Committees headed by Zonal/Regional Managers with chiefs of Zonal/Regional Audit Offices/Inspectorates hold meetings at periodic intervals where various aspects of inspection matters are discussed viz.,

(i) review of progress of branches in rectification/removal of irregularities,

(ii) steps required to be taken for expeditious turnaround of branches having poor audit rating or those branches beset with large number of serious irregularities or having huge backlog of balancing of books and

(iii) closure of inspection file of any particular branch having some problems/special features.

The minutes of these meetings are sent to Central Audit and Inspection Department.

2.3.2 In all banks whether having centralised or decentralised inspection/audit set up, it is the primary responsibility of operational wing i.e. Branch/Regional/Zonal Managers to ensure that the irregularities pointed out in inspection/audit reports of bank's inspectors or by RBI inspectors in Annual Financial Inspection reports are rectified well before the stipulated time-schedule and certificate to the effect(Rectification Certificate/Compliance Certificate) is sent to Central Inspection and Audit Department/Reserve Bank of India. The Group suggests that Zonal/Regional Audit Offices/Inspectorates should be made responsible for overseeing the follow-up and rectification work and bringing about close co-ordination between Zonal/Regional level functionaries and Zonal/Regional level Inspection/Audit offices.

2.3.3 At Central Office level, whenever quarterly/half-yearly business review conferences are held, Central Audit and Inspection Department at Head Office level should prepare a profile of performance of each zone on audit parameters and Zonal Managers should be required to incorporate into their action plans, steps taken for improving their performance on this score. Furthermore, data on critical branches/serious irregularities observed during inspection/audit are compiled by the Zonal/Regional Audit Follow-up Cells and forwarded to Central Audit and Inspection Department at Head Office which in turn takes up the matter with the Zonal-in-Charges for initiating appropriate action. Besides, information on developments/progress on audit performance is circulated among branches, functionaries of Zonal/Regional Audit Follow-up Cells(under control of Zonal-in-Charge) and Zonal/ Regional Audit Offices/Inspectorates. This exchange of information facilitates timely rectification of irregularities pointed out during inspection/audit which in turn results in the improvement of branch performance.

2.3.4 In the opinion of the Group, it should be appreciated that inspection work is more a fact finding mission rather than fault finding one. There is a greater room for co-ordination between inspection and operational departments to bring about synergic effort towards effecting overall positive changes in the functioning of the bank. The approach of the Inspection Department should be re-oriented to look at the time of inspection/audit of branches, their operational health and qualitative aspects rather than carrying out quantitative assessment in a routine manner. With sea-change in banking environment, quality of assets of a bank rather than the size of such assets has to be recognised as the hall mark of excellence. This shift in emphasis should be reflected in inspection reports.

Overlapping in the role and responsibility of Inspection and Audit Department at Zonal and Head Office level

2.4 As role of different tiers of management and functionaries has been clearly defined, most banks do not experience ambiguity/ overlapping in the roles and responsibilities of inspection/audit departments at Zonal and Head Office level. However, in a few banks overlapping exists in the areas of inspection/audit and concurrent audit/revenue audit/income and expenditure audit. The Group suggests that effective measures should be initiated by banks to remove areas of ambiguity and overlapping as also reduce multiplicity of different types of inspection/audit. However concurrent audit and regular inspection should not be construed as overlapping as perspective and focus of concurrent audit is qualitatively different from that of regular inspection/audit.

Extent of computerisation in Inspection and Audit Department

2.5.1 The Group notices with concern the tardy development made by banks towards computerisation of Inspection and Audit Department. While some banks have so far not made any progress on this front, others except State Bank of India are still in the process of computerisation. In State Bank of India, the Inspection and Audit Department is computerised and stores data culled from inspection reports. The bank has introduced note book computers for on-site data capture on experimental basis. Personal Computers are used for monitoring purposes. The Group would like to stress that in view of increasing volume of transactions, emergence of new areas of products/services, and associated complexities, the expeditious computerisation for data storage, programming and performance monitoring is imperative. It is also desired that each bank should maintain on computer a profile of each branch on performance in respect of various parameters like audit rating, assets quality, level of non-performing assets, revenue leakages, house-keeping, profitability etc. A study of this profile would enable the management to pinpoint the causes of poor performance of the concerned branch and initiate appropriate and timely corrective measures.

2.5.2 The Group observes that there is considerable scope for widening and quickening computerisation efforts. With the signing of agreement with Employees Associations/Unions regarding total branch computerisation, banks should move at a faster pace in order to achieve this objective. Banks should also computerise the track record of branches in reporting compliance of inspection/audit reports so that it will help the Audit Committees and functionaries at Zonal/Head Office level to have a constant track and suggest corrective action at appropriate time. Track record of frauds in branches, incorporating details such as, number of frauds, amount involved, modus operandi and region-wise incidence of frauds could be computerised. Data on branches could be stored in computer memory in such a way that the management should be in a position to know at any point of time, which branches/regions are susceptible to what types of problems/frauds. This will also enable the inspectors to be aware of which region/geographical area is susceptible to what types of irregularities/frauds much before commencement of inspection/audit of a branch.

Vigilance arrangements

2.6.1 The Group has examined the desirability of separating vigilance arrangement from inspection/audit functions in banks and bringing them under the charge of two different executives. It also considered as to how co-ordination could be ensured if vigilance and inspection/audit functions are to be brought under two different departments. Generally, following reasons are advocated for bringing these two functions under one executive.

(i) Separation would isolate/insulate the vigilance machinery.

(ii) Free exchange of information at peer level among vigilance and inspection staff would strengthen the functioning of vigilance machinery.

(iii) Chief Vigilance Officer will get first hand information on findings of concurrent/revenue audits, Long Form Audit Report(LFAR) of statutory auditors and Reserve Bank of India inspection reports and this will facilitate monitoring of frauds effectively.

(iv) CVO would be an action taking executive rather than an overseer.

2.6.2 While there is considerable merit in the reasoning, the Group is of the opinion that considering the greater reliance being placed, of late, on efficient internal control and inspection/audit systems in banks and the recent spurt in frauds/ malpractices in the banking industry, vigilance and inspection departments should be placed under the charge of two different executives so that individual attention could be given to these two important functions. The Group also recommends separation of these two functions for the following reasons:

(i) Nature of these two functions is different. Inspection and Audit entails both preventive and detective aspects. Vigilance emphasises detective and investigative aspects. The former dwells on rectification and improvement which are necessary to serve better operational health of branches whereas the latter concerns more with punitive approach warranted in specific instances.

(ii) Inspector/auditor is supposed to be a friend, philosopher and guide to branch functionaries, whereas vigilance is looked more from the discipline angle.

(iii) In public sector banks with large branch network, it would not be practicable for any single executive to have effective control over both vigilance as well as inspection/audit functions.

(iv) Combining these two functions will entail heavy workload on one executive which may result in accumulation of pending vigilance cases.

(v) Head of the Inspection and Audit Department should be well conversant with all minute details of the existing systems and procedures of the particular bank and should be able to analyse its inherent defects/shortcomings. Chief Vigilance Officer(CVO) who is appointed from some other bank/institution cannot be expected to be well-versed in the existing internal systems and procedures of the bank.

(vi) CVO should not build on his work entirely on the basis of feedback from inspection and audit reports. Where as, head of Inspection and Audit Department should identify areas attracting vigilance angle and intimate them to CVO from time to time for further action.

2.6.3 The Group further recommends that while Vigilance Department could be headed by an officer drawn from other banks, the Inspection Department must be brought under an officer from the bank itself for the reasons mentioned at (v) in the preceding paragraph.

<u>Co-ordination between vigilance and inspection/audit</u>

2.7 When vigilance and inspection/audit are brought under two different departments, there is a need to ensure closer co-ordination between these two functions. This could be achieved in many ways. As and when serious irregularities particularly those with vigilance angle are noticed during the course of inspection/audit a special report should be sent to the Chief Vigilance Officer. There could be further periodical meetings of the two department executives as suggested by Ghosh Committee.

<u>Fixing accountability of inspectors/auditors</u>

2.8.1 Banks should have a system of fixing accountability of inspectors/auditors for their failure to detect and report serious irregularities provided banks have always updated their operations manuals, book of instructions, circulars, inspection manuals and formats etc.

2.8.2 If omissions on the part of inspectors/auditors are grave enough and irregularities are very apparent and of serious nature, non-reporting of the same by them should be viewed seriously by banks and suitable action should be initiated. For this purpose, broad guidelines to establish accountability for inspectors/ auditors should be laid down. While formulating these guidelines, care should be taken to provide to the inspectors/auditors a comprehensive checklist as far as possible on each areas of inspection/audit to reduce the risk of human errors and omissions and to give allowance to the difficulties faced by inspectors/ auditors such as limited mandays allowed for inspection, lack of experience as well as exposure to the inspection assignment etc. Invoking dereliction of duty should not dampen the morale or enthusiasm of inspectors/ auditors and it should be exercised mainly in cases of grave mistakes/suspected collusion with the operating staff. Inspectors/auditors are expected to discharge their duties with due diligence.

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CHAPTER III

STAFFING OF INSPECTION AND AUDIT DEPARTMENT.

Qualities of an inspecting officer/auditor

3.1.1 The inspecting officer/auditor has to play a key role in the matter of conducting a thorough scrutiny of affairs of a branch. He should have certain personal qualities viz., the ability to communicate effectively, a high sense of integrity, strong common sense, drive, initiative and analytical ability and a sense of thoroughness and orderliness.

3.1.2 Professional skills of an inspecting officer/auditor should cover knowledge of both the existing and emerging commercial banking procedures and practices as also of the working of all departments/sections of a branch. He should have worked in a responsible position, preferably as a branch manager for a certain minimum period. A good knowledge of inspection/audit procedures and skills in their judicious application along with a fair idea about sampling methods are also essential to enable the inspecting officer/auditor to select for scrutiny a representative cross-section of transaction and to draw meaningful conclusions.

Approach and attitude of an inspecting officer

3.2.1 The Inspection and Audit Department in most of the banks has become a place for posting officers who are found not suitable in other areas. This situation has to be changed and the profession should be made to acquire creditable status which it deserves. This would be possible only if right persons with aptitude for investigation and scrutiny are posted in the Inspection and Audit Department. The inspecting officer/auditor should also endeavour to bring about improvement in his relationship with the branch and its staff by emphasising upon 'human factor' in inter-personal behaviour. Some of the points which could enable him to build up the right approach and attitude are discussed below.

(i) His approach should be objective and unbiased while conducting inspection/audit and in reporting his findings.

(ii) His inspection/audit work should be thorough, exhaustive and dispassionate. If there is even the slightest suspicion of fraud, defalcation, embezzlement, misappropriation or possible loss to the bank, he should immediately institute a thorough probe and should also suggest all possible preventive measures.

(iii) He should develop empathy with the branch manager or the officer heading the office under inspection and other functionaries. Since reciprocal confidence and trust are the prerequisites for effective communication, he should endevour to have proper understanding of their feelings.

(iv) He should work not only as 'eyes and ears' of the Head Office, but should take responsibility of guiding the operating staff by explaining the rationale of corporate policies and disseminating better knowledge of the procedures/practices of the bank.

(v) He should inculcate a sense of motivation in the branch manager in developmental activities. He should along with the branch manager meet some of the present/prospective constituents etc. This would help in assessing the business potential and also create an impression about customer service offered by the branch.

(vi) He should have constructive and helpful approach while on inspection duty and avoid turning the inspection into a fault finding exercise. To the extent possible, he should endeavour to get defects rectified on the spot.

(vii) He should discuss the findings with the branch officials before drawing his final report. He must remember that he is as much a part of the organisation as the staff of the branch are. He should appreciate that while conducting the inspection he has the advantage of hindsight which the operating staff involved in the actions under review did not have. It is also possible that due to rapid expansion, the concerned staff did not have the opportunities to acquire requisite experience in handling various banking transactions. He should, therefore, have a frank discussion with the branch manager and other officials of the branch with regard to his findings. He should take their views into account while suggesting ways and means to reduce the number of irregularities observed and to improve the routine and overall working of the branch. This will help in enhancing the acceptability of the inspection findings and their eventual rectification.

(viii) He should always maintain a courteous and dignified behavior towards the staff at the branch.

3.2.2 By and large all banks have opined that present complement of inspection/audit staff is adequate. However, a few banks have expressed shortage of inspecting officials on account of increase in volume of business and also due to increased periodicity of inspection/audit, following implementation of recommendations of Ghosh Committee. Another problem faced by banks is that experienced and skilled inspection officials cannot be retained in the Inspection and Audit Department for longer period and as such a specialised work force for inspection/audit could not be developed.

Procedure and criteria for selection and posting of officers to Inspection and Audit Department

3.3 Personnel Department in banks usually identifies few officers from the list of successful candidates in promotion process exclusively for inspection/audit department. The criteria for selection normally include thorough exposure to all operational areas of banking, while in some banks previous stint as a branch manager/assistant branch manager is mandatory. Aptitude and willingness for taking up inspection work, proven integrity, clearance from all vigilance angles and preparedness for undertaking extensive touring are some of the other factors which are given weightage. Possessing of professional qualifications like CA/ICWA/CAIIB is preferred. In many foreign banks personnel for inspection/audit are drawn from particular control group which may cover inspection/audit operations of branches situated in more than one country. These inspectors/auditors are specially recruited for this purpose and continue to remain in inspection/audit wing and a separate career path is chalked out for them.

Prescribed tenure for service in the Inspection and Audit Department.

3.4 At present, normal stint of inspectors/auditors in Inspection and Audit Department ranges between 3 to 5 years. The Group is of the opinion that stay of an officer in the Inspection and Audit Department for a period beyond 3 years could be counter productive and hence recommends that normally no officer may continue in inspection/audit work beyond 3 years.

Financial and other incentives to inspectors/auditors

3.5.1 At present no bank allows financial or other incentives to officers posted to the Inspection and Audit Department to the extent given by State Bank of India. Leased accommodation at any center in the country, special HTC facility in a block of one year, permission to spouse to accompany the official on duty at bank's cost as per entitlement of the official, kit allowance, supplementary halting allowance etc., are some of the special incentives provided by State Bank of India to its inspecting officers. Apart from these incentives 3 years of inspection duty is treated as equivalent to 2 years of independent line assignment which is a precondition for promotions to certain grades. On the question of providing financial and other incentives to inspecting officers, (beyond what is provided at present) many banks have expressed the view that such incentives are necessary as the nature of inspection duty is totally different from other assignments in the bank and the inspectors have to face many hazards including continuous tour. They have also recommended for giving weightage to inspection/audit experience while considering such officers for promotion.

3.5.2 The Working Group favours that efforts should be made to make inspection/audit work more attractive, by giving financial incentives to inspection/audit staff in view of the hardship faced during mobile duty. The Group does not recommend giving any weightage for promotion to inspection/audit staff for their experience since such a practice might create many other administrative problems.

Training of Inspectors/Auditors

3.6.1 New products and services are fast emerging in banking industry. At the same time, incidence of frauds are also on the increase and are being perpetrated in new ares especially in non-borrowal areas. Further, the inspectors/auditors who have to conduct inspection/audit of specialised branches/activities such as computerised branches , service branches, overseas branches, merchant banking activities, treasury operations etc., should possess the required technical knowledge. Functionaries at branches look upon the inspector/auditor as a 'think tank'. Role of an inspector/auditor is perceived to be that of a friend, philosopher and guide to the staff of the branch he is inspecting. To perform this role effectively, he should sharpen his knowledge and skills on a continuing basis. The special responsibility for improving and updating knowledge of inspecting staff has to be shouldered by Central Audit and Inspection Department as well as Zonal/Regional Audit Offices/Inspectorates. This may be done through developing a database on training inventory of each inspector/auditor and arranging for training in those areas to which he has not been exposed so far. Banks should have a system of sending officers posted newly to Inspection Department as under-study with the main inspection team initially for 2/3 branches. Persons having work experience and training in specialised areas like foreign exchange, dealing room operations, computers etc., should be associated with inspection team.

3.6.2 The Group stresses the need for updating the knowledge base and techniques of inspectors/auditors at periodic intervals through training/seminars specially conducted for inspection/audit department staff. Institutions like National Institute of Bank Management, Pune and Bankers Training College, Bombay can play a more active and leading role in organising special purpose training for inspecting officers/auditors of banks. The Group further recommends that banks could request NIBM/BTC to organise in-company programmes to the inspection/audit staff. Ultimate endeavour would be to build up an Inspection Academy over a period of time. It is important for chief of Inspection and Audit Department to convene at periodical intervals conferences of inspecting/audit staff in batches to share their experiences in investigations and make them uniformly knowledgeable.

3.7 Over the last few years, pace of policy/procedural changes and obsolescence of technology in banking industry has become faster and in consonance with the same the Inspection and Audit Department of the bank should provide periodically (preferably at an interval of one year) to each inspecting/audit official a booklet/compendium of instructions incorporating changes in procedures/RBI norms, contents of important circulars etc. Such a literature would also benefit external audit firms which are engaged by the banks for inspection/audit of its branches/other offices. These efforts could be further supplemented by developing a compact library with collection of books on various aspects of inspection/audit and specialised areas of banking such as foreign exchange, balance sheet analysis, computerisation, merchant banking etc.

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CHAPTER IV

SCOPE AND COVERAGE OF INSPECTION/AUDIT

4.1 Banks have evolved their own systems and procedures for their efficient functioning and regulation of all their transactions, with appropriate checks and controls. It has been the practice of all well managed banks with a network of branches to compile a Manual of Instructions setting out the procedures for handling various banking functions and to supplement it from time to time with circulars, containing suitable instructions for the guidance of the staff. This is achieved by instituting the system of internal inspection and audit which is a tool of direct control, while the indirect control being exercised through periodical returns. For achieving better control on their operations which are constantly expanding both in magnitude and complexity, banks have over the years introduced different types of internal inspection/audit. Besides, banks are subject to statutory audit by external auditors approved/appointed by the Reserve Bank of India as also periodical inspections by the latter. Thus, various types of internal and external audits and inspections are prevalent in the banking system in India. Their objectives and scope are briefly outlined hereunder.

Objectives and principles of internal control

4.2.1 Internal controls comprise of plan of organisation and all of the 'co-ordinate methods' and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. It involves appropriate segregation of functional responsibilities, system authorisation and record procedures adequate to provide reasonable accounting controls over assets, liabilities, revenues and expenses, sound practices to be followed in performance of duties and functions in each department, a degree of quality of trained personnel commensurate with the responsibilities. Assets have to be safeguarded against loss that may arise from waste, fraud, stagnancy, error, inefficiency on carelessness or casualty or untoward happenings. The foundation of internal controls is, therefore, greatly dependent on well -qualified and motivated personnel, administrative and accounting controls. Administrative controls require neatly codified responsibility areas, job functions, selection and training of personnel, fidelity standards, supervision, accountability, division of duties, i.e., no one in complete control, separation of those who deal with operations on assets from those who maintain relevant accounting and records, separate custodianship, a system of periodical double checks, rotation of duties, a system of authorisation at various levels, periodical internal auditing and independent examination.

@ "Co-ordinate methods" mean the systems and procedures which provide complimentarity, cross-checks and independent review methodologies for a business management of any work place with functions distributed among large number of supervisors and employees.

Accounting controls require a complete and integrated system of accounting, written manual, forms and documentation, authorisation standards, controls to verify accuracy of accounting inputs and outputs as well as operational results.

4.2.2. In many banks, the expressions 'audit' and 'inspection' are synonymously and interchangeably used. Often, their coverage also is found to overlap. There is, however, a distinction between the two. Audit is a quantitative analysis of the operations of an organisation. It is primarily concerned with correct and honest record-keeping in accordance with sound accounting principles and statutory requirements. Its basic purpose is to assess the integrity of the books of account and other records to ensure that they reflect the assets, liabilities, incomes, and expenses correctly. Inspection is somewhat broader in scope than audit. Inspection does include elements of audit but it is fundamentally a qualitative review of the affairs of an organisation. Its objective is not only to verify observance of the prescribed procedures and guidelines but also to promote and maintain safe and sound operating practices and conditions.

Scope of internal audit

4.3 Internal audit of a branch involves verification as to whether the books of account are properly maintained, checked and balanced periodically, whether all transactions are properly accounted for, and various checks prescribed by the Head Office regarding investments, advances, custody of cash, securities and other valuables are strictly observed. Internal audit has to pay particular attention to the following aspects:

(i) whether the books and records are maintained in accordance with the Head Office instructions,

(ii) whether an accurate and correct record of the liabilities and assets of the branch is shown in its books,

(iii) whether the assets shown in the books physically exist or are otherwise identifiable and their condition or realisability is satisfactory,

(iv) whether the documents obtained by the branch from its borrowers are complete and enforceable,

(v) whether a proper record of instructions received from the Head Office from time to time is kept and the extent to which they are being complied with,

(vi) whether the advances granted and the expenditure incurred are under proper authority,

(vii) whether internal checks and controls as prescribed are being properly operated, and

(viii) whether the returns to the Head Office/controlling office (Zonal/Regional/Divisional Office) and the statutory returns are being correctly compiled and regularly as well as promptly submitted.

Scope of internal inspection

4.4 Internal inspection includes all the above aspects, and in addition, it involves a critical review of the entire working of the branch. It includes an assessment of the quality as well as quantum of business the branch has attracted, and the scope for further development in the area of its operation. It has to examine whether the pattern of advances at the branch is generally in conformity with the overall lending policies of the bank and in furtherance of the socio-economic goals. It has also to recommend corrective action for removal of deficiencies/irregularities and make practicable suggestions for toning up the entire working of the branch so as to improve its overall efficiency.

Separation of inspection and audit functions

4.5.1 At present, only one bank is having separate inspection and audit departments. These twin functions are carried out by a single Inspection and Audit Department in other banks. Majority of banks have not favoured segregation of inspection from audit on grounds that such a segregation would lead to deployment of additional staff, non-availability of clear picture of functioning of the branch in its totality, possibility of scope of inspection getting diluted, duplication of work and consequential increase in cost on account of overlapping of duties. However, a few banks are in favour of segregation of these two functions in order to achieve speedier completion and qualitative excellence in reporting compliance.

4.5.2 The Working Group also does not favour segregation of inspection from audit. However, it has desired that more emphasis and accent should be given to inspection function.

Different types of inspection/audit

4.6.1 Besides regular inspection, banks subject their branches and other offices to various other forms of audit as enumerated below :

Concurrent audit

4.6.2 Concurrent audit is carried out in exceptionally large branches/very large branches/poorly rated branches/specialised branches/Investment Department/Foreign Exchange Department etc., almost covering 50 percent of bank's business. Concurrent audit is carried in banks either through outside firms of chartered accountants or through internal inspectors/auditors. This aspect of audit is dealt with in detail in Chapter VI.

Revenue/income audit

4.6.3 This exercise is done normally once in a year, usually through outside firms of chartered accountants empanelled with the respective banks. The purpose of such audit is to identify the instance of revenue/income leakages caused either by erroneous interpretation of rules/procedure, erroneous computation of income/revenue and to effect recovery of undercharges detected or otherwise. The Group suggests that revenue/income audit should be conducted at certain select large/medium sized branches or such of the branches identified on the basis of income leakages or possibilities thereof reported under such audit or concurrent auditors or Head Office inspecting staff or statutory auditors. Revenue/income audit should cover areas such as interest on loans and advances, overdue interest on bills/DD purchases, penal interest, exchange, commission and discount earned, interest paid on deposits etc. A substantially large portion as compared to the total volume of business should be subjected to this audit. If, however, a large number of errors are detected under any category, a comprehensive check of such items should be done. In order to avoid duplication or overlapping in this effort, it is recommended that in branches where concurrent audit has been instituted, this exercise need not be undertaken separately and the scope of concurrent audit could be extended to cover revenue audit also.

Computer Audit

4.6.4 Computer/EDP audit is conducted for ensuring data integrity, safety of data/assets and effectiveness in achieving organisational goals. Computer audit covers audit of relevant systems controls. Computer audit also assists in creation of right type of computer culture among the operators and controllers. The inspecting officials should take care to guide the branch staff about the importance of the prescribed controls while conducting computer audit. Computer audit is in fact a process which emphasises proper appreciation among the bank personnel about the controls that should be practiced diligently in computer environment. This aspect of audit is dealt with in detail in Chapter IX.

Short/spot audit

4.6.5 Spot audit is conducted either by internal inspection/ audit staff or by outside firm of chartered accountants at the instance of Head Office/Zonal office either on their own or at the specific requests from Regional Offices as and when warranted by any emergent situations such as detection/suspected frauds etc., that might have developed at branches. Such spot audits, which should carry a surprise element in a large measure, should be swiftly carried out and should cover specific areas of branch operations and other areas such as advances, bill business, deficiencies/lacunae in the systems and procedures or in the implementation which generally lead to perpetration of frauds etc. Spot audit reports are required to be acted upon with a greater degree of urgency attending to the special circumstances. Under normal circumstances, such spot audit reports should not be handed over to the branch manager.

Management audit

4.6.6 Management audit, which is normally conducted by experts is an independent and systematic appraisal of how well an organisation is accomplishing its objectives and performing the management functions of planning, organising, directing, co-ordinating and controlling. Broadly, it covers the organisational structure, management processes, management styles and performance. Ideally, management audit should cover all the three tiers of the organisational structure, i.e., the Head Office at the corporate level, Zonal/Regional/Divisional Office at the intermediary level and at the base level, at least the critical branches. Management audit is a total audit system encompassing the entire gamut of management functions and tools including the internal audit/inspection machinery.

Statutory/external audit

4.6.7 The main purpose of statutory audit, which covers the audit of the selected branches of a bank and various departments at Head Office, is to ensure that its balance sheet and profit and loss account reflect a true and fair view of the state of its affairs and profit or loss for the period. Such an audit includes scrutiny of transactions to see how far they are within the powers of the bank and also an assessment of bad and doubtful debts. The statutory audit report is normally addressed to share holders but is used by many other parties such as depositors, other creditors, financial institutions etc. The auditor's opinion helps in establishing credibility of the financial statements. The Long Form Audit report(LFAR) submitted by the branch/central statutory auditors of the bank which deals with, apart from other aspects, internal controls including written guidelines/instructions/manual for accounting aspects, balancing of books, reconciliation of control and subsidiary records, inter branch reconciliation, branch inspection, vigilance, fund management, credit appraisal, documentation and review/monitoring/supervision could help the Inspection and Audit Department of the bank to pick up certain critical issues for further review and corrective action.

Inspections by the Reserve Bank of India

4.6.8 The basic objective of inspections by the Reserve Bank of India is to protect the interests of banks and their depositors through maintenance of a sound banking system and to ensure implementation by the banks of the declared policies of the Government and Reserve Bank of India aimed at promoting a balanced growth of the economy. Its inspections involve an overall assessment of the assets and liabilities of the bank to find out whether the financial position of the bank is satisfactory, whether it is in a position to pay its depositors in full as and when their claims accrue and in the event of loss, whether it has adequate cushion of owned funds to safeguard the interests of the depositors. Besides, they include an examination of the organisational set-up of the bank, branch expansion, man-power planning and training, profit planning, etc. It also looks into whether the bank's lending policies and programmes sub-serve the socio-economic objectives. In assessing the methods of operation of a bank, the Reserve Bank of India, among other things, takes into consideration the adequacy and effectiveness of the Head Office control and supervision over its branches. Internal audit/inspection system constitutes an important means towards this end.

Relationship between internal inspection/audit and external audit

4.7. The role of the internal inspection/audit function within a bank is determined by the management and its prime objective differs from that of statutory audit. Nevertheless some of the means of achieving their respective objectives are often similar and thus much of the work of the internal inspection/audit may be useful to the statutory audit and vice-versa. Reliance on the work of the internal auditor is an integral part of the work carried out by the external auditors. Accordingly, the external auditors need to assess the effectiveness of the internal audit function in determining the nature and level of testing that they feel compelled to carry out. A constructive relationship between the external and internal auditors is important for an institution like banks and its regulators.

Elements of Inspection

4.8 The elements of inspection can be broadly grouped under verification, compliance and evaluation. Verification includes verification of assets and liabilities to ensure their physical existence and also of records, returns and reports to check their reliability. Compliance would cover the extent to which policies, rules, procedures, instructions, good banking practices and even sound common sense are observed while transacting the banking business. Evaluation which requires a very high degree of judgement, would be on the basis of inspection findings of overall working of the branch.

Manual of Instructions for inspection/audit

4.9 Most of the banks have a manual of instructions for their inspectors/auditors. This is supplemented by compendium of circulars, list of major irregularities, historical data on interest rates/service charges and check list for foreign exchange business, documentation on advances, staff matters, etc. Guidelines for revenue/income audit also exist in most of the banks. The manual is being updated periodically in most of the banks. However, in some banks updating is overdue for quite some time. The Working Group is of the view that every bank should have a manual of instructions for their inspectors/auditors and it should include new ares of activity undertaken from the last revision and updated periodically to keep in tune with latest developments in its area of operations and in its policies and procedures.

Composition of inspection/audit team

4.10 There is no uniform pattern of composition of inspection/ audit team. It varies with size and scale of operation of each bank. Most of the banks employ officials upto Scale III as inspectors/auditors whereas some of the large banks use the services of Scale III to Scale IV officers for inspection/audit. There is also no uniformity found in the size of inspecting team sent to branches/offices. Usually, for small branches 2 officers, for a large branch team leader with 2 officers and for a VLB/ELB, team leader with 2 to 5 officers are included in the inspection/ audit team. All banks are as far as possible try to ensure that leader of the inspection/audit team is one scale above branch manager/officer-in-charge. The Group is of the view that no specific size of inspection/audit team could be prescribed for banks and this should be left to the individual bank. However, the Group suggests that an inspection assistant may be provided to the inspection/audit team to facilitate quicker completion of inspection/audit report. Inspection unit should be a self contained one.

Duration of inspection/audit of branches

4.11.1 There is no discernible uniformity in respect of duration/ mandays prescribed for inspection/audit of branches. Mandays are largely decided on factors like, past experience, criticality of the branch, size,. volume of business and location of the branch. However, the average prescribed mandays for inspection/audit prevalent in the various banks are as under:

Type of branch	Prescribed mandays
Small branch	5 - 7
Medium branch	8 - 12
Large branch	20 - 35
Very large branch(VLB)	60 - 70
Exceptionally large branch(EVLB)	100 - 120

4.11.2 The Group suggests that each bank can decide the duration of the inspection/audit taking into account various factors. However, duration of inspection/audit of any branch should not be beyond two months. Even in case of very large and exceptionally large branches, the task should be completed within 2 months by providing additional officers to the inspecting/audit team, if necessary. It should be ensured that the inspection/audit team completes the task within the prescribed time limit. Extension of time could be granted in genuine cases on specific requests of inspectors. Cases of unauthorised or deliberate extension of prescribed mandays should be firmly dealt with. It should also be ensured that prescribed mandays do not lead to compromise in quality of inspection.

Frequency of inspection

4.12.1 In most of the banks, branches are subjected to inspection once in 12 to 15 months. Unsatisfactory branches are subjected to inspection at an interval of 6 to 9 months. Treasury and dealing room operations are inspected/audited in every quarter. Besides inspection, these two departments are subjected to concurrent audit also. Administrative Offices, Merchant Banking Departments and EDP Cells are inspected once in 2 - 3 years. Most of the banks are normally able to complete inspection of all the branches as per prescribed periodicity. However, in a few banks, backlog exists in the coverage due to shortage of manpower, increase in business, location of branches in far flung and disturbed areas etc.

4.12.2 The Group makes the following recommendations in this regard :

(i) All poorly rated branches should be inspected within twelve months and others between 12 - 18 months from the date of previous inspection. This will reduce the strain on branches as well as on Inspection and Audit Department caused by frequent inspections.

Branches will also get adequate time for rectification of deficiencies pointed out in the inspection/audit report.

(ii) All the branches should be brought under the purview of inspection/audit on an on going basis since by only this way the Management could ensure that the branch is run on sound lines both from the financial and organisational point of view.

(iii) In-ordinate delay has been observed in inspection and follow-up of irregularities in respect of very large branches functioning in major metropolitan centres. The Group recommends segmentation approach to eliminate delay in inspection of large branches. Banks should arrange for inspection of very large branches department-wise and follow-up of such irregu- larities observed during inspection should also be done department-wise so that focussed attention could be given to preparation of inspection report, its timely forwarding to branches, monitoring of the progress in compliance by the branches etc.

Inspection report format

4.13.1 Significant increase in the number of branches of banks, wide range of functions carried out by branches, as well as steep rise in business levels at all the branches have brought about the need for streamlining not only the procedures for conduct of inspection/audit of branches, but also the format in which the reports should be presented. Homogeneity, precision and comprehensiveness should be achieved in reporting on branches inspected. The reports should cover not only the entire gamut of branch operations but also furnishing a proper management view of the branches inspected/audited in the true sense of the term. The structure of the inspection report format should be such that it contains significant self-guiding features and check-lists to ensure that, as far as possible, inspecting officials are able to competently carry out inspection and audit of any type of branch.

4.13.2 The Group observes that all banks might have introduced prescribed/structured format for inspection/audit report, but what is more important is periodical updating of these formats in order to incorporate various changes in products, systems and procedures. Inspectors/auditors should be provided with a check-list of major and serious irregularities in various areas of banking operations. There should also be a system of reporting separately of serious and grave irregularities surfaced during the course of inspection/audit. It would be appropriate if structure of bank's inspection/audit report is remodelled as per format in which information for Annual Financial Inspection conducted by Reserve Bank of India is submitted. Such dovetailing would ensure co-ordination between various departments in banks engaged in follow-up of these two types of reports. With the growing trends of deregulation and competition in banking industry, it would be appropriate if a periodical return is compiled by each branch, indicating its assets and liabilities pattern. Inspectors should comment upon these returns. This should give a fair idea to controlling offices about assets/liabilities pattern, mismatches therein, status on non-performing assets, capital adequacy details, risk exposure etc., at branch level. The Group also recommends that there should be a chapter on assets maturity in the inspection report. Ratio analysis of branch on the same lines as done in Annual Financial Inspection reports of Reserve Bank of India should be carried out during inspection. The Group further recommends that an executive summary should be prepared by inspecting officer for each and every inspection/audit report and forwarded to in-charges of Zonal/Regional Offices controlling such branches, instead of confining it to those reports where very serious or grave irregularities have been highlighted or malafide is suspected. The Group emphasises that delay in submission of the inspection/audit report to the branch inspected/audited should be avoided. It is better if the inspectors/auditors submit the report to the concerned branch manager prior to leaving for next assignment. Necessary assistance/facilities should be provided to the inspectors so that they complete the report in the shortest possible time. Some banks prefer to have the inspection reports edited by Zonal/Regional Inspection and Audit Cells/Inspectorates. In such cases, irregularities in the borrowal accounts can be listed and handed over to the branch manager for rectification of deficiencies and remaining findings could be sent to the branch after editing.

Inspection of Zonal/Regional Offices and Head office Departments

4.14.1 Zones/circles and regions/divisions are important tiers of organisational structure of banks for ensuring achievement of organisational goals efficiently and effectively. Inspection/audit of these offices, therefore, becomes an important task. They should be periodically inspected and the following aspects, inter-alia, of their functioning should be looked into:-

(i) how far various powers and functions delegated to Zonal and Regional functionaries are being properly exercised,

(ii) whether Zone/Region are coming up to the expectations of the corporate management in development of business and achievement of national goals, sub-goals and priorities laid down by Reserve Bank of India.

(iii) whether any deficiencies/deviations in quantitative and qualitative aspects of credit management including foreign exchange and non fund business both in respect of pre-sanction appraisal as well as post-sanction control exist.

4.14.2 Regular inspection of Zonal/Circle/Regional Offices will enable the corporate management to make comparative analysis of the quality of bank's assets, house-keeping and effectiveness of control system at the time of last and current inspection/audit 2and formulate suitable Zone/Region wise strategies for rectification of the deficiencies/deviations and further improving strong areas to achieve corporate excellence. Such inspection would bring to the fore instances of staff accountability involving injudicious use of powers, gross negligence in matter of credit sanction and irregular procedures adopted for awarding contracts, acquisition/hiring of premises, placement of purchase orders etc.

4.14.3 Inspection/audit reports on Zonal/Regional offices should among other things highlight trends in deposit/advances growth, control return follow-up, branch visits by functionaries, house-keeping, reconciliation, frauds, credit management, follow-up of claims with DICGC/ECGC, recovery efforts towards reduction of non performing assets and efforts made to improve performance of poorly rated branches. It should be incumbent on inspectors/auditors to highlight and comment upon the persisting deficiencies or emergence of new deficiencies and the factors responsible for the same.

4.14.4 In almost all the banks Head Office departments and administrative/controlling offices are subjected to inspection at a periodicity of 2 to 3 years. Normally, the team is headed by a senior executive from inspection/audit department. The Working Group is of the opinion that there should not be any rating for inspection of Head Office departments/administrative/controlling offices.

Quality of inspection

4.15 Most of the banks have assessed the quality of inspection and reporting in their organisation as good to satisfactory. The Group suggests the following measures for improving the quality of inspection in banks :

(i) Officers having a thorough exposure to all areas of banking and aptitude should be posted in the Inspection and Audit Department. The Department should not be a place for officers who were found not suitable in other areas.

(ii) Training on continuing basis especially in areas like credit management, foreign exchange, treasury/investment operations, computerised operations etc., should be imparted to all inspecting officers.

(iii) Rectification and follow-up action on deficiencies/ irregularities observed should be expedited.

(iv) Inspection should be coupled with policy measures intended for avoiding recurrence of irregularities.

Inspection/audit of overseas branches

4.16.1. The primary objective of inspection/audit of the overseas branches is to find out whether they are working on sound lines and on a profitable basis and whether the pace of development of their business is satisfactory. In addition to the usual scrutiny of assets, liabilities and internal control systems, the inspecting officer is required to pay special attention to certain developmental and other aspects of branch management such as resource mobilisation, advances, non-deposit and non-credit services, working results etc. Having regard to types of and scale of operations of a foreign branch, any short-comings, if not corrected in time, may have a larger impact on the profitability of the bank, as compared to a domestic branch and also result in an outflow of foreign exchange. It may not be out of place to mention here that while supervisory authorities in each country have evolved their own systems and supervision over the operations of banks functioning in their country, they are essentially concerned about the soundness of their operations consistent with the local regulations, whether formal or informal, relating to capital and liquidity adequacy, permissible business activities, foreign currency exposure, loan concentrations and quality of loans. Reserve Bank of India as the supervisory authority of the parent office is far more concerned with assessment of the risk exposure and the likely impact on the working of the foreign branches on the overall position of the banks. In spite of the above supervisory structure, each bank having branches and subsidiaries abroad should put in place appropriate operational and supervisory control systems in respect of the operations of their overseas branches.

4.16.2. Reserve Bank of India has been impressing on all Indian banks having overseas presence the imperative need to have an effective system of inspection/audit, In August 1984, Reserve Bank of India set up, in consultation with the Government of India, a Working Group comprising senior officers of Reserve Bank of India, Ministry of Finance, Government of India and the major public sector banks for reviewing and formulating guidelines on the Systems for Overseas Operations(SOO) appropriate for Indian banks to help them in improving their credit portfolio and asset liability management practices as well as their administrative policies. The various systems recommended by the SOO Group had been commended by Reserve Bank of India for adoption by our banks as norms, based on which the management of each bank might reassess and reformulate, if necessary, their policies and systems in relation to their overseas offices.

4.16.3. Responses to the questionnaire sent out by the present Group received from various banks having overseas branches indicate that they have a system of control and general supervision by the Head Office/International Division over the operations of overseas branches/ offices. Following measures have been taken by these banks to exercise control over their overseas branches:

(i) periodical inspection by the inspection teams deputed by them,

(ii) system of annual performance budgeting and periodical review of performance,

(iii) scrutiny of inspection/audit reports submitted by statutory auditors, Reserve Bank of India inspection teams and local banking/deposit insurance authorities, exchange control authorities/tax authorities, etc,

(iv) on-going audit by internal auditors of the bank positioned at large overseas branches and

(v) visits to overseas branches/offices by senior executives from Head Office.

(vi) Scrutiny of various control returns in respect of resources, investments, advances, sticky advances, positions maintained in various currencies, charges, suspense and sundry deposit accounts, purchase and disposal of deadstock, monthly profit and loss accounts, performance report etc., received from overseas branches at Head Office and taking appropriate follow-up action there on.

4.16.4. The Group deliberated on the above aspects of controls exercised by banks over their overseas branches and is of the opinion that since the nature of problems and characteristics of operations of overseas branches are wide and varied, no uniform guidelines could be suggested for internal control, inspection/ audit of overseas branches. It also feels that, unless it studies in detail the systems of inspection and control exercised by banks over their overseas branches to find out the deficiencies, if any, it will not be in a position to suggest any modifications. Such a task would be very time consuming as it involves a detailed study of various control systems including examination of the coverage and periodicity of internal inspections/audits as also of the returns and statements called by the Head office/Central Office of banks from their overseas branches. However, the Group emphasises the need for banks evolving proper Management Information System which could indicate clearly all aspects relating to control over liquidity management, maturity mismatch of assets-liabilities, interest rate exposure and foreign exchange exposure of their overseas branches. Also, executives should visit these branches periodically and identify the areas of weaknesses/shortcomings and suggest remedial measures within a time bound programme. Periodical review of country exposure, client exposure and bank exposure should be undertaken by the Head Office taking into account, overall exposure of all branches/ offices and fix limits for each overseas branch. It may be prudent for inspectors/

auditors to have a dialogue with overseas central banks/ supervisory authorities before commencement of inspection/audit in order to have their full co-operation and meet local legal requirements, if any, prescribed by them.

4.16.5. The Group also generally recommends that inspection/audit of overseas branches should cover the following aspects:

(i) Exercise of discretionary powers for lending by the functionaries in a judicious manner.

(ii) Compliance by overseas branches in taking proper documentation for the facilities granted and compliance with terms and conditions stipulated by sanctioning authority.

(iii) Early detection of warning signals of incipient sickness/problems in respect of parties enjoying credit facilities.

(iv) Scrutiny of liquidity management, asset-liability mismatches, foreign exchange exposure and adherence to limits fixed by the Head Office as also efforts made by the branches to reduce the interest rate exposure risk etc.

(v) Exchange of market intelligence (e.g. names of defaulters, nature of frauds/attempted frauds, etc.,)

New type of activities undertaken by banks and their control

4.17.1 With more emphasis being given to increase in profitability and shore up the bottom line, banks have forayed into new types of activities. Some of the new activities undertaken by banks include leasing, hire purchase, factoring, mutual funds, venture capital, merchant banking, housing finance, consumer credit finance, credit card scheme, primary dealership in Government securities, stock invest facility, overdraft against shares/bonds, service branches for meeting credit needs of particular group of clients/collection of high value instruments for fast track clearance, electronic fund transfer, custodial services, increased trading activities in foreign exchange, asset re-construction activities etc. With such diversified activities, banks have become financial super markets. Banks are also handling new instruments such as interest rate swaps, financial futures/ options and derivatives. These instruments enable them to hedge, minimise or even transfer the risks associated with market operations.

4.17.2 Most of the banks have undertaken some of these activities either themselves or through subsidiaries established by them. Since the new activities are very much different from the traditional activities of banks and exposed to a greater degree of risk there should be a thorough and critical evaluation, preferably done through experts or consultants, of risks, threats and opportunities associated with each of the new activities. Based on these evaluation, impeccable internal controls should be devised (the same should be documented) containing the duties and responsibilities for all tiers of functionaries. Furthermore, maximum limit for market exposure under each of new activities should be set out clearly and befitting management information system should be introduced to keep the management apprised of the exposure on a day to day basis. Besides, specific cut loss limits should be introduced so that in the event of market trends getting adverse , expeditious steps could be initiated to withdraw from the market or reduce the extent of losses. Hence it is imperative for the banks to have proper control systems and monitoring mechanisms to review the performance and the level of risk associated on a continuing basis. It is essential for the banks to evolve a proper control system right from the day of allowing such activities and not at a later stage when the bank finds itself in a difficult situation. The need for greater computerisation of these activities should be thought of from the very beginning so that proper control/ reporting measures could be put in place. It is also imperative that the staff who are required to handle such activities are exposed to specialised training to acquire necessary skills. Executives of banks should also improve their knowledge in these new areas of business so as to have a proper perspective and control over the new activities. More professionalism and efficiency should be infused in those wings of management that are responsible for controlling the newer areas of activities. Any lackadaisical approach on this front may prove to be too costly for the banks.

Preparation of check lists for the use of inspecting officer and formats/ guidelines for controlling offices of banks

4.18.1 In the third meeting of the Board for Financial Supervision(BFS) held on February 22, 1995 at Bombay, Shri Y.H. Malegam, Member made the following suggestion:-

"Checklists should be prepared by both the Working Groups for the use of inspecting officers of RBI and banks respectively".

4.18.2 Further in the fifth meeting of the BFS held on April 24, 1995 at Bombay the following suggestion was made:-

"In many banks, the controlling offices were not able to perform their functions effectively since too many branches were attached to them. To help such banks, RBI could prescribe formats/ guidelines for controlling offices. In this connection, the Chairman mentioned that these matters could be looked into by the Working Group on internal inspection/audit(Jilani Group): in particular, a format of the report could be devised for submission by officers of controlling offices after visiting the branches."

4.18.3 The Group has deliberated at length, on both these suggestions and come to the conclusion that looking at the size and complexities of the operations of banks vis-a-vis limited time available for the Group to present its report, it will not be in a position to accomplish the task. The Group is also of the opinion that in view of the wide ranging systems and procedures prevalent in banks as also specificity and uniqueness of each bank's policies, procedures and internal control mechanism, prescription of an omnibus checklist/format/guidelines might not be of much use to banks. Such checklists and formats/guidelines for controlling offices should be prepared by banks themselves taking into account their policies and procedures.

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CHAPTER V

SYSTEM AND CRITERIA REGARDING RATING OF BRANCHES

Importance of Rating of Branches

5.1 Evaluation of the performance and functioning of a branch based on inspection and audit findings is an important judgmental decision having far reaching impact on perception of the Board/Top Management about branch in particular and of the entire bank, attitude and decisions of Zonal/Regional Managers concerned, career prospects of the branch officials especially branch managers and morale of official and staff. Hence an objective and accurate judgement by inspecting officials is of paramount importance. Objectivity is the essence of good reporting and the wording of the report is equally important as its contents. It is, therefore, very much necessary that the inspecting official very carefully, eschews casting aspersions on branch/field/ administrative officials and ensures that the reporting exhibits a dispassionate and objective reflection of findings of inspector/ auditor. The report should follow the principle of reporting by exception and reporting the exceptional. Reporting should not only highlight negative features of operations but also present positive and commendable features. Further, it needs to be emphasised that brevity and dignified tone are the hallmark of every good report.

Parameters for rating

5.2 During inspection/audit the health and efficiency of the branch is judged through the process of rating with some standard health indicators like following parameters;

(i) Follow-up and rectification of previous inspection/audit report/s,

(ii) Performance of branch concerned on business development, profitability, credit management and recovery,

(iii) Status of non performing assets and its recovery,

(iv) Quality of internal control system in vouge,

(v) Safety and quality of assets like cash, premises etc.,

(vi) General administration and staff,

(vii) Security arrangements,

(viii) Customer service and

(ix) House keeping including reconciliations.

Methods of rating

5.3.1 The overall assessment and evaluation of performance of the branch/office is done by one of the two following methods:

(i) In the first method, rating is based upon the total marks scored in each select parameters. Branches scoring total marks above the threshold level are rated as A, B or excellent, very good whereas those scoring below the threshold level are categorised as C, D or poor, unsatisfactory etc. Each of the of negative marking for unsatisfactory health of any areas of operations. This system tries to foreclose the possibility where the high score secured by the branch in certain parameters might camouflage the poor performance in important areas like credit management, house-keeping and internal control and still the branch may succeed in getting a higher or better rating. Rating varies from bank to bank. Some banks follow A/B/C/D rating whereas some follow rating Excellent/Good/Fairly Good/Satisfactory/Not satisfactory. The final rating is based on the sum total of scores obtained under each sub parameters.

(ii) In the second method, banks do not award ratings based on marks scored under various parameters. Instead, grades are awarded based on performance in select parameters on which the efficiency of the branch is evaluated. The parameters include housekeeping, customer service, business development, profitability, credit management, follow-up of government accounts, recovery etc. The final grade is arrived by taking into account the sum total of grades awarded under individual parameters/sub parameters. Evaluation of branch performance under core parameters and sub-parameters is made on a 5 scale(or 3 scale) rating viz., excellent,good, above average, average and below average. Based on this rating the general efficiency of branch is rated on a scale viz., efficiently run, well run, fairly well run, satisfactorily run and not satisfactorily run.

5.3.2 Many banks have the system wherein the inspector/auditor awards rating which is subsequently ratified/changed by Zonal/

Regional Audit Offices/Inspectorates/Head Office, according to their perception of the performance of the concerned branch as revealed in the inspection report.

Suggestions to improve the rating exercise

5.4 (i) The Group observes that every bank should necessarily have a system of rating of its branches on the basis of inspection/audit reports. The system of rating should also be reviewed periodically keeping in mind changed priorities and objectives set for proper working of the branches so as to give improved weightage to achievements under crucial areas. If the system of rating is based on marks given for different criteria, the parameters should include among others, mobilisation of low cost deposits, improving productivity/profitability and NPA recovery which have become priorities to banks. The system should also envisage imposition of penalties for increase in NPAs, and for persisting serious irregularities including non-tallying of accounts.

(ii) Comparing the two methods of rating, system of rating based on the performance in select key parameters is better than rating based on marks since the latter system is a straight forward exercise. Awarding marks could lead to embarrassment to all concerned. For further improvement in rating system based on performance in select key parameters, rectification of inspection irregularities/compliance by branch could also be added to the list of key parameters.

(iii) Banks do not have a system of rating of inspecting/audit staff. This Group also considers such rating not necessary. However, if deviations in the ratings given by the inspecting officer are significant, they should be suitably counselled by the controlling Zonal/Regional Audit Offices.

(iv) Computerised track record of efficiency ratings earned by branches over the past four/five inspections/audits should be maintained in the Inspectorate and updated from time to time and also made available to the inspection/audit staff. Subsequent inspection/audit must lay emphasis on parameters where low scoring was obtained by the concerned branch. Computerised analysis of such data would bring out many clues valuable for toning up the administration of branches.

(v) There should be a system of preparing summary of inspection report of unsatisfactorily rated branches for submission to the Competent Authority. Branches showing chronic and wide ranging deficiencies in operational areas and business administration may be given unsatisfactory rating in the inspection/audit report depending upon the seriousness and gravity of the situation. The purpose is to attract attention at all levels of the controlling offices as well as Head Office for initiating quick remedial measures to arrest the slippages. The reports should be dealt under a special footing at controlling offices in order to restore the branch within a stipulated time say, one year from the date of the report to an acceptable level of efficiency. The controlling offices should make a suitable report to Head Office both on receipt of inspection/audit report and also necessarily within one year about the fact that the branch concerned has been restored to normal state of operations. A suitable certificate to this effect should be furnished by the controlling offices to Zonal/Regional Audit Offices/inspectorates and Inspection and Audit Department at Head Office. It is also necessary that Zonal/Regional Manager should visit the branch soon on receipt of report on the unsatisfactory position to draw up a time-bound action plan of rectification. The controlling offices should also arrange to freshly inspect branch which has earned unsatisfactory rating within one year from the date of previous report. They should also have the fraud prone branches inspected at a similar frequencies in order to arrest the disturbing trend, if any, even though the branches might have secured better rating in the previous inspection reports.

(vi) Some large banks prepare a health card for the entire bank/circle/modules/regions. Under this exercise, performance in case of select parameters such as housekeeping, customer service, credit management, business development, profitability etc., are quantified in terms of a score by converting various parameters into numerical values. This exercise enables the Top Management to have an alternate tool to assess the progress being made by the bank. Even though this exercise has its own utility the Group feels that it should be left to other banks to decide whether they should follow this practice.

CHAPTER VI

CONCURRENT AUDIT

Need for concurrent audit

6.1 Based on the recommendations of the High Level Committee on Frauds and Malpractices in banks (Ghosh Committee), Reserve Bank of India advised all scheduled commercial banks (other than RRBs) in October 1993 to introduce a system of concurrent audit at large and exceptionally large branches. The concurrent audit system is now in vogue in almost all the banks. Some banks, in addition to concurrent audit, resort to revenue/income audit once a year as also spot/short audit, whenever necessary in areas where frauds and malpractices are suspected. Concurrent audit provides necessary checks and balances on key areas of branch functioning on day-to-day basis. It helps in preventing recurrence of irregularities in transactions and maintenance of books and accounts in accordance with the prescribed rules and procedures. Under concurrent audit weaknesses and deficiencies in branch functioning are identified promptly and rectification process is set in motion expeditiously. Concurrent audit of branches, (norms for selection of branches are set out later in this Chapter) should, therefore, form an essential part of internal control system in banks, besides internal inspection of branches at prescribed intervals. The system should be put in place wherever it is yet to be introduced in a regular way. Bank management should clearly spell out the linkages between different forms of internal inspection/audit already in existence and the concurrent audit.

Role of a concurrent auditor

6.2 Apart from the duties of audit, concurrent auditor is expected to function as a resource person to Branch Manager/ Division Heads. He should not sit in judgement of the decisions taken by a Branch Manager or an authorised official. The main role of the concurrent auditor is to supplement the efforts of the bank in carrying out simultaneous internal check of the transactions and other verifications and compliance with laid down procedures. A supplementary role for the concurrent auditor would be to recommend early action in respect of non-performing assets since the follow-up action taken by branches/controlling offices would be under his constant review. The concurrent auditor should be in a position to throw early warning signals about incipient sickness of accounts which should be promptly analysed for timely remedial action.

Scope of concurrent audit

6.3.1 Concurrent audit (or continuous audit) aims at keeping the routine transactions under continuous check. The object is to carry out audit tasks on an on-going basis. Concurrent audit attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. This audit is essentially a substantive checking in key areas rather than test checking. It helps bank management to establish a sound internal accounting functions and to have effective controls so as to preclude incidence of serious malpractices and fraudulent manipulations.

6.3.2 Concurrent audit goes beyond the verification of accuracy of transactions and accounting under the appropriate heads. The auditor has the added responsibility of ensuring that transactions or decisions are strictly in conformity with the policy parameters prescribed by the Head Office and are undertaken within the clearly defined delegated powers and terms and conditions for exercise of such powers. It is the duty of the concurrent auditor to ensure that no violation of Reserve Bank of India's directions and instructions takes place.

6.3.3 In majority of banks where concurrent audit is in vogue, regular inspection/audit and revenue audit are not conducted separately, while in a few banks revenue audit and/or regular inspection/audit are also conducted separately. It is needles to say that the scope of concurrent audit also encompasses revenue/ income audit which is undertaken as a separate exercise in certain banks. In fact, verification of expenditure and income under different sub-heads is an essential function of concurrent auditor. The Group is, therefore, of the view that in respect of branches which have been placed under concurrent audit, no separate exercise by way of revenue/income audit is considered necessary to avoid possible duplication of work and save costs. As, however, internal inspection/audit has a broader perspective, branches put under concurrent audit should also be subjected to internal inspection/audit, at periodicity applied to branches in general. It should be possible to confine the scope of inspection to the areas not specifically covered under concurrent audit.

Coverage and selection of branches

6.4.1 There is at present no uniformity among banks regarding the selection of branches and offices for the purpose of concurrent auditing. Since audit should have a focus on areas of business having high risks, concurrent audit should cover the departments/ divisions in Head Office and controlling offices dealing with treasury functions such as, investments, funds management including inter-bank borrowings, bills rediscounting, foreign exchange business, merchant banking, portfolio management service, credit card business, dealing room operations etc.

6.4.2 According to Reserve Bank of India guidelines, concurrent audit should initially cover branches which account for not less than 50% of the business of the bank (total of deposits and advances), which should be gradually increased to 75%. Within this parameter, concurrent audit should cover all exceptionally large branches (having business of Rs.150 crore and above), very large branches (having business in the range of Rs.50 crore to Rs.100 crore) and problem branches rated as poor or very poor during internal inspection/audit. Some banks have suggested coverage of those branches which have advances over Rs.10 crore or total business of Rs.50 crore irrespective of percentage of bank's business to be covered. Some other banks have indicated that business should not be sole criterion and other factors like advances, cost-benefit and efficiency rating should also be considered. The Group is of the view that since all the branches are subjected to internal inspection at prescribed periodicity, there is a need to avoid overlapping to save manpower and costs. The Group, therefore, suggests that size and complexity of credit and other high risk business portfolio would be a more meaningful parameter than the size of total business in selection of branches. It would be more beneficial to cover those branches under concurrent audit system which would account for 50% of total advances of the bank rather than 50% of total business. The banks may conduct an ABC analysis of branches with respect to advances and select the branches in accordance with the descending order of advances outstanding in such branches. In such an eventuality the number of branches placed under concurrent audit would be in the range of 30 to 50 depending upon the size of bank. The Group also recognises the need to cover high-risk branches and branches with poor rating under concurrent audit. The banks should post concurrent auditors at these branches and not at Zonal/Regional Offices. Reserve Bank of India may review the matter and consider issuing modified instructions.

Coverage of activities

6.5 Reserve Bank of India have issued an illustrative list of activities to be put under concurrent audit vide its circular DBOD No.BC.182/16.13.100/93-94 dated 11 October.1993. This covers cash, investments, deposits, advances, foreign exchange transactions, housekeeping, Government business, etc. In addition, concurrent auditors would verify accuracy of statements and returns, compliance on internal inspection/audit reports and aspects relating to customer service. RBI has also laid down norms regarding the extent of coverage of areas of business in respect of larger branches where volume of transactions is heavy and 100 percent check would be onerous and time consuming. These areas relate to income and expenditure items, inter-bank and inter-branch accounting, interest paid and interest received, clearing transactions and deposit accounts, where check can be restricted to 10 to 25 percent of the number of transactions. The Group is of the view that the coverage of activities and norms prescribed in this regard by RBI could be adopted by banks. It is needless to add that concurrent auditor would concentrate on high value transactions having financial implication rather than large transactions involving small amounts.

Agency to conduct concurrent audit

6.6 In State Bank of India, concurrent audit is undertaken by the inspection/audit staff of the bank. In all other banks concurrent audit is conducted partly through external audit firms and partly through their internal inspection/audit staff. On an average, 60 to 70 per cent of branches put under concurrent audit are at present assigned to external firms of chartered accountants. The Group feels that since concurrent audit is day-to-day checking of transactions in order to alert the bank management; it would be advantageous to undertake concurrent auditing through bank's own staff in the long run instead of depending on outside agency. Each bank could, therefore, form a core group of staff as a part of its manpower planning exercise and make suitable arrangements for training in this specialised field. However, till such time, banks can avail of services of external firms of chartered accountants by paying suitable remuneration for such job without compromising on the quality of such audit and also taking into consideration of likely reduction of branches coming under the scope of concurrent audit in light of the recommendations made by the Group.

Reporting system and rectification of irregularities/deficiencies

6.7.1 Except in a few banks there is no structured format for documenting the findings of the concurrent auditor. While it is admitted that very minor irregularities occurring in routine transactions which are rectified at the end of the day need not be documented, certain irregularities having financial implications, defective documentation or of similar nature need to be recorded in a structured form. This would also serve as a check list for the concurrent auditor. A structured reporting system would also be helpful for the bank management to assess the extent of coverage and the effectiveness of the concurrent audit. This could also be used for an annual review of the working of concurrent audit. The Group, therefore, suggests that each bank should introduce a structured format for the use of concurrent auditor.

6.7.2 In almost all the banks, list of irregularities is handed over to the branch/controlling office by the concurrent auditor for rectification. The progress of rectification is monitored by the Zonal/Regional Audit Offices. The purpose of concurrent audit would be achieved if rectification of irregularities is faster and recurrence of irregularities is avoided. While the present practice should continue, the Group recommends that major/serious irregularities detected during concurrent audit should be reported to the appropriate authorities so that a time-bound action programme for rectification could be drawn up and closely monitored. Whenever any fraudulent transactions are detected by the concurrent auditors, such matters may be immediately reported to the Inspection and Audit Department at Head Office with a copy to the Chief Vigilance Officer of the bank and also reported to the Branch Manager for immediate action unless he himself is involved in such fraudulent transaction.

Remuneration of the external concurrent auditor

6.8.1 There is no uniformity among banks in regard to fees paid to the external firm of chartered accountants for engaging them to do concurrent audit. While in some banks, there is a three to four tier structure of fees depending on the size of the branch, there are more number of tiers in certain other banks. Reserve Bank of India have advised banks that whenever external auditors are appointed for concurrent audit, the terms of appointment and remuneration may be fixed by the banks. For this purpose, broad guidelines could be framed by the Audit Committee of the Board of Directors of the respective banks.

6.8.2 The two Chartered Accountant members of the Group strongly felt that the performance of the external firm of chartered accountants as concurrent auditors is directly related to/affected by amount of remuneration received by them. In their experience, it is just not possible to engage qualified, experienced and well-trained personnel within the fees paid for concurrent audit of branches. With the result the reputed chartered accountant firms having developed expertise in audit of banks do not come forward to accept concurrent audit assignment. General experience of banks is that such work is often undertaken by professionals having inadequate organisation/infrastructure and many of them are found wanting in experience/expertise. In order that the objective of concurrent audit is achieved, it is imperative that the personnel should be well-versed and trained for the task. The Group feels that there is a case for up scaling concurrent audit remuneration to a level which will enable the external firms of chartered accountants to engage experienced and well-trained personnel.

Accountability of external concurrent auditor

6.9 Most banks have found that performance of external firm of chartered accountants as concurrent auditor leaves room for further improvement. Banks should, therefore, set up their own machinery for periodical review of the performance of external concurrent auditors.

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CHAPTER VII

FOLLOW-UP AND COMPLIANCE OF INSPECTION REPORTS.

7.1.1 Banks are being subjected to a variety of inspections/ audits. Objective behind each inspection/audit exercise is different. However, the costs incurred on these exercises are significant and expected pay-off would be realised only if reports are promptly attended to, irregularities rectified and operational health of branches improved. While rectification of deficiencies and removal of irregularities should be the job of the branch/ office concerned, the responsibility for follow-up of the inspection findings should primarily be that of controlling authority (and not the Inspection and Audit Department). In follow-up, the role of the Inspection and Audit Department should be confined to overseeing whether the branch and the controlling authority are discharging their responsibilities properly. These role boundaries should be clear and respected to avoid confusion if any, and prevent overlapping in monitoring follow-up.

7.1.2 There is no room for display of laxity or let-up in follow-up up of inspection reports. On many occasions, qualified rectification/compliance certificates are sent as well as received in a casual manner. Even irregularities that may have grave or serious impact are glossed over. Such perfunctory attitude may completely negate, at great incalculable cost to the bank, the efforts and energy spent by inspectors/auditors for preparation of reports and may render the whole process of inspection/audit infructuous or counterproductive.

Time frame for rectification/compliance

7.2.1 Average time prescribed in banks for full rectification of irregularities pointed out in inspection/audit reports, for branches, ranges between 3 to 6 months. As against this, actual time taken for effecting full rectification ranges, on an average, between 6 to 12 months. While, the Working Group appreciates the difficulties faced by larger branches in rectifying the irregularities within the stipulated time, it also feels that for smaller & medium sized branches, there is no need for giving longer period beyond 3 months for accomplishing full rectification. Incidentally, full rectification need not be defined and does not mean 100 percent rectification of deficiencies pointed in inspection/audit report. It has been observed that in many banks on an average 25-30% of irregularities pointed out in the previous inspection/audit report remain unrectified. Major factors that contribute towards such a large percentage of arrears are non co-operation from borrower, delay associated with ROC/RTO, indifference at branches, low priority accorded to inspection /audit follow-up work, delay occurred at DICGC and other such Government agencies etc.

7.2.2 There is unanimity of opinion, among the banks that certain types of irregularities take longer time to get rectified/ regularised. Irregular documentation for loans/advances, matters involving legal/technical issues, balancing of books, interbranch/ interbank reconciliations, recovery of revenue leakages detected, claiming reimbursement of pension paid, claims in respect of DICGC/ECGC etc, are some of the instances where long time is taken for rectification.

Closure of inspection report file

7.3 The issue of closure of branch inspection/audit file deserves closer attention. As stated earlier, closure of a branch inspection report should be proposed by controlling office to Zonal Inspection Office who will satisfy itself of the quality of compliance while authorising closure. In the absence of any closure, there would be multiple reports on the same branch that need to be followed-up. To avoid such eventuality, only the latest report should be followed up. However, it needs to be ensured that all the residual irregularities of the previous report/s that have not been attended to must be included in the latest report. Each inspector/auditor should look into the position of rectification of these irregularities during his stay at concerned branch. He should comment upon the efforts made by branch functionaries towards rectification of irregularities rather than mere commenting that these irregularities have remained unattended to. Closure of inspection/audit file on a particular branch should not be a ritualistic exercise. It must be made incumbent for senior officials at Zonal/Regional Offices to sift and critically examine the compliance certificates while taking a decision about closure of a file. This calls for more active and alert role from in-charges of Zonal Audit Offices/ Inspectorates.

Quality of rectification of irregularities and follow-up of inspection/audit reports

7.4.1 Although, most banks have rated the quality of present rectification of irregularities and follow-up of inspection/audit reports, as good or satisfactory, there is a need for a substantial improvement. Senior management should initiate steps to usher in positive development in this area of paramount importance as suggested in the following paragraphs.

7.4.2 Special marks may be granted for efforts made by branches in rectification of deficiencies while judging them for awards and also for performance appraisal of branch managers/officials. In case of poorly rated branches, a time limit be set to restore such branches to normal state of operations. Special reports should be submitted to Audit Committee of the Board on such branches. A critical analysis of factors that have contributed to the sorry state of affairs in these poorly rated branches should be made available to Zonal/Regional managers and they should use this information during their visits to such branches and also during their meetings with branch managers. Meetings of Zonal /Regional audit committees which are also attended by functional in-charges of Zones/Regional Inspection and Audit Offices should be held at frequent intervals to monitor and hasten the process of rectification of irregularities as well as tone up the performance of the poorly rated branches. Minutes of these meetings should be scrutinised critically by Central Inspection and Audit Department to assess the performance of zones/regions in follow-up and rectification of irregularities, to have an integrated view of the health of the bank and also to place before the Audit Committee of the Board/executives the progress achieved in these areas for their information and issuance of necessary directions.

7.4.3 In charges of Zonal/Regional Audit Offices/Inspectorates should be advised to play a more proactive role by not only associating with inspection/audit of big/critical branches but also by interacting with zonal/regional audit follow-up cells more frequently and effectively.

7.4.4 Inspectors/auditors should try to get majority of irregularities rectified during their stay at auditee branches. They may have to guide the branches properly for this purpose. Branches should be made to understand that expeditious submission of rectification/compliance certificates should be given unremitting attention. They should also realise that qualified or manifestly incorrect rectification/ compliance certificates would be liable for outright rejection.

7.4.5 Working of audit follow-up cells at Zonal/Regional/ Divisional Office level needs gearing up to hasten the speed of rectification. These cells should be manned by persons having sufficient operational or inspection experience.

7.4.6 Whenever, excerpts of very serious irregularities/revenue leakages which have surfaced owing to abnormal deviations from laid down procedures/norms or existence of gaps/lacunae/loopholes in the existing procedures/norms are given to departments concerned, these departments should in consultation with O&M Department or Systems and Procedures Department or EDP Dept., take immediate action to plug these gaps/lacunae/loopholes through issuance of fresh/revised guidelines.

7.4.7 Branch Managers/Departmental in-charges should discuss the relevant portion of the inspection/audit report with the members of staff concerned and guide them suitably to avoid recurrence of the irregularities arising out of inadequate job knowledge. In the event of their transfer, the outgoing officer should arrange for the incoming officer to go through the previous inspection/audit report and the latter should satisfy himself that all the defects pointed out have been rectified or adequate steps have been taken to rectify them.

7.4.8 In some of the banks, senior executives like GM(Inspection) writes directly to the branch manager concerned where serious irregularities in credit management have been noticed with the instructions to Zonal/Regional functionaries that if the branch manager does not reply within the stipulated time limit, Zonal/Regional in-charges should take up the matter with him. If the branch manager still does not provide satisfactory explanation, he will be proceeded against according to disciplinary regulations. This system, if used with restraint in all banks may create sufficient respect for inspection/audit follow-up work.

Audit Committee and its role in follow-up

7.5.1 Almost all banks have formed Audit Committee of Directors as per directive issued by Reserve Bank of India. Principal functions of the Audit Committee are;

(i) to review follow-up action on inspection reports particularly of "unsatisfactory" branches, specialised branches and extra large branches(ELBs),

(ii) to ensure compliance with inspection reports of Reserve Bank of India and reports of statutory auditors including Long Form of Audit Reports and management reply to the latter,

(iii) to ensure accountability for unsatisfactory compliance of inspection reports, delay in compliance and non-rectification of deficiencies,

(iv) to take periodical review of accounting policies/ systems in the bank with a view to ensuring greater transparency in the banks's accounts and adequacy of accounting controls and

(v) to give directions in respect of lacunae observed in performance reports and other reports whenever necessary.

7.5.2 In almost all the banks Audit Committee consists of Chairman/Managing director, Executive Director and three Directors. In one bank, one of these Directors is a Chartered Accountant. In some banks, RBI nominee is also included in the Audit Committee meeting. During 1994-95 all banks have formed Audit Committee and on an average 2-4 meetings were held in these banks.

7.5.3 In the opinion of the most of the banks, where Audit Committee has been functioning for over a year its objectives are achieved to a large extent. A few banks have commented that as the Committee has been formed recently it would be premature to form an opinion. As regards the system followed for following up the directions of the Audit Committee, in majority of the banks, directions/decisions of the Audit Committee are minuted and sent to the concerned Zonal/Regional Inspection and Audit Cell and progress of compliance is placed before the Audit Committee. Where the directions are for revamping systems and procedures, the same is examined by the concerned department at Head Office. In some banks, compliance to Committee's directions is being monitored by senior executives/ executives secretariat.

7.5.4 Effective functioning of Audit Committee can greatly contribute towards overall improvement in the functioning of banks. There is scope for this Committee to broaden its domain and effectiveness through its study of additional areas such as frauds, progress in Annual Financial Inspection carried out by Reserve Bank of India, progress in inter-branch and inter-bank reconciliation, clearing adjustment accounts, sundry/suspense items, balance sheet items, etc. The Committee should meet more frequently, say once a month.

7.5.5 The banks should have structured items for discussion to be placed to Audit Committee. An indicative list of such structured item is given below:

(i) Review of follow-up action on inspection/audit reports.

(ii) Compliance with inspection reports of Reserve Bank of India and reports of statutory auditors including LFAR.

(iii) Investment policy - particularly investment in SLR securities like shares and debentures.

(iv) Reconciliation of inter bank, inter branch and Clearing Adjustment Account entries.

(v) Funds management - with specific reference to maintenance of CRR/SLR.

(vi) Observance of various controls prescribed by Reserve Bank of India for foreign exchange/dealing room operations.

(vii) Compliance with various norms prescribed by Reserve Bank of India in the area of credit administration including consortium lending.

(viii) Position of balancing of books and other house keeping functions.

7.5.6 Group discussed at length whether the CMD/CEO should head the Audit Committee. Views are expressed at certain quarters that, if the Chairman is associated with this Committee, its free functioning will be affected to a great extent. This Group does not endorse this view. Chairman, being the overall in-charge of the bank should be involved in the deliberations of the Committee. His presence would act as a balancing factor in the Committee's deliberations. Hence the existing practice of having CMD/CEO as the Chairman of the Audit Committee should continue.

Reporting of serious irregularities

7.6.1 It has been proved a number of times and also corroborated by findings of Ghosh Committee that the major causes for perpetration of frauds are, laxity in observance of laid down systems and procedures by operational as well as by supervisory staff and overconfidence reposed in bank's constituents. Some of them have however, indulged in breach of trust and perpetrated frauds taking advantages of laxity on the part of bank officials in observance of established and time tested safeguards. It needs to be emphasised that if the detailed systems and procedures evolved by the bank from time to time on various operational aspects are strictly adhered to, chances of malpractice could be reduced to a great extent. Vigilant inspecting officer/auditor should always be on the look out for pitfalls in growing and diversified banking arena. The Group recommends that banks should, therefore, continuously motivate their staff and develop them into an alert and well trained working force capable of timely detection of irregularities, malpractices and frauds. During the course of regular inspection, the inspecting officers should give special attention to certain vulnerable and fraud-prone areas of working of the branch and report any disquieting feature observed. Another area which requires a careful scrutiny is opening of new accounts in branches. Many instances of frauds especially relating to encashment of forged instruments and crediting the proceeds to such newly opened accounts have surfaced in recent times. Inspecting officer should ensure that the branch officials have taken all precautions to comply with norms prescribed in this regard including the genuineness of the introducer of the account.

7.6.2 Inspection findings relating to frauds detected during the inspection and matters involving malafides, corrupt practices and gross indiscipline which require immediate corrective action should be reported under special reports and not to be included in regular inspection/audit report. It is necessary that the inspector/auditor exercises restraint and due circumspection while submitting such special reports. It should always be ensured that these special reports are submitted forth-with to the required authorities to avoid delay in initiating action. Such authorities should ensure that reports are scrutinised thoroughly on an urgent basis and are treated as closed only after all the related issues are fully dealt with and taking a conscious view of all the attending factors. To enable the controlling offices reply on action taken on special reports and also to eliminate the avoidable correspondence, a special format should be designed to handle the follow-up of special reports. Alongside, policy decisions should be taken to remove the shortcomings/lacunae in the existing system that have contributed to the incidence of frauds/malafide action. In respect of undertaking special audits and/or occasions demanding preparation of special reports banks should develop detailed check lists/guidelines for different types of documents/ evidences that inspectors/auditors should look for and how they should be preserved(in a sealed cover) and recorded in branch document register. The sealed cover should be placed in the safe deposit under advice to Zonal/Regional Office so that the evidence collected is not tampered with.

7.6.3 Revenue/Income audit reports should attract the same rigorous follow-up as any other inspection/audit report. Zonal/ Regional authorities are expected to report revenue/income audit findings on select branches every year to Head Office/Zonal Office/Local Board as a mechanism of control over follow-up. Whenever instances of large scale revenue/income leakages are detected during the course of the audit, inspector/auditor should make a special report of the same for ensuring speedy remedial action. It is necessary that inspector/auditor develops the skill for spotting cases of income/revenue leakages in all types of transactions.

Reporting of staff accountability

7.7.1 It has been observed on many occasions, which is also confirmed by the report of Ghosh committee that staff responsibility for commission of serious irregularities such as injudicious use of powers, non-obtention of documents, failure to ensure their timely revalidation, disbursal of loans/advances prior to compliance with terms and conditions of sanctions and laxity in post disbursement supervision does not get reflected in reports of inspectors/auditors. Similarly, instances of lack of observance of prescribed procedure in awarding contracts, acquisition/hiring of premises, placement of purchase orders etc. are not mentioned in the inspection/audit reports. Such instances undermine the importance of using staff accountability as an effective tool for preventive vigilance.

7.7.2 In view of social responsibility cast on banks, especially public sector banks and also with a view to keep incidence of corruption and malpractices under check, there is a need for fixing staff responsibility aspect of irregularities, malpractices etc. at all levels, at the appropriate time. The Group makes the following recommendations in this regard.

(i) Capabilities of the vigilance and internal inspection /audit set up should be examined to see whether they are adequate to identify staff accountability and effective steps should be taken to strengthen them.

(ii) Effective linkages between the machinery for vigilance, internal inspection/audit and disciplinary action must be established so that they work in close co-ordination. The officials posted in these departments should have sufficient experience and exposure and they should be headed by officials of sufficient seniority and proper integrity.

(iii) The internal inspection/audit officials should be impressed upon the need for making in depth study of corruption/fraud prone areas during the course of inspection/audit so that there is no scope for any malpractice/irregularity remaining undetected.

(iv) Banks should put in place an effective system of inspection/audit of Head Office Departments and Zonal/Regional

Offices. It is imperative that these departments and offices are inspected/audited regularly at specified intervals by senior officials.

(v) In the course of revenue audit, reasons for leakage of income unearthed during such audit should be analysed in depth to see whether the mistake is genuine or deliberate. Stringent action should be initiated against the officials responsible for deliberate lapses.

(vi) A system of exclusive scrutiny of advances portfolio with focus on large advances and group exposures, at various branches at regular intervals may be introduced. The summary of important findings may be submitted to the Audit Committee of the Board.

(vii) Banks should examine staff accountability timely.

(viii) Inspection/audit team should critically examine the investment transactions in order to ensure that they are undertaken in accordance with laid down policies. It should be in particular, be ensured that these transactions are above board i.e., undertaken on business considerations alone and are in the best interest of the bank. In case any malpractice is noticed, officials/staff responsible for irregular transactions should be identified by inspection/audit team for fixing staff accountability.

(ix) Guidelines framed for delegation of powers for sanction of advances, post-sanction monitoring etc., should clearly indicate as to what constitute abuse of authority, negligence in compliance with terms of sanction, post-sanction monitoring etc. Non observance of the prescribed procedures and safeguards, laxity in sanction, disbursement and post-sanction follow-up of credit facilities and non-compliance with the terms of sanction should be viewed seriously and appropriate action should be initiated against the officials concerned.

(x) Cases of malpractices/irregularities/frauds where involvement of seniors officials (Scale IV and above) has been noticed and/or where the amount involved in the transaction is larger say Rs.5 lakh or above should be put up to the Board/Audit Committee, Further status reports on action taken on complaints of irregularities on the part of the senior officials and/or transactions involving larger amount should be placed before the board from time to time.

(xi) The Group emphasises that it is necessary to appreciate that in the process of fixing staff accountability there will be a downslide in employee morale. Therefore, bank managements should be very careful to balance action and its impact so that negetivism in decision making does not set in.

CHAPTER -VIII

INSPECTION AND CONTROL OF SUBSIDIARIES OF BANKS

8.1 With growing trends of deregulation and disintermediation coupled with momentous changes in information technology banks all over the world have been extending the arena of their activities into newer areas that are more lucrative. The range of newer areas is quite diverse such as executor trustees, mutual funds, housing finance, leasing, hire purchase, factoring, forefaiting, custodial services, primary dealers etc. Banks usually engage themselves in all these activities through formation of subsidiaries. With the growth of these subsidiaries and some of them involved in irregular transactions in recent times, the issue of control over them by the parent banks assumes importance. Any act of mismanagement on the part of a subsidiary or a major loss incurred by it has an adverse impact on the parent bank. More often the parent bank is questioned for the misdemeanour of the subsidiary in putting through its financial transactions.

Need for inspection/audit of subsidiaries by parent banks

8.2 As regards the issue whether the activities of a subsidiary should be inspected/audited by the parent bank, diverse views are expressed. One view is that as subsidiary has been formed by the parent bank, looking it as a profit centre, it has to retain its control over the subsidiary. Reserve Bank of India has specifically asked the Board of Directors of banks to review the working of subsidiaries/ mutual funds on a half yearly basis and also have them inspected at appropriate intervals. Banks are expected to exercise adequate supervision over their subsidiaries so that they conform to prudential requirements and operate on healthy lines. However, it is not expected that banks should interfere in the day-to-day management of the affairs of the subsidiaries/mutual funds. As and when RBI proposes to undertake inspection of subsidiaries, directives are issued by it to the concerned subsidiary as well as to the parent bank. A copy of the Reserve Bank of India inspection report is also forwarded to the parent bank with an advice to give their comments on the deficiencies pointed out in the report and also steps it proposes to take for the effective functioning of the subsidiary. The parent bank is also advised to give their observations on the compliance furnished by the subsidiary on the inspection report. This approach of Reserve Bank of India confirms the view that as a parent organisation promoting subsidiaries, the bank has a role in monitoring their functioning with a view to ensure that the activities and operations are conducted within the framework of the objectives and in a manner which is not detrimental to the interests of the bank/depositors/investors and others having dealing with these entities; besides ensuring that the desired compliance is made with statutory requirements and those of statutory bodies, licensing/regulatory and supervisory authorities. This could be achieved only when the banks ensure that each subsidiary establishes appropriate internal control and other control systems and procedures both accounting and administrative. Therefore, it becomes necessary for the parent bank to sponsor teams of inspectors, either internal or external, to subsidiaries. Furthermore, in the event of grave irregula- rities committed by the subsidiary and the consequent substantial losses, only through a quality inspection/audit, the parent bank may be able to pinpoint exact causes of irregularities and assess the extent of losses.

8.3 The other view on this subject is that banks need not be involved in the inspection/audit of their subsidiaries. Several arguments are put forth in support of this view:

(i) Parent/holding banks can not be held legally liable for the debts of their subsidiaries. In the case of subsidiaries several features have to be taken into account to see if there is a possibility of the group being treated as one economic unit. Financial contribution by the sponsoring bank and its participation in the management are the principal characteristics of the company being bank's subsidiary. Further, the experience has been that almost every subsidiary has been found to be representing, through advertisements and other literature disseminated by it, in such a way as if to create an impression

in the minds of general public unaware of the finer nuances of such relationship, that the subsidiary's activities are only an extended business of the parent company. While these features would have their own significance and implication, it may become necessary for the subsidiaries to make it clear in the interest of their growing clientele about the extent of financial backing they enjoy from their parent bank. Even now it can be positively asserted that the policy has precisely been to keep the banking assets separate from the assets relating to non banking activities i.e., of subsidiaries, such separation being necessary in the interest of the depositors. An attempt to fasten the subsidiaries' liabilities on the parent bank would jeopardise the interests of the bank's depositors.

(ii) Subsidiaries should be given enough autonomy for their free functioning. The need for autonomy becomes all the more necessary when subsidiaries attain maturity in their business methods and operations. Unnecessary or vexatious controls over the subsidiaries should be relaxed or removed. Any provision of law or control mechanism which tends to restrict the autonomy of a subsidiary or which creates the image of the parent bank as an overwhelming controller acts as a roadblock to the growth of the subsidiaries. In the circumstances, control over subsidiaries in the form of inspection/audit need not be the concern of the parent bank, since it would be as hazardous as backseat driving.

(iii) As the subsidiaries are annually audited by their statutory auditors and periodically inspected by RBI, inspection by the parent bank becomes an avoidable tier. Such inspections need not be undertaken as a matter of course unless the management of a subsidiary requests it to carry out a special inspection.

(iv) Parent bank may not have staff conversant enough with the

.vities of the subsidiaries to take up the inspection/audit. has to have a futuristic view also in this regard. New ivities are emerging in the financial sector and subsidiaries might pick up some of these activities. It will be extremely difficult for the parent bank to have at all times well trained inspectors/auditors to inspect these new activities.

(v) Another argument given for parent bank for not assuming the responsibility of inspecting its subsidiaries is that the latter might not have adequate staff to carry out the inspection. In that situation, subsidiaries can engage the services of external auditors for the purpose.

Other forms of corporate control over subsidiaries

8.4.1 The Group supports the view that it will not be advisable for the parent bank to conduct inspection/audit of operations of its subsidiaries. While there cannot be two opinions on the need for controlling the subsidiaries created by banks, what the Group emphasises is that this control by banks could be exercised by parent banks through methods other than direct inspection/audit of subsidiaries by the inspection team of parent bank. Incidentally, the requirement that the parent bank should maintain an "arms length" relationship with each subsidiary, is only in regard to business parameters and not in regard to monitoring its functions. Such control could be exercised by the parent bank in the following ways:

(i) Bank, through its nominated representatives acting as directors on the boards of subsidiaries/sponsored companies/mutual funds can get appropriate feed-back on the working of the entities to which they are nominated. The feed back could be obtained on such matters as the bank shall determine, keeping in view the nature of activities and operations of each entity.

(ii) The bank can enter into annual memorandum of understanding with its subsidiaries on certain critical parameters and obtain its compliance on half-yearly basis.

(iii) The bank can direct its subsidiaries to submit such further information reports for purposes of review/monitoring the activities of the subsidiaries as it may deem necessary and can prescribe the manner in which such information/report is to be furnished, as well as the periodicity of the submission of the same.

(iv) The bank can also direct its subsidiaries to furnish information at stipulated intervals, and within specified time frame, relating to assets, liabilities, rights, obligations and commitments, its operating results etc., and on receipt, it can examine the nature and composition of liabilities/assets of the subsidiaries as also the quality of assets build up.

(v) Each subsidiary being an independent entity must have its own internal audit system as measure of internal control of its operations. Internal inspection/audit brings reporting responsibility for the subsidiary's management to its stock holders and parent bank and as such the parent bank cannot inherit the right for conducting inspection/audit of its subsidiary.

(vi) Managing Director of a subsidiary is either implicitly covered by indemnity under Company's Act or explicitly covered under provisions of its charter against consequences of situations beyond his control etc.(also implied are situations as a result of interference by the parent body). This being the case, Managing Director of the subsidiary should be bound by his own internal audit discipline to avail the protection of indemnity for only situations of extra-ordinary nature. By assuming inspection and audit responsibility, the parent bank may end up enlarging the scope of indemnity protection.

(vii) Where the subsidiaries are engaged in extending credit facilities and finance related activities such as leasing/hire purchase/housing finance/factoring services and other similar activities, the bank can call for and review, information relating to sanctions/disbursements and performance of accounts under these activities. The bank can cause separate reviews of the activities and operations to be placed before the boards of respective subsidiaries and determine, for the purpose of review/monitoring, the status of the quality of business/assets at periodic intervals.

(viii) The bank can cause the policy/objectives relating to investments to be placed before the controlling authority/board of each of the subsidiaries as also review thereof by the subsidiaries, at specific intervals.

(ix) The bank can also ensure that the subsidiaries introduce continuous/concurrent audit of its offices either by in-house team or external auditors for the purpose of review/follow-up action on the basis of such audit.

(x) The bank can review the working of the subsidiaries and place at periodic intervals, reports covering various aspects such as deposits, advances, investments, recovery etc. before its Board of Directors.

8.4.2 Lastly, the Group suggests appreciation of parent bank and subsidiary relationship in a broader perspective. It is true that when people do business with the subsidiary, they should know that they are dealing with a limited liability company. But in practice, the creditors assume that the subsidiary has the parent bank's backing and nothing is done to remove this notion. It is therefore, recommended for subsidiaries of banks to make it clear to those with whom they do business the extent of parent bank's financial backing so that creditors will know where they stand and will act accordingly. Subsidiaries are managed by professionals who are well aware of the complexities of their operations and they would be in a position to take care of its operations by instituting inspection/audit as an internal control measure. Such an approach will give autonomy to the subsidiaries and at the same time, make them realise their responsibilities to conduct their operations on sound lines.

CHAPTER IX

COMPUTER AUDIT

Need for computer audit

9.1 Computer audit or Electronic Data Processing(EDP) audit assumes greater importance in the context of accelerated pace of computerisation taking place in banking sector. Even though computerisation leads to improvement in customer service, housekeeping, decision making, productivity and profitability, it need not be construed as a panacea for all the problems being faced by the banking industry or its implementation is not going to be without attendant problems or areas of concern. Uncontrolled use of computer may cause loss of important data. Inaccurate or untimely data may lead to incorrect decision making. Computer abuses/frauds caused by outsiders or employees may land the bank in serious trouble and in the absence of any vigilant machinery, detection of computer frauds/abuses may be left to chance. Protecting the assets of EDP viz., hardware, software and data is of vital importance. Computer error may prove to be costly in the long run and loss of confidential data may attract claims for compensation. Hence there is an urgent need for banks to have competent EDP system with proper audit/control over such system.

Scope of computer audit

9.2 EDP audit could be defined as a process of collecting and evaluating evidence to determine whether a computer system could safeguard assets through adoption of adequate security and control measures, maintain data integrity, achieve the goals of the organisation effectively and result in efficient use of resources available. Data integrity implies that data having certain attributes like completeness, accuracy, timeliness, effectiveness and reliability are consistently maintained during input processing, communication storage and retrieval. EDP audit is a subset of normal audit process. The overall objective and scope of an audit do not change in EDP environment.

Task of EDP auditors

9.3 EDP auditor's tasks would include:-

(i) Planning an efficient and effective audit approach by defining audit objectives and scope, preparing the audit programmes and scheduling the resources.

(ii) Obtaining and documenting evidence that audit area is adequately controlled and audit area's operations are effective and efficient by using appropriate audit techniques.

(iii) Evaluating strengths and weaknesses of audit areas and reporting its efficiency, effectiveness and state of control by analysing the audit evidence.

(iv) Writing and processing a report of findings, conclusions and recommendations to inform the management of the adequacy of controls and effectiveness of operations.

(v) Assessing action taken by the management regarding follow-up and reporting techniques and

(vi) adhering to laid down norms of ethics and professional standards to ensure quality and consistency of audit work.

Pre-requisites for an efficient EDP auditor

9.4 The overall competence level required for an EDP auditor depends upon the size and complexity of the EDP operations as well as responsibilities that have been given to the auditor. Some of the specific skills required for an efficient EDP auditor in a bank are as follows:-

(i) Sound knowledge of bank accounting practices and record keeping requirements.

(ii) Ability to investigate thoroughly and to document the investigative work.

(iii) A general understanding of system design and project management concepts.

(iv) A general knowledge of operating systems, automated operations, methods of storing and retrieval of data and controls used in the systems.

(v) Ability to identify general security measures and work flow including risk analysis and disaster assessment.

(vi) A working knowledge of methodology used in data processing.

(vii) An advanced level EDP auditor should possess substantial knowledge about system development, implementation and operation. He should also have an understanding of various control levels in development of systems, maintenance of data and network management.

Approach to EDP audit

9.5.1 Although the principle of audit does not undergo any change under EDP audit or under computerised set-up the EDP auditor should consider the following components of EDP environment as they affect the design of accounting system and related controls.

Organisational structure

9.5.2 In an EDP centre since the work is of specialised nature the number of persons involved may be less and in some cases only one person may be involved in such work. This indicates the vulnerability of automation resulting in total stoppage in case of sudden non-availability of staff at times of crisis. Hence it is necessary to have stand-by staff to take care of such eventualities. Duties of system programmer/designer should be segregated from person operating the system and there should be separate persons to perform the above two functions. Systems person will only do modifications/ improvements to programmes and the operating person will only use such programmes without having the right to do any modifications.

Nature of processing

9.5.3 Increasing use of on-line computers brings about situations where data can be directly entered without corresponding input document in physical form. In such a situation, audit trails are not visual or available for a limited period of time. Lack of visible input/output may prove to be a constraint for an EDP auditor. However, through distributed data processing, remote access to data/programme is quite possible. Therefore, an appropriate control measure should be devised and documented to protect the system from attacks of unscrupulous elements within and outside the organisation.

Design and procedural aspects

9.5.4 EDP functions are similar to that of manual procedure and are more reliable in a controlled atmosphere wherein all probable types of situations are anticipated and incorporated into the system. In the event of any logical error at the stage of designing the system and if such system is implemented without proper testing it would result in erroneous output. Absence of procedures like logical access control through passwords, data validation through limit checks and non-generation of exception reports could render security of the system vulnerable to interception or lead to unauthorised access to system. The Group, therefore, suggests that before introducing an EDP application in place of certain manual procedure, parallel run of both the systems should be done for a reasonable period to ensure that all aspects of security, reliability and accessibility of data are ensured in EDP application.

Control measures for EDP applications

9.6.1 Controls are necessary to achieve the objective of preventing the negative impact of certain events. Preventive controls keep undesirable events from occurring. They have to be designed to ensure that inputting, information processing and generation of outputs take place in a reasonably controlled and consistent environment. Major EDP controls are:-

(i) System development/maintenance controls

The auditor can be involved in system development review of controls in two ways. He can be used to evaluate the quality of system development and control measures to be incorporated on such application and also, to review the quality of control actually exercised during operation of any system.

(ii) Data security/access controls

Operations controls are exercised through establishment of standards for control measures and comparison of actual performance against such standards. Controls over data input and instruction input are important to auditors as they have largest number of controls and high degree of human intervention which are error prone. Output controls are exercised to ensure that delivery of output is effected only to authorised users in the form and design and medium as desired by user. Audit trail to maintain chronological events should be made available for further scrutiny/audit. All outputs which are of important nature should be preserved through back-up facility.

(iii) Database controls

Two key elements in database controls are data administration and database administration. EDP auditor should ensure that these two functions are properly carried out without any ambiguity in their operations.

(iv) Telecommunications controls,

(v) Contingency planning through back-up recovery and redundancies and

(vi) System software controls.

9.6.2 The EDP auditor should consider how EDP controls are inter dependent for each type of application in order to review the overall control under various applications. It may be more prudent for him to review the design of general controls before reviewing the application controls. EDP auditor would conduct a preliminary evaluation of those general EDP controls and EDP application controls which he believes, to be effective and efficient to conduct audit. EDP controls have a pervasive effect on the processing of transactions in the application system. If the controls at the stage of designing are not incorporated, there may be risk of errors creeping in the processing and it may go undetected in application controls.

Procedures for testing EDP applications

9.7 In order to ensure that the EDP application have resulted in a consistent and reliable system for inputting, processing and generation of output of data, the following checks should be introduced:-

(i) tests to identify erroneous processing,

(ii) tests to assess the quality of data,

(iii) tests to identify inconsistent data,

(iv) tests to compare data with physical forms and

(v) confirmation of data with outside sources.

Different methods of EDP auditing

9.8.1 Under EDP audit, besides those methods used under manual auditing such as enquiry, observation and sampling methods, various sophisticated methods aided by computer assisted audit techniques, such as integrated test facility(ITF), parallel testing, generalised/specialised programmed audit software, base case system evaluation, embedded audit data collection and transaction tagging are widely used.

Auditing around computer

9.8.2 Under this method the output is examined in relation to the input without going into the details of processing involved in such EDP application. This procedure is adopted in cases where the system is simple and batch oriented and the system uses generalised software that is well tested and used by many users. The processing primarily consists of sorting input data and updating of master files. The process generates audit trails such as generation of exception reports along with the main reports. At present most of the banks are using auditing around the computer method for the audit of cash credit/current/savings accounts softwares implemented through Advanced Ledger Posting Machines.

Auditing through computers

9.8.3 Under this system, auditor could use computer to test logic and controls existing within the system and also records produced by the system. Auditing through computer is used where

(i) application system consists of processing of large volume of input and producing large volume of output and where direct examination of input/output would be difficult,

(ii) logic of the system is complex and

(iii) there are substantial gaps in visible trails.

Concurrent audit techniques

9.8.4 Concurrent audit techniques collect audit evidence at the time of processing of application system. The evidence is recorded in a file created in the system and periodically printed for analysis and evaluation by concurrent auditor. Concurrent auditor has control over the time lag between evidence collection and reporting. Various methods used in concurrent auditing under EDP environment are as follows:-

(i) Integrated Test Facility:- It involves creating a dummy entity on application system files and processing an audit test transactions against such dummy entity.

(ii) The snapshot/extended record technique:- It involves evolving audit modules in an application system and capturing images of transactions as they pass through the system.

(iii) System control audit review file technique:- It is similar to snapshot technique, but it also includes capturing variances and exceptions/deviations of standards which are set as controls over such operations.

(iv) Continuous and intermittent simulation technique:- It replicates application system processing when it is invoked by the auditor and it identifies a particular transaction of interest to him.

Computer abuses/frauds and role of security

9.9.1 Risks associated with computers/communications are varied. They are caused by natural disasters as well as human errors arising out of non familiarisation/ little knowledge of security aspects, carelessness, loss of information, theft/fraudulent use of information, unauthorised access/use of information, loss of integrity of information on account of unauthorised/intentional change or manipulation of data, loss of data due to attack of virus on hard disk and also wrong application of software. These vulnerabilities in the use of computers are exploited by perpetrators of computer abuses/frauds in various ways viz., addition, deletion or modification of data, use of communications/ computers for unauthorised purposes, interception of communication in the network for unauthorised access/change of data etc.

9.9.2 Major factors which lead to security violations in computers are inadequate or incomplete system design, programming errors, weak or inadequate logical access controls, absence or poorly designed procedural controls, ineffective employee supervision and management controls. These loopholes could be plugged by

(i) strengthening physical, logical and procedural access to systems,

(ii) introducing standards for quality assurance and periodically testing and checking them and

(iii) screening employees prior to induction into EDP application areas and keeping a watch on their behavioural pattern.

9.9.3 The role of an EDP auditor in minimising the effect of computer abuses/frauds is through verifying all the security aspects of system, inputting, processing and generation of output critically and suggesting immediate steps for removing any laxity in control. Also, he should examine in detail all stoppages/ disruptions in computer operations from the last audit period till the current date in order to assess breach of security, if any, which could have resulted in such stoppages/disruptions. All failures due to human error should be documented for preventing recurrences in future. EDP auditor should also examine the security aspect of data preserved under back-up arrangements so that it could be ensured that data are kept under proper security/ custody and proper type of preservation is adopted.

Engagement of outside service agencies for EDP processing and system software development

9.10.1 There are four types of outside agencies that are associated with data processing/system development. They are system integrators, vendors, consultants/contractors and service bureau/processors. System integrators are hired to manage software acquisition process/manage system development process/manage network development process or integrate hardware and software to ensure optimum use. Services of venders are hired for both hardware and software purposes like installation of hardware devices, software applications, its installation/updation, maintenance and service contracts. Consultants and contractors are hired to conduct special studies in computer operations, databases, networks etc., for development of application systems as also to enhance/maintain existing application systems. Service bureau and processors are employed to perform the specific work of inputting and minor processing of data.

9.10.2 EDP auditor might be associated with these outside agencies regarding audit related matters. The main risk in engaging these outside agencies is that the guidelines and safeguards applicable to the staff of the bank could not be enforced on the staff engaged by such outside agencies. Hence, there may be a possibility of corruption of data either intentionally or unintentionally which may prove to be a security risk for data as a whole. Hence while engaging the outside agencies, banks should ensure to incorporate the clause of visitorial rights in the contract so as to have the right to inspect the process of application and also to ensure the security of the data/inputs given to such outside agencies. Contractual arrangements with any outside agency should be made after taking into account the financial stability of such agency, and other other aspects like, protection available to the bank, bank's right to use the program in the event of nonfulfilment of contract, suitability of hardware and software used by the agency to meet the current as well as future processing needs, future adaptability of languages used and flexibilities built in the programs, competence/experience of the personnel employed by the agency, flexibility to shift the work to another agency in case of emergency, procedures adopted by agency regarding documentation/ control mechanism, its ability to reconstruct lost or damaged/corrupted data, and its track record in maintenance of security and confidentiality of data.

9.10.3 Audit of work entrusted to outside agencies should consider the costs associated with such operations. It should also evaluate losses likely to be incurred on account of errors/delays/ non-completion of required work entrusted to outside agencies. It should also evaluate the risk of destruction or loss of files/ records and clearly indicate the responsibility of the outside agency under such eventualities. It should also critically examine the ownership of programs developed/used by the outside agency and ensure that such programs will not fall into the hands of unscrupulous elements. Logical access control of data files and programmes by outside agencies should be viewed in the context of the extent of use, when and under what condition they would use such data. Whenever any data processing work is entrusted to outside agency, it is difficult for the auditor to be physically present at the data processing centre. Even with data communication facilities with outside agency, the auditor may not be in a position to conduct audit as files may be stored in a remote installation without proper access mode. A solution to such problem could be to use concurrent audit techniques by including audit routines and records into application system. A trail of audit could be created through such procedure and the auditor could examine them at a later stage when the files are returned after processing.

Recommendations of the Working Group

9.11 Considering the ever increasing use of computers and increasing automation taking place in the banking industry, the Group suggests the following measures in addition to what have been suggested in the earlier paragraphs for proper control over computer system.

(i) There is a need for formal declaration of system development methodology, programming and documentation standards to be followed by the bank, in the absence of which quality of system maintenance/improvement would suffer. EDP auditors should verify compliance in this regard.

(ii) Entire domain of EDP activities(from policy to implementation) should be brought under scrutiny of inspection/ audit department. Financial outlay as well as activities to be performed by EDP department should be reviewed by senior management at periodical intervals.

(iii) Efforts should be made to develop a team of competent and motivated EDP personnel. It is beneficial to have a collective development of system consisting of many persons instead of a few in order to take care of situation of exodus of key personnel. Also, there is a need for setting up of an EDP audit division within inspection and audit department of a bank which specialises in EDP audit functions. Complement of EDP audit team should be drawn from internal audit department and also from EDP department.

(iv) More emphasis should be given for total system development rather than adhoc implementation for ensuring effective working and control of EDP applications.

(v) Banks are racing against time while upgrading/implementing EDP applications. In such a scenario, they may not be in a position to develop software packages in-house resulting in seeking outside vendor's help in software development. In such cases, the relationship and role of EDP department with outside software vendors need to be clearly defined. Also, it needs to be ensured that, these packages developed by outside vendors conform to standards and specifications and meet all requirements of audit. In order to bring about uniformity of software used by various branches/offices there should be a formal method of incorporating any changes in standard software and it should be approved by senior management. Inspection/audit department should verify such changes from the view point of control and for its implementation in other branches in order to maintain uniformity.

(vi) EDP auditors' technical knowledge should be augmented on a continuing basis through deputation to seminars/conferences, supply of technical periodicals and books etc.,

(vii) Contingency plans/procedures in case of failure of system should be introduced/tested at periodic intervals. EDP auditor could put such contingency plan under test during the audit for evaluating the effectiveness of such plans.

(viii) Due to increase in use of on-line applications, the EDP auditor must place greater emphasis on information security controls than physical security. Further, as the set of rules and security standards will be different from each application he should ensure that proper control measures are used in different types of applications.

(ix) EDP auditor should be concerned with controls over access to computer programmes and data and should examine in detail the adequacy of controls to prevent any unauthorised changes/ interruptions/access to data/programme. He should critically examine the need for level of access to system for the entire tier of personnel operating such system on the principle of least privileges.

(x) In all application systems, there should be a system of generating exception reports which is automatically triggered when a control point is violated and such reports should form a part of MIS report so that deviations could be brought to the notice of senior management for ratification/rectification on an on going basis. EDP auditor should verify whether all the exception reports have been put up to immediate senior management and ratification is obtained for such deviations. He should verify whether ratifications are done in a routine manner or enough care is taken for minimising deviations in future.

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CHAPTER X

FRAUDS IN BANKS

10.1 Rapid growth of banking activities has been witnessed in the post nationalisation era. Rapid branch expansion has taken place to reach the people to fulfil the national objective and to implement poverty alleviation programmes and sponsored schemes of Government. Consistent with this rapid expansion, incidents of frauds in all areas of operations of banks - both borrowal and non borrowal, have consequently increased. Frauds are acts of criminal deception resorted to by persons singly or in collusion with others in order to derive gains to which they are not entitled. They may be perpetrated in banks by misappropriation or criminal breach of trust, encashment of forged instruments, manipulation of books of accounts, operations of fictitious accounts and conversion of property, unauthorised credit facilities extended for reward or for illegal gratification, cheating and forgery and irregularities in foreign exchange transactions. A close scrutiny of frauds perpetrated on banks would reveal that they are perpetrated on banks not due to lack of instructions or absence of proper systems and procedures, but mainly due to the flouting of established systems and procedures by the officials. The primary responsibility for preventing frauds is that of bank management.

Nature and type of frauds

10.2.1 There is no limit to human ingenuity. The nature and type of frauds that can be perpetrated on banks, therefore, defy classification. An analysis of the fraud cases reported by banks to the Reserve Bank of India broadly indicates that frauds perpetrated in banks can be grouped into three categories viz.,

(i) frauds committed by employees of the bank,

(ii) frauds committed by employees of the bank in collusion with outsiders and

(iii) frauds committed by outsiders.

The first category can be further classified as frauds committed by an employee and in collusion with other employees and frauds committed by an employee without collusion of other employees. If in a bank instances of frauds of latter type surface, it indicates that there is a serious lacunae in the systems and procedures and banks should initiate corrective action immediately.

10.2.2 Frauds/malpractices so far perpetrated on banks could be classified as under:

(i) misappropriation of cash tendered by constituents and misappropriation of cash in remittance.

(ii) withdrawals from deposit accounts through forged instruments.

(iii) fraudulent encashment of negotiable instruments by opening of account in fictitious/false names.

(iv) misappropriation through manipulation of books.

(v) misutilization/overstepping of lending/discretionary power, non-observance of prescribed norms/procedures in credit discipline.

(vi) opening of letters of credit, bank guarantees, co-acceptance of bills without proper authority and consideration and

(vii) frauds in foreign exchange transactions mainly through non-adherence of Exchange Control Manual provisions.

The above list is only illustrative and not exhaustive.

Causes for perpetration of frauds

10.3 While banks have set up Vigilance Cell/Department, both at the Head Office and also at controlling office levels in some cases to look into the vigilance cases in respect of both award staff and officers, it has been observed that generally the Vigilance Depar'ments have not been developed into an effective instrument in curbing the growing trend of vigilance cases in banks. In fact, in most of the banks, the vigilance function generally related to punitive role rather than preventive and detective vigilance. The detective role in respect of sensitive areas such as advances, purchases/hiring of premises etc., involving large amounts has not been performed suo motu. The Group feels that absence of a regular system of preventive vigilance and looking at vigilance angle only on receipt of complaints or source of information, have to a large extent resulted in the detection of frauds, malpractices, irregularities etc., at a very late stage. An analysis of fraud cases reported by banks indicates that the major causes for perpetration of frauds are (i) laxity in observance of laid down systems and procedures by operational staff/supervisory staff, (ii) over-confidence reposed in the bank's constituents who however indulge in criminal breach of trust (iii) unscrupulous constituents who take advantage of laxity on the part of officials in observance of established and time-tested safe guards. (iv) lack of dual control in sensitive areas, (v) lack of built in safeguards under agency arrangement and (vi) misuse of lending powers and ineffective control over supervision of advances.

Analysis of fraud prone areas in the working of the bank

10.4.1 Reserve Bank of India has advised banks from time to time about major fraud prone areas and safeguards necessary for their prevention. It has also been circulating to banks details such as modus operandi, contributory factors, corrective action etc., and other disturbing features of frauds of an ingenious nature which come to notice so that individual banks could introduce the necessary built-in safeguards by means of appropriate procedures and internal checks having regard to the modus operandi of the frauds. The inspectors/auditors should verify whether the systems and procedures existing at branches, controlling offices and Central Office departments for handling and controlling different types of transactions have been devised/suitably modified taking into account the details of frauds, modus operandi and the preventive steps advised by the Reserve Bank of India. It should be verified whether any employee is allowed to handle the same set of books/operations continuously for long periods. A proper system of checks and counter-checks and periodical rotation of duties go a long way in prevention/early detection of frauds, if not their total elimination.

10.4.2 For the guidance of inspectors/auditors, important cases of frauds perpetrated on banks in the past in various areas of functioning of the bank are listed below.

(a) Cash, valuables, safe custody articles and other negotiable instruments:- Some of the instances of frauds involving the above items reported are:-

(i) embezzlement of cash by cashiers

(ii) theft of cash from cash counters by outsiders by distracting the attention of cashiers

(iii) accepting cash for depositing, misappropriating it by issue of spurious counter-foil receipts, making unauthorised entries in passbooks, issuing of fake fixed deposit receipts and withdrawing inflated amounts from the accounts of illiterate account holders,

(iv) reporting of inward/outward remittance of cash in the books for lesser/larger amounts and forging the relative advice received from the other branch to tally with the entries made.

(b) Deposit accounts:- A large number of frauds are committed in banks under deposit account by:-

(i) opening of accounts in fictitious name either for money laundering or for tax evasion purposes.

(ii) irregular payment of cheques.

(iii) unauthorised operations in dormant accounts.

(iv) manipulation of accounts

(c) Fraudulent encashment of negotiable instruments:- These frauds are perpetrated through payment of forged instruments or chemically altered cheques/drafts presented through clearing. They may also include theft of blank demand draft forms from the safe custody and issue of fake demand drafts issued with forged signature. Similar instances may take place in respect of blank pay-order/mail transfer forms.

(d) Manipulation of books of accounts:- These frauds have been perpetrated through

(i) destruction of outward/inward clearing cheques

(ii) preparation of spurious payment advice

(iii) debiting difference in the books to 'suspense account'

(iv) allowing withdrawals against uncleared effects which facilitate kite-flying operations by the depositors.

(v) taking payment through unauthorised debit to "interest accrued account" or through similar debits to expenditure heads.

(e) Advance portfolio:- The major areas of frauds reported in advances are

(i) depriving the banks of its securities against advances granted like removal of goods pledged/hypothecated, spurious goods offered as security, inflating the value of goods, obtaining multiple finance against the same stock from different banks and diverting sale proceeds to other banks etc.

(ii) defrauding the bank by misutilising funds by diverting for personal use and to other group concerns etc.,

(iii) fraudulent discount of negotiable instruments resulting in kite-flying operations like purchase self cheques, accommodation cheques etc.

(iv) gross abuse of bill finance by discounting accommodation bills, bills accompanied by fake/forged lorry/railway receipts with or without connivance of transport operators, bills with inflated value or with altered LR/RR receipts and receiving payment directly from drawee. There were also instances where goods sent under lorry receipts were removed under indemnity and bills returned unpaid were presented as fresh bills.

(v) malpractices in opening of letters of credit, issue of bank guarantees, co-acceptances and discount of co-accepted bills.

(f) Frauds in non-fund based business:- These are of the nature of co-acceptance of bills, issue of bank guarantees and opening of letters of credit without recording the same in the books of the bank.

(g) Frauds in computerised environment:- Frauds in computerised activities include,

(i) changing the data before inputting/generating output.

(ii) use of general instructions to gain access to a programme for unauthorised purposes.

(iii) unauthorised use of computer utility to modify/destroy/ copy/disclose/insert/use or deny use of data stored in computer.

(iv) use of non-standardised computer programmes resulting in unauthorised access.

(v) unauthorised access by immediately following the person who has access to computer after his use and linking/tapping other's communications during transmission of data.

(vi) inserting of virus into the computer system by use of corrupted floppy diskettes or other means of access to system.

Preventive vigilance and the role of inspectors/auditors

10.5.1 Banks have been constantly emphasising upon the branches to observe strictly the rules and procedures prescribed by them in the Manual of Instructions and in various other circulars and maintain their books of accounts up-to-date. The systems and procedures prescribed by the banks for various transactions are quite adequate and what is needed is adherence to them scrupulously by field functionaries so as not to facilitate unscrupulous elements to get an opportunity to perpetrate the frauds. Therefore, in order to effectively combat the growing menace of frauds/malpractices, the inspectors have to be vigilant and alert while performing their duties.

10.5.2 Some of the preventive vigilance aspects need to be reviewed by the inspectors/auditors in certain key areas of bank's functioning at the time of inspection/audit in order to minimise the occurances of frauds are discussed below:

(I)Deposits:- Precautions to be taken at the time of opening and operation of new accounts have already been enumerated under Annexure VI to this report. Inspectors/auditors should ensure that such precautions mentioned therein are observed by the operational staff. Cheque books should be issued only to the authorised person under the laid down procedure. Storage of security stationery like cheque books, blank draft books, inter office funds transfer letters/manifolds, foreign inward remittance certificates etc., should be under the dual custody of officials, one of them being Assistant Branch Manager and receipt/deliveries of these items should be properly recorded under signatures of officials concerned. Under no circumstances sub-ordinate staff should be allowed to have access to security stationery. These items could also be checked by officials of controlling offices who conduct surprise verification of cash at branches. Staff members should be advised to desist from the practice of accepting/receiving cash on behalf of any constituents. Name of the person to whom payment is made should be recorded in the payment register. Specimen signature cards should be kept in proper custody, made available only to the operational officials who are manning the counters and kept in safe custody after close of banking hours. Inspectors/auditors should verify whether all dormant accounts are segregated, details of such accounts are recorded in separate ledgers and the same are kept under safe custody of Branch Manager/Asst. Branch Manager. Operations in the dormant accounts should be allowed only after authorisation by Branch Manager/Asst. Branch Manager. They should also verify the balancing of ledgers and supplementary books and also see whether overwritings/cuttings are properly authenticated by concerned officials. It is also necessary to verify during inspection/audit whether sufficient precautions have been taken at branches to prevent unauthorised persons having access with the intention of making fictitious entries in ledger accounts. Under no circumstances, the account holders or their messengers should be allowed to write their passbooks by referring their accounts.

(II)<u>Clearing transactions</u>:- In many branches, large number of entries are left unreconciled in the clearing adjustment account and this has led to unscrupulous employees taking advantage of this situation to destroy cheques received in inward clearing. With the result, these cheques are not debited to the respective accounts and the amounts are withdrawn from other banks which have forwarded these instruments. Hence, it is imperative to confirm receipt of all the instruments and ensure that they are correctly listed in the schedule and sorted departmentwise/branchwise. Inspectors/auditors should see whether the same clerk or group of clerks is doing the checking/listing of instruments received from the same bank. All clearing differences should be located on the same day and claims for the difference and refund of excess are made on the same day.

Frauds are also committed on banks by allowing withdrawals against uncleared effects which facilitates kite flying operations by the depositor. The depositor opens accounts with two or more banks and resorts to kite-flying operations by issuing cheques against cheques on the accounts kept with various banks and in the process, withdraws sizable amounts. This would not be possible if due care is exercised while allowing withdrawals against uncleared effects. This is one of the sensitive fraud prone areas where unscrupulous customers, under the guise of offering business deposits to the branch prevail upon it to part with sizeble funds free of interest. Lodging huge amount of cheques drawn by certain group of parties disproportionate to their business dealings in clearing and receipt of similar cheques drawn by customer in favour of the said group of parties more or less to the extent of cheques lodged in the account are indication of kite-flying transactions.

(III)Demand drafts:- Inspectors/auditors have to verify whether the following precautions are taken by branches while handling demand drafts in payment of which frauds could be perpetrated:-

(i) Drafts which are paid without advice are properly marked and receipts of advices are ensured so to ascertain their genuineness.

(ii) Drafts tendered for payment are subjected to scrutiny in all respects including verification of signature and verification under Hanovian lamp, particularly the drafts for large amounts, favouring other than reputed companies and Government organisations.

(iii) Specimen signatures of authorised officials issuing drafts are kept safely and updated regularly.

(IV)Advances:- Non-observance of prescribed systems and procedures have been mainly responsible for many frauds taking place in the area of advances. The unscrupulous borrowers could commit frauds in this area mainly on account of the lapses on the part of the officials such as misutilisation/overstepping of lending powers, failure to comply with the terms of sanction, inadequate and ineffective post sanction follow-up and supervision. The major areas of frauds reported in the advances are (i) depriving the banks of its securities against which advances are granted, (ii) defrauding the banks by misutilisation of funds, (iii) clandestine removal of goods pledged/hypothecated, (iv)pledge/hypothecation of spurious goods (v) inflating the value of stocks in the stock statements submitted to the bank, (vi) obtaining multiple finance against the same stocks and (vii) diverting sale proceeds to other banks.

Following precautions should be taken by banks to safeguard themselves against perpetration of frauds in the area of advances.

(i) Confidential enquiries should be made by interacting with local people to know the background and integrity of the prospective borrowers. In case of borrowers who switch over from other banks, apart from obtaining status report from them, interaction with them may also help in knowing more details about the borrowers.

(ii) The assets and liabilities declared by the borrowers should not be accepted as it is and they should be verified with the relevant documents of title as well as by personal visit to know the genuineness. Income tax/Wealth tax returns/assessment orders should be perused to countercheck the assets/liabilities and income of the borrowers.

(iii) Apart from satisfying the transferability and marketability of the securities offered to the bank, borrower's ability to carry on the business, infrastructure available to the unit, technical feasibility of the unit, marketability of the product etc., should also be thoroughly scrutinised.

(iv) Branch Manager should exercise powers within his lending limit and sanction should be recorded along with his views on all viability aspects.

(v) All prescribed documents should be properly executed and all set-out procedures should be meticulously followed.

(vi) Cases have been noticed where borrowers have fraudulently tampered with the share scrips and with the aid of chemicals increased the number of shares shown therein. In order to ensure genuineness of share certificates, corroborative documents like allotment letters, dividend warrant intimations etc., should be verified.

(vii) After disbursing the amount, post-sanction inspection should be conducted immediately within a reasonable time and verify the end-use of funds.

(viii) Renewal of credit facilities should not be a ritual. Unsatisfactory features should be highlighted in the renewal proposals.

(V)<u>Bills portfolio</u>- Banks should ensure while allowing advances against bills(irrespective whether they are clean or documentary, usance or demand) that they represent genuine trade transactions and not accommodation bills. Banks should be wary against tendering of lorry receipts(LRs) of only a particular lorry company, consignment showing full loads, bills for round sums, drawing bills on the same party or confined to few parties, drawing bills disproportionate to borrower's business standing, bills not accompanied by pucca invoices, weight lists etc., long delay in retirement of bills by drawees, frequent instructions of the drawees to deliver documents free of payment and frequent return of bills. The facility should be withdrawn if bills are frequently returned unpaid. For the purpose of retirement of bills, the borrower should not be allowed the facility of bills purchase/discount. At the time of discounting the accepted bills/ hundies, confirmation in regard to acceptance should be obtained from drawees especially where the bill amounts are large or where there are reasons to suspect the genuineness of the bill or acceptance.

(VI) Inter-branch reconciliation:- This is a fertile ground for perpetrating frauds if necessary precautions are not taken. The modus operandi invariably adopted is manipulation and fraudulent alterations of books of account and concealment of facts. The delay in reconciling the entries periodically and lack of proper follow-up can contribute to frauds. It has been found that some undesirable elements from inside the bank by themselves or in collusion with outsiders have committed frauds on banks by booking fictitious bills/cheques for collection. The only way to prevent frauds in this area is to ensure that arrears do not build in reconciliation of inter-branch transactions . Debit entries outstanding should be given utmost attention.

(VII) Foreign exchange business:- Frauds in foreign exchange business could be perpetrated in every area of transactions if adequate safeguards are not put in place. Frauds have been detected in dealing room operations, documentary credits, NRE accounts, etc. Failure to adhere to various provisions prescribed in "Guidelines for Internal Control over Foreign Exchange Business" issued by the Reserve Bank of India is the main reason for frauds in dealing room operations. Failure to conduct audit of dealing room operations periodically has led to non-detection of frauds in time. Frauds have also been perpetrated by negotiating export documents which were not strictly in accordance with the terms of export letters of credit, in collusion with export constituents of the banks who had submitted export bills accompanied by fictitious/materially altered documents for purchase/negotiation. Import especially under open general licence is another fraud prone area. Branches of many banks had, in the past, effected huge remittances against collection bills tendered by new parties who had opened their accounts with small sums, by giving bogus addresses of their place of business. These parties could not be traced when the branches called for bills of entry evidencing imports. Even though banks had not lost money in these transactions, there was huge loss of foreign exchange for the country. Inspectors/auditors should verify during the scrutiny of import bills that Exchange Control Manual provisions as well as guidelines issued by Foreign Exchange Dealers' Association of India have been meticulously followed by the branches in handling import transactions.

10.5.3 "Frauds in banks" is a wide area which cannot be discussed at length in this report. What has been mentioned above is an indicative list of fraud prone areas about which inspectors/

auditors should necessarily be aware of.

Staff accountability and penal action

10.6.1 Examination of staff accountability needs improvement in many banks. The staff accountability is generally examined only when the question of loss and write offs arises by which time either the records are not traceable and/or the concerned officials have retired or left the service of the bank. The number of cases where enquiry is not yet over is rather high in some banks. The Group is of the view that banks must take appropriate action when there is failure on the part of any of their officials to comply with the prescribed system/procedures not only as a punitive measure but also from preventive angle. Such a failure may occur because of an act of omission or commission, deliberate or otherwise. When an official makes significant error, commits an irregularity or fails to detect an irregularity which he is expected to detect, there is a failure to discharge due responsibility. Thus, while an official committing an irregularity is answerable, the official charged with the responsibility of checking the relative entry or transaction is equally responsible for default, if he fails to detect the irregularity.

10.6.2 Banks should complete enquiries expeditiously and bring to book the delinquent staff so as to deter others from perpetrating frauds and malpractices. To complete enquiries quickly, banks may segregate charges where Central Bureau of Investigation/Police have been entrusted with investigation of the case so that charges of non-criminal nature could be inquired departmentally without delay. Banks should also keep in touch with CBI/Police authorities so that the latter are provided with all assistance to complete the investigations early. Above all, banks should strengthen their vigilance machinery and review its working once in six months at the level of the Board.

Reporting of frauds

10.7 Details of frauds detected during inspection and other matters involving malafides, corrupt practices/gross indiscipline on the part of the staff etc., could be reported in the inspection/audit report itself or separately in the form of special report depending upon the gravity of the matter. While the matters which rightfully pertain to the special reports would need to be invariably reported as such, it is necessary that the inspecting official exercises due circumspection in this respect and resorts to submission of special report only where the circumstances so warrant. Submission of special reports on old frauds, overdues, etc., which are already known to the bank and reported to CBI etc., and under correspondence will not serve any purpose unless there are certain new significant developments/ areas which were not known/reported earlier. Banks should devise a standard format of the special report in order to streamline the procedure of submission of special reports. While the inspecting officers should submit the special report to the Zonal/Regional Audit Offices/Inspectorates, a copy of it should be sent to the

Head Office directly to avoid delay in initiating action. The contents of the special report should not be discussed/revealed to any of the branch staff. The special report should be treated as closed only after the related issues are fully dealt with.

CHAPTER XI

EMERGING AREAS OF CONCERN IN BANKING BUSINESS

11.1 Considerable developments have taken place in the banking sector during the last five years. Banks have diversified their activities to a great extent to shore-up their bottom line. Along with this growth, new areas of concern for the bank supervisors have also started emerging. Solvency and capital adequacy, level of non-performing assets(NPAs), negotiated settlements to reduce NPAs, income recognition, asset classification and provisioning for bad debts are some of the new areas where extensive guidelines were issued by the Reserve Bank of India. Some of the areas in the bank functioning which did not attract much attention of the bank supervisors a few years ago have now become major areas of concern. Inter-branch/inter-bank reconciliation, balancing of books, nostro accounts reconciliation, etc., are some of them. The manner in which certain operations have been carried out by banks has started attracting the attention of Reserve Bank of India/ Government of India viz., operation of stockinvest scheme, merchant banking, funds management and investment operations etc. The Group is of the opinion that it would be necessary for the inspectors/auditors of banks to be aware of these emerging areas of concern, deficiencies noticed in these areas of working of banks, the nature of guidelines/instructions issued by Reserve Bank of India and above all, what they should look for in these areas when they take up inspection/audit of branches, controlling offices as well as Head Office Departments.

Capital adequacy norms

11.2.1 The question of strengthening the capital base of banks had been under consideration for some time in the light of the low levels of capital of banks in India and the Basle Committee framework on capital adequacy norms. In most of the countries, the risk assets ratio system has been adopted as the basis of assessment of capital adequacy which takes into account the element of risk in the various types of assets in the balance sheet as well as off-balance sheet business. Considering all relevant factors, a risk assets ratio system for banks(including foreign banks) in India was introduced in April 1992. As per this new norm, balance sheet assets, non-funded items and other off-balance sheet exposures are assigned weights according to the prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an on-going basis. For Indian banks, which have branches abroad, the norm of 8 percent should be achieved by March 1995; other Indian banks should achieve the target by March 1996. Foreign banks operating in India had achieved this norm by 31 March 1993.

11.2.2 Banks should scrupulously follow the norms prescribed by the Reserve Bank of India to calculate capital risk assets ratio(CRAR). Over estimation of CRAR by wrong assignment of risk weights to certain assets such as PSU bonds, Post Office deposits, financial guarantees etc., incorrect evaluation of assets and exclusion of certain items of assets for assigning risk weight should be avoided. Failure to take into account erosion in provisions and reserves due to loan and other losses also leads to over estimation of CRAR. Wrong computation of Tier I capital by including items like intangible assets, investment in subsidiaries etc., also tend to inflate CRAR. Inspecting officers while conducting inspection of Head Office Departments should ensure that the above aberrations do not creep in, in calculation of capital adequacy ratio.

Prudential norms for income recognition, asset classification and provisioning

11.3.1 If balance sheet of a bank is to reflect its actual financial health, proper system of recognition of income, classification of assets and provisioning for bad debts on prudential basis should be followed. The policy of income recognition should be objective and based on record of recovery rather than on any subjective consideration. Similarly, the classification of assets has to be done on the basis of objective criteria which would ensure a uniform and consistent application of norms. Provisioning requirements should be arrived at on the basis of classification of assets into four different categories viz., standard, sub-standard, doubtful and loss assets. Banks have to prescribe operative guidelines to branches for income recognition and asset classification.

11.3.2 In the area of income recognition, following operative guidelines should be followed:

(a) No interest should be charged on any advance account once it is identified as NPA unless interest amount is recovered.

(b) Nonetheless,interest should be calculated and recorded in Dummy Ledger but it should not be debited to the respective accounts. The borrower shall continue to be liable for the entire recorded interest till actual recovery.

(c) The unrecovered interest already debited and taken into income account upto the date of classification as NPA should be reversed or appropriate provision should be made.

(d) In an account where interest is not charged on account of identification as NPA, commission/fees and other income also should not be charged and taken into amount until the amount is realised.

(e) Amount of commission/fees and other income already charged but not recovered should be reversed or provided for.

(f) Fees/commission earned as a result of rescheduling should be recognised on accrual basis over the time permitted for reschedulement, and

(g) Advances below Rs 25,000 should be classified into performing and non-performing.

11.3.3 All banks have issued detailed guidelines to their branches on identification of performing and non-performing assets, income recognition, classification of assets under four groups and provisions for loans and advances. In order to ascertain the correctness of the information compiled/furnished by branches in conformity with the prescribed norms, there should be regular checking by the inspectors/auditors. During the inspection/audit, if any discrepancy has been found out, the same should be informed to the Branch Manager and got rectified on the spot. It should also be ensured that correct information is furnished by the branches to their respective controlling offices. Errors likely to be committed in this area are listed below for the guidance of inspectors/auditors.

(a) Reckoning balance sheet date as date from which the account has become as NPA instead of actual date on which it ceased to be performing.

(b) Issue of internal instructions for classification of assets at variance from RBI guidelines.

(c) Treating NPAs initially as sub-standard for one or two years from the date of becoming NPA and only, thereafter as loss assets though no security has been available from the beginning.

(d) Facility-wise classification is done instead of borrower-wise classification.

NPA Management

11.4.1 Apart from the magnitude of current profit, the level of NPAs provides an important measure of the performance of banks as it reflects on the quality of the loan portfolio. Banks should exercise due care in assessing the extent of their NPAs. The following guidelines issued by the Reserve Bank of India in respect of NPAs should be remembered both for computation of NPAs and verification of the above exercise by inspectors/ auditors.

(a) Both interest and instalments, wherever applicable should be taken into account for assessing the NPA status of an account, after, of course, allowing 30 days grace period for both the cases.

(b) If a particular facility of a borrower becomes NPA, then all the facilities granted to the borrower should be treated as NPA. This is based on the logic that in the case of health code classification, banks follow the principle that a borrower falls in the category of satisfactory, irregular etc., and not a particular facility.

(c) In order to have uniformity in approach regarding a borrowing unit, classification adopted by the leader of the consortium should be adopted by the members.

(d) Availability of security or net worth of borrower/ guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

(e) credit facilities backed by Government agencies, though "past due" should not be treated as NPA. However, for the purpose of income recognition, these are to be treated on par with other accounts i.e., income can be booked only to the extent of realisation, once these are "past due" and thereby NPA

11.4.2 The Group is of the view that at individual bank's level, appropriate measures/strategies should be initiated to reduce the NPA component comprising of sub-standard, doubtful and loss assets. Above all, the best way to tackle the NPA problems is to prevent it from happening in the first place. Since all lending is risk prone, it is not always possible to totally prevent in advance emergence of NPAs. But banks should ensure that the NPA component is kept to the minimum by taking appropriate timely action once accounts tend to slip into NPA net so that their operational viability/profitability is not eroded. The Group suggests that banks may take following precautions/steps to prevent the accumulation of NPAs and inspectors should specifically comment on the adequacy of steps taken.

(a) Interest/instalments recovery should be done on war-footing basis for which existing strategies need a fresh look. Involvement of staff members besides the Branch Managers has to be increased. Recovery performance of all concerned officials should be critically evaluated and outstanding performance should be appropriately recognised.

(b) Recovery through rehabilitation of sick units is always desirable provided these projects are viable. For effective rehabilitation, speedy decisions relating to formulation and implementation of rehabilitation package should be taken. For this purpose, there should be decentralisation of authority.

(c) Banks should invariably undertake timely review exercise and assess properly the borrowing/non-borrowing limits so as to prevent the possibility of accounts slipping into NPA category. However, banks should not merely sanction additional limits with the objective of regularising the accounts and upgradation of the asset status of the accounts by this process is not permitted.

(d) Compromises or negotiated settlements with the borrowers is another strategy to reduce NPAs. If a compromise is successfully implemented, the asset (whether substandard, doubtful or loss) will be wiped out from the books of the bank leading to immediate reduction of NPA to that extent. Banks could recycle the funds with advantage instead of resorting to expensive recovery proceedings spread over a long period. Reserve Bank of India has advised banks to have a loan recovery policy which sets down the manner of recovery of dues, targetted level of reduction, norms for permitted sacrifice/waiver, factors to be taken into account before considering waivers, decision levels, reporting to higher authorities and monitoring of write-off/waiver cases.

The following guidelines prescribed by Reserve Bank of India should also be followed by banks meticulously.

(i) Compromise should be a negotiated settlement under which the bank should ensure to recover its dues to the maximum extent possible with minimum expense.

(ii) Proper distinction should be made between wilful defaulters and the borrowers defaulting in repayment due to circumstances beyond their control.

(iii) Where security is available for assessing the realisable value, proper weightage should be given to the location, condition and marketable title and possession thereof.

(iv) All compromise proposals are approved by any functionary should be promptly reported to the next higher authority for post facto scrutiny.

(e) Where staff accountability has not been examined, it should be ensured that the same is completed expeditiously within a time frame.

(f) The proposals for write off/compromise falling within the authority of Executive Director/Chairman and Managing Director/Management Committee/Board of the bank should be first processed by a committee of senior executives of the bank (i.e., by Chief General Managers/General Managers).

(g) Recovery officers have to be appointed at branches having sizable NPAs and their recovery progress should be monitored on a monthly basis.

(h) Special Recovery Cells have to be set up at all Zonal/ Regional Office levels and

(i) Adequate attention should be paid to upgrade sub-standard advances.

The Group recommends that the bank's Top Management should ensure that the above guidelines are strictly followed in letter and spirit and there is no significant deviation from the general principles of compromise/write-off. All write-off decisions should be judicious and in the best interests of the bank.

Investment Portfolio

11.5 Reserve Bank of India have advised banks to frame investment policy which should contain broadly five areas viz.,

(a) objectives of investment and transaction activities, (b) operational systems, (c) internal controls, (d) brokers and (e) reporting systems. In case a bank offers portfolio management service/agency services, these details need to be provided for each of the activities. All these details could be set out in a policy note or a summary may be provided in the note and details by way of a manual; but both must have the approval of the Board. Inspectors/auditors undertaking inspection of Investment Department at Head Office/Corporate Office should comment on compliance of following guidelines by the bank.

(a) Whether the bank has framed a suitable investment policy with the approval of the Board to ensure that operations in securities are conducted in accordance with sound and acceptable business practices and in accordance with RBI guidelines.

(b) Whether the bank has undertaken a half-yearly review as of 31 March and 30 September of their investment portfolio, which should apart from other operational aspects of investment portfolio clearly indicate and certify adherence to laid down internal investment policy and procedures and RBI guidelines and put up to its board within a month i.e., by end April/October; whether a copy of the review report put up to the bank's Board has been forwarded to RBI by 15 May/15 November.

(c) Whether the treasury transactions are separately subjected to concurrent audit and the findings are placed before the Chairman and Managing Director every month.

(d) Whether segregation of duties between persons responsible for entering into deals, persons having custody of investments, and persons responsible for recording transactions in the books of accounts have been done.

(e) Whether the bifurcation of approved securities into 'permanent' and 'current' has been done as per RBI instructions.

(f) Whether the periodic reconciliation of investment account and independent verification thereof is carried out.

(g) Whether appropriate controls over the issue of SGL forms and BRs as well as verification of the authenticity of BRs and SGL forms received have been established.

(h) Whether a limit of 5 percent of total transactions (both purchases and sales) entered into by the bank during a year as the aggregate upper limit for each of the approved broker has been fixed.

(i) Whether a specific mention has been made in the investment policy that Portfolio Management Scheme(PMS) transactions will not be undertaken without obtaining specific prior approval of RBI.

Stockinvest Scheme

11.6 The stock-invest scheme was introduced in February 1992 to avoid hardship and loss of interest to the small investors to public issues on account of delays in allotment of shares and debentures. As there were reports and complaints about the abuse of the scheme by some banks issuing these instruments, the scheme was modified in September 1994. Certain important restrictions for issue of stockinvests which the inspector/auditor should be aware of are indicated below.

(a) Issue of the stockinvest should be restricted to individual investors and mutual funds only. Stock brokers, corporate bodies, banks and financial institutions should not be allowed this facility.

(b) Stockinvest should be issued only against term deposits and credit balance available in saving bank or current account.

(c) Stockinvest instrument should not be issued in blank. The bank should fill in the name of capital issuing company before the stockinvest instruments are delivered to the applicants.

(d) Banks should issue stockinvests only if they have made arrangements at all mandatory centres as decided by Securities and Exchange Board of India(SEBI) from time to time.

(e) Banks should not allow bulk purchase of stockinvest by financial institutions

(f) Stockinvests should not be issued against third party deposits, including FCNR/NRE deposits.

(g) Predated stockinvests should not be issued. i.e., instruments bearing dates prior to date of deposit/creation of lien. They are issued ostensibly with a view to enabling the clients to submit share applications even after the official closure of the public issue.

(h) Stockinvests should not be issued against overdrafts, cheques for collection or funds from borrower's cash credit accounts.

(i) There were instances where, against meagre amount of deposits, a number of stockinvests were issued. As encashment of all the stockinvests generally do not meterialise, the bank takes the risk for the difference between the amount of deposit and value of stockinvests issued. However, such a situation can lead to financial loss for the bank if all stockinvests are tendered for payment and bank does not have cover for the amount.

(j) Stockinvests should not be issued against funds in joint deposit accounts in which some of the account holders are other than individuals/mutual funds.

Bank's Top Management should guide inspectorate to be vigilant against the abuse of the stockinvest scheme by branches since violations committed in the operation of the scheme may be viewed seriously by the regulatory authorities and may attract levy of penalties by them.

Operations on Non-Resident(External) Accounts(NRE A/c.)

11.7.1 Among the various types of foreign exchange operations undertaken by branches authorised to deal in foreign exchange, proper conduct of NRE accounts assumes greater importance since serious irregularities as mentioned below have, of late, come to the notice of Reserve Bank of India and Enforcement Directorate.

These irregularities have enabled the account holders and others to resort to money laundering.

(a) NRE accounts were opened without proper verification as to whether the account holder had a status of non-resident under the provisions of Foreign Exchange Regulation Act, 1973 at the time of opening the account.

(b) credits were afforded to NRE accounts when foreign currency notes were tendered by a person other than a the NRI account holder.

(c) credits were afforded to NRE accounts when a person other than the account holder presented rupee cheques/deposited rupee funds supported by encashment certificate issued by other banks/full-fledged money changers.

(d) Proceeds of foreign currency tendered by the account holder were credited to NRE accounts without verifying whether he had come to India on a temporary visit and whether he continued to have a non-resident status.

(e) Withdrawals from NRE accounts by cheques in favour of different parties in India were allowed without obtaining information about the purpose of such withdrawals.

(f) In certain cases funds from local sources which were not eligible for crediting to the NRE accounts were allowed to be credited which were subsequently transferred abroad by the account holder.

11.7.2 The types of irregularities indicated above are likely to help unscrupulous persons in money laundering through the medium of NRE accounts. Instances were reported wherein some unscrupulous persons purchased foreign currencies from local market at havala rate and offered the same for credit to the NRE account either in foreign currency or in the form of rupee funds supported by encashment certificates. The Group, therefore, recommends that banks should issue suitable instructions to their branches/operational staff to comply with the Exchange Control provisions fully in this regard and also to be careful when there are frequent operations on a particular NRE account. Suitable guidelines may also be issued to inspecting officials in this regard. In case, they suspect bona fides of the transaction, the matter should be reported with full details through the appropriate level to the Reserve Bank of India.

Reconciliation of inter-branch accounts

11.8.1 Among the general fallout of rapid expansion of business was the increasing volume of arrears in inter-branch reconciliation. Government of India and Reserve Bank of India have been monitoring the progress in inter-branch reconciliation, but the progress has not been satisfactory. Recently, the Government has also expressed serious concern once again regarding the state of inter-branch adjustment accounts in most of the public sector banks. The Government has further indicated that Chief Executives of the banks should personally monitor the progress in bringing the inter-branch accounts upto date. The Group also shares the concern of the Government and Reserve Bank of India in this regard since the presence of unadjusted entries makes banks quite vulnerable; it could enable unscrupulous people to take advantage of the situation and cause grievous harm to banks.

11.8.2 Factors which hinder speedier reconciliation of inter-branch transactions are (a) delay in compilation of branch daily statements at the gross root level viz., branches, which is the basic input for inter-branch reconciliation, (b) low priority given at branches to the work pertaining to clarifications in respect unmatched entries, (c) errors in punching, (d) delay on the part of outside computer agency engaged by banks for this work, (e) over-centralisation of work of inter-branch reconciliation at Head Office, (f) long intervals at which reconciliation/matching process is attempted at controlling offices/Head Office, the interval being 3 months for many banks and (g) lack of serious efforts to eliminate old outstanding (unadjusted) entries on the pretext of old records being not available or cost factor or time involved.

11.8.3 The Group suggests that the under noted aspects may be taken into account by banks while devising their own strategy to clear the arrears in reconciliation of inter-branch account

(a) Segregation of large value entries and bestowing special attention for their immediate elimination.

(b) Computerisation of large and all service branches to ensure correct and speedy reporting.

(c) Back office computerisation of large branches.

(d) Creation of Special Monitor Cell at Head Office for clearing the backlog and devising procedures for timely reconciliation in future.

(e) Setting of task forces for speeding up reconciliation of inter-branch accounts in each Zone/Region.

(f) Monitoring timely submission of daily transaction statements by branches and taking punitive action for delays.

11.8.4 The Group is of the view that originating debits require more attention than originating credits . Inspectors should make a special mention of long outstanding debit entries in the inspection report. It is generally perceived that originating debits are comparatively more fraud prone. It is, therefore, necessary to ensure that originating debit entries are restricted to the extent possible taking care to ensure that customer service is not affected.

11.8.5 Besides inter-branch reconciliation, there are many other miscellaneous accounts such as clearing differences, suspense and draft payable account etc., where entries are outstanding for long periods and these need to be tackled on the same footing and suitably commented upon by the inspecting officers.

Reconciliation of Nostro balances

11.9 Reconciliation of Nostro account balances is an essential control function. The importance of reconciliation stems from the fact that the Nostro balances are comparable to a trader's inventory and must be supervised in like manner. The Management in banks should realise that there is considerable scope for defalcation of foreign currency balances in a bank where reconciliation is not done methodically, by unscrupulous persons, inside and outside the bank, through several means. The Group makes the following recommendations in this regard.

(a) In the larger banks, reconciliation should be done by a separate Department headed by an officer of sufficient rank. In smaller banks, the work of reconciliation may be entrusted to the Accounting Department itself, but placed under the charge of a separate official.

(b) Standing arrangements should exist with foreign banks (including branches/offices abroad) for forwarding statements of account not less frequently than once a month(weekly or bi-weekly in case of more active accounts).

(c) Reconciliation must be done choosing the same date for Mirror accounts and foreign bank statement.

(d) Reconciliation should be done not less frequently than once in a month and must be completed by a pre-determined date.

(e) Delay in initiating correspondence regarding unreconciled items will make reconciliation only more difficult and hence to be avoided.

(f) Introduction of suspense accounts for putting items of transactions such as export bills purchased, export bills discounted, drafts/travellers cheques issued, advance bills received, etc., will reduce the number of items to be reconciled.

(g) Management should ensure that no set-off of debit and credit items has been made, nor has any unreconciled item been written-off or appropriated to profit and loss without proper authority.

Inspectors auditing 'A' category branches should be well trained in the Nostro account reconciliation system to ensure timely detection of frauds.

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CHAPTER XII

RECOMMENDATIONS OF THE WORKING GROUP

1. The Group proposes no change in the existing structure of inspection/audit department of banks. Each bank may continue with the set-up that is suitable for its scale of operations and from the angle of administrative convenience. [Para 2.1.10]

2. The Group emphasises that independence of Inspection and Audit functionaries must be preserved for their effective performance. [Para 2.2.]

3. The Group suggests that the Zonal/Regional Audit Offices/ Inspectorates should also be made responsible to oversee the follow-up and rectification work done by the operational heads at Zonal/Regional Offices and to bring close co-ordination between operation and inspection functionaries. [Para 2.3.2]

4. Co-ordination between inspection and operational wings should be ensured to bring about synergic effort effecting overall positive changes in the functioning of the bank. Inspection and Audit Department has to be re-oriented to look into, at the time of inspection/audit of branches, their operational health and qualitative aspects rather than carrying out quantitative assessment in a routine manner. [Para 2.3.4]

5. Effective measures should be initiated by banks to remove areas of ambiguity and overlapping as also reduce multiplicity of different types of inspection/audit. However, concurrent audit and

regular inspection/audit should not be construed as overlapping as the perspective and focus of concurrent audit are qualitatively different from that of regular inspection/audit. [Para 2.4]

6. In view of increasing volume of transactions, emergence of new areas of products/services and associated complexities, expeditious computerisation for data storage, programming and performance monitoring is imperative. Each bank should maintain on computer a profile of each of its branches on performance in various thrust areas like audit rating, assets quality, level of non performing assets, revenue leakages, profitability etc., to enable it to pin-point the causes for poor performance and initiate appropriate and timely corrective measures. Track record of frauds in branches, incorporating details such as, number of frauds, amount involved, modus operandi and region-wise incidence of frauds could be computerised. Data on branches could be stored in computer memory in such a way that the management should be in a position to know at any point of time, which branches/regions are susceptible to what types of problems/frauds. The Group observes that there is considerable scope for widening and quickening computerisation efforts. With the signing of agreement with Employees Associations/Unions regarding total branch computerisation banks should move in a faster pace in order to achieve this objective. Banks should also computerise the track record of branches in reporting compliance of inspection/audit reports so that it will help the Audit Committees and functionaries at Zonal/Head Office level to have a constant track and

suggest corrective action at appropriate time. This will also enable the inspectors/auditors to be aware of which region/ geographical area is susceptible to what type of irregularities/ frauds much before commencement of inspection/audit of a branch.

[Paras 2.5.1 and 2.5.2]

7. Considering the greater reliance being placed, of late, on efficient internal control and inspection/audit systems in banks and recent spurt in frauds/malpractices in the banking industry, vigilance and inspection departments should be placed under the charge of two different executives so that individual attention could be given to these two important functions. The Group also recommends separation of these two functions. The Group further recommends that, while Vigilance Department could be headed by an officer drawn from other banks, Inspection Department must be brought under an officer drawn from the bank itself for the reason that the in-charge of Inspection Department should be well conversant with all details of the existing systems and procedures of the particular bank and should be able to analyse its inherent defects/short comings. [Paras 2.6.2 and 2.6.3]

8. Banks should have a system of fixing accountability of inspectors/auditors for their failure to detect and report serious irregularities provided banks have always updated their operations manuals, book of instructions, circulars, inspection manuals and formats. If omissions on the part of inspectors are grave enough and irregularities are very apparent, non-reporting of the same by them should be viewed seriously by banks and suitable action

should be initiated. For this purpose, broad guidelines to establish accountability for inspectors/auditors should be laid down. Invoking dereliction of duty should not dampen the morale or enthusiasm of the inspectors/auditors and it should be exercised mainly in cases of grave mistakes/suspected collusion with operating staff. [Paras 2.8.1 and 2.8.2]

9. The Inspection Department in most of the banks has become a place for posting officers who are not found suitable in other areas. This situation has to be changed and the profession should be made to acquire the creditable status it deserves. Right persons with aptitude for investigation and scrutiny should be posted in the Inspection and Audit Department. [Para 3.2.1]

10. Inspecting officer should have constructive and helpful approach while on inspection duty. To the extent possible, he should endeavour to get defects rectified on the spot. [Para 3.2.1]

11. Inspecting officer should have a frank discussion with the branch manager and other officials of the branch with regard to his findings. He should take their views into account while suggesting ways and means to reduce the number of irregularities observed and to improve the routine and overall working of the branch. [Para 3.2.1]

12. Stay of an officer in the Inspection and Audit Department for a period beyond 3 years could be counter productive and hence normally no officer may continue in inspection/audit work beyond 3

years. [Para 3.4]

13. Efforts should be made to make inspection/audit work more attractive, by giving financial incentives to inspection/audit staff. The Group does not recommend giving any weightage for promotion to inspection/audit staff for their experience since such a practice might create many other administrative problems.

[Para 3.5.2]

14. Role of an inspector/auditor is perceived to be that of a friend, philosopher and guide to the staff of the branch he is inspecting. To perform this role effectively, he should sharpen his knowledge and skills on a continuing basis. [Para 3.6.1]

15. The responsibility for improving and updating the knowledge of inspecting staff has to be shouldered by Central Audit and Inspection Department as well as Zonal/Regional Audit Offices/ Inspectorates. This may be done through developing a database on training inventory of each inspector/auditor and arranging for training in those areas to which he has not been exposed so far.

[Para 3.6.1]

16. Banks should have a system of deputing officers posted newly to Inspection and Audit Department as under-study with the main inspection team initially for 2/3 branches. Persons having work experience and training in specialised areas like foreign exchange, dealing room operations, computers etc., should be associated with inspection team. [Para 3.6.1]

17. Institutions like National Institute of Bank Management, Pune and Bankers Training College, Bombay can play a more active

and leading role in organising special purpose training for inspecting officers of banks. Banks could request NIBM/BTC to organise in-company programmes to the inspection/audit staff.

[Para 3.6.2]

18. Inspection and Audit Department of the bank should provide periodically (preferably at an interval of one year) to each inspecting/auditing official a booklet/compendium of instructions incorporating changes in procedures/RBI norms, contents of important circulars etc. [Para 3.7]

19. Inspection work need not be segregated from that of audit since, it would result in deployment of additional staff, non-availability of clear picture of functioning of the branch in its totality, possibility of inspection getting diluted, duplication of work and consequential increase in cost on account of overlapping of duties. However, more emphasis and accent should be given to inspection function. [Paras 4.5.1 and 4.5.2]

20. Revenue/income audit should be conducted at certain select large/medium sized branches or branches where income leakages have been noticed. Revenue/income audit should cover areas such as interest on loans and advances, overdue interest on bills/DD purchases, penal interest, exchange, commission and discount earned, interest paid on deposits etc. In branches where concurrent audit has been instituted, this exercise need not be undertaken. [Para 4.6.3]

21. Every bank should have a manual of instructions for their inspectors/auditors and it should be updated periodically to keep in tune with latest developments in its area of operations and in its policies and procedures. [Para 4.9]

22. No specific size of inspection/audit team could be prescribed for banks and it is for the individual bank to decide the size of the inspection team. [Para 4.10]

23. Inspection/audit of any branch should not be continued beyond two months. Even in the case of very large and exceptionally large branches, the task should be completed within 2 months by providing additional officers in the inspection team, if necessary. [Para 4.11.2]

24. All poorly rated branches should be inspected within twelve months and others between 12 - 18 months from the date of previous inspection. This will reduce the strain on branches as well as on Inspection and Audit Department caused by frequent inspections. All branches should be brought under the purview of inspection/audit on an on going basis since by only this way, the Management could ensure that the branch is run on sound lines both from the financial and organisational point of view. Segmentation approach under which inspection/audit and follow-up in respect of large branches are done department- wise could be followed in order to eliminate delay in inspection/ audit and follow-up work of such branches. [Para 4.12.2]

25. Inspection/audit report format should be updated periodically in order to incorporate various changes in products, systems and procedures. Inspectors/auditors should be provided with a check-list of major and serious irregularities in various areas of banking operations. There should be a system of reporting separately of serious and grave irregularities surfaced during the course of inspection/audit. It would be appropriate if structure of banks's inspection/audit report is remodelled as per format in which information for Annual Financial Inspection conducted by Reserve Bank of India is submitted. An executive summary should be prepared by the inspecting officer for each and every inspection/audit report and forwarded to in-charges of Zonal/Regional Offices controlling such branches.

Inspectors/auditors may submit the report to the branch manager prior to leaving for next assignment. Some banks prefer to have the inspection reports edited by Zonal/Regional Audit Offices/Inspectorates. In such cases, irregularities in the borrowal accounts can be listed and handed over to the branch manager for rectification of deficiencies and remaining findings could be sent to the branch after editing. [Para 4.13.2]

26. There should not be any rating for inspection of Head Office Departments/administrative/controlling offices. [Para 4.14.4]

27. Since the nature of problems and characteristics of operations of overseas branches are wide and varied, no uniform guidelines could be suggested for internal control, inspection/

audit of overseas branches. However, the Group emphasises the need for banks evolving proper Management Information System which could indicate clearly all aspects relating to control over liquidity management, maturity mismatch of assets-liabilities, interest rate exposure and foreign exchange exposure of their overseas branches. [Para 4.16.4]

28. Of late, new activities are undertaken by banks in a significant manner. It is essential for the banks to evolve a proper control system right from the day of taking up of such activities. The need for greater computerisation of these activities should be thought of from the very beginning so that proper control/reporting measures could be put in place. It is also imperative that the staff who are required to handle such activities are exposed to specialised training to acquire necessary skills. [Para 4.17.2]

29. Looking at the size and complexities of the operations of banks vis-a-vis limited time available for the Group to present its report, it will not be in a position to accomplish the task of preparing checklists for the use of inspecting officers of banks and formats/guidelines for controlling offices. In view of the wide ranging systems and procedures prevalent in banks as also specificity and uniqueness of each bank's policies, procedures and internal control mechanism, prescription of an omnibus checklist/ format/guidelines might not be of much use to banks. Such checklists for inspecting officers and formats/guidelines for controlling offices should be prepared by banks themselves taking

into account their policies and procedures. [Para 4.18.3]

30. Every bank should necessarily have a system of rating of its branches on the basis of inspection reports and it should also be reviewed periodically keeping in mind of changed priorities and objectives set for proper working of the branches. [Para 5.4]

31. System of rating based on the performance in select key parameters is better than rating based on marks since the latter system is a straight forward exercise. Awarding marks could lead to embarrassment to all concerned. [Para 5.4]

32. Computerised track record of efficiency ratings earned by branches over the past four/five inspections should be maintained in the Inspectorate and updated from time to time and also made available to the functionaries. [Para 5.4]

33. There should be a system of preparing summary of inspection report of unsatisfactorily rated branches for submission to the competent authority. [Para 5.4]

34. Some banks follow the practice of preparing a health card for the entire bank/zone/regions. Under this exercise, performance in case of select parameters such as housekeeping customer service, credit management, business development, profitability etc., may be quantified in terms of a score by converting various parameters into numerical values. This exercise enables the Top Management to have an alternate tool to assess the progress being made by the bank. The Group feels that, it should be left to the individual bank to decide whether it should follow this practice.

[Para 5.4]

35. Branches put under concurrent audit need not be subjected to revenue/income audit. However, they should also be subjected to internal inspection/audit, at periodicity applied to branches in general. [Para 6.3.3]

36. Size and complexity of credit and other high risk business portfolio would be a more meaningful parameter to decide the coverage under concurrent audit rather than the size of total business. It would be more beneficial to cover those branches under concurrent audit system which would account for 50 percent of total advances of the bank rather than 50 percent of total business. The banks may conduct an ABC analysis of branches with respect to advances and select the branches in accordance with the descending order of advances outstanding in such branches. At the same time, there is also a need to cover high risk branches and branches with poor rating under concurrent audit. The banks should post concurrent auditors at these branches and not at Zonal/ Regional Offices. [Para 6.4.2]

37. Since concurrent audit is day-to-day checking of transactions in order to alert the bank management, it would be advantageous to undertake concurrent auditing through bank's own staff in the long run instead of depending on outside agency. [Para 6.6]

38. Each bank should introduce a structured format for the use by concurrent auditor. This would serve as a checklist for the

concurrent auditor. A structured reporting system would also be helpful for the bank management to assess the extent of coverage and effectiveness of the concurrent audit. [Para 6.7.1]

39. The purpose of concurrent auditing would be achieved if rectification of irregularities is faster and recurrence of irregularities is avoided. While the present practice should continue, major/serious irregularities detected during concurrent audit should be reported to the Head Office and also the branch manager concerned. A time-bound action programme for rectification should be drawn up and closely monitored. Whenever any fraudulent transactions are detected by the concurrent auditors, such matters may be immediately reported to Inspection and Audit Department at Head Office with a copy to Chief Vigilance Officer of the bank. They may also be reported to the branch manager unless he, himself, is involved in the fraudulent transactions. [Para 6.7.2]

40. The two Chartered Accountant Members of the Group strongly felt that the performance of the Chartered Accountants as concurrent auditors was directly related to/affected by their remuneration. In their experience, it is just not possible to engage qualified, experienced and well-trained personnel within the fees paid for concurrent audit of branches. The Group feels that there is a case for up scaling audit remuneration to the level which will enable the external firms of chartered accountants to engage experienced and well trained personnel. [Para 6.8.2]

41. There is no need for giving longer period beyond 3 months to smaller and medium sized branches for fully rectifying the

irregularities pointed out during inspection/audit. [Para 7.2.1]

42. In the absence of any closure, there would be multiple reports on the same branch that need to be followed-up. To avoid such eventuality, only the latest report should be followed up. Each inspector/auditor should comment upon the efforts made by branch functionaries towards rectification of irregularities. [Para 7.3]

43. Special marks may be granted for efforts made by branches in rectification of deficiencies while judging them for awards and also for performance appraisal of branch managers/officials. In case of poorly rated branches a time limit should be set to restore such branches to normal state of operations. Special reports should be submitted to Audit Committee of the Board on such branches. [Para 7.4.2]

44. Inspectors/auditors should try to get majority of irregularities rectified during their stay at the concerned branch. They may have to guide the branches properly for this purpose. [Para 7.4.4]

45. Whenever, excerpts of very serious irregularities/revenue leakages which have surfaced owing to abnormal deviations from laid down procedures/norms or existence of gaps/lacunae/loopholes in the existing procedures/norms are given to departments concerned, these departments should in consultation with O&M Department or Systems and Procedures Department or EDP Department take immediate action to plug these gaps/lacunae/loopholes through issuance of fresh/revised guidelines. [Para 7.4.6]

46. There is scope for Audit Committee to broaden its domain and effectiveness through its study of additional areas such as frauds, progress in Annual Financial Inspection carried out by RBI, progress in inter-branch and inter-bank reconciliation, clearing adjustment accounts, sundry/suspense items, balance sheet items, etc. Banks should have structured items for discussion by the Audit Committee. Review notes on these items should be placed before the Audit Committee in a prescribed periodicity so that it can exercise control over the functioning of the bank on an on-going basis. Banks can decide the periodicity of the Audit Committee meetings. [Paras 7.5.4 and 7.5.5]

47. Chairman, being the overall in-charge of the bank should be involved in the deliberations of the Committee. His presence would act as a balancing factor in the Committee's deliberations. Hence the existing practice of having CMD/CEO as the Chairman of the Audit Committee should continue. [Para 7.5.6]

48. During the course of regular inspection, the inspecting officers should give special attention to certain vulnerable and fraud prone areas of working of the branch and report any disquieting feature observed. An area which requires careful scrutiny is opening of new accounts in branches. Inspecting officer should ensure that the branch officials have taken all precautions to comply with norms prescribed in this regard including the genuineness of the introducer of the account.

[Para 7.6.1]

49. Inspection findings relating to frauds detected during the inspection and matters involving malafides, corrupt practices and gross indiscipline should be submitted as special report to the concerned authorities for initiating action and not to be included in regular inspection/audit report. These reports should be thoroughly scrutinised by such authorities and they should be treated as closed only after all the related issues are fully dealt with and taking a conscious view of all the attending factors. Alongside, policy decisions should be taken to remove the shortcomings/lacunae in the existing system that have contributed to the instances of frauds/malafide action. [Para 7.6.2]

50. With a view to keep incidence of corruption and malpractices under check, there is a need for fixing staff accountability aspect of irregularities, malpractices etc., at all levels, at the appropriate time. [Para 7.7.2]

51. Parent banks need not be involved in the inspection/audit of their subsidiaries. They may not have staff conversant enough with the activities of the subsidiaries to take up inspection/audit. One has to have a futuristic view also in this regard. New activities are emerging in the financial sector and subsidiaries might pick up some of these activities. It will be extremely difficult for the parent bank to have at all times well trained inspectors/auditors to inspect these new activities. Inspection/ audit is not the only method by which a parent bank can retain

corporate control over the subsidiaries. There are other methods like nominating its representatives as directors on the boards of subsidiaries, calling for periodic information, reports and review notes etc., by which the parent bank can monitor the functioning of its subsidiaries. [Para 8.3]

52. Duties of system programmer/designer should be segregated from person operating the system and there should be separate persons to perform the above two functions. Systems person will only do modifications/improvements to programmes and the operating person will only use such programmes without having the right to do any modifications. [Para 9.5.2]

53. An appropriate control measure should be devised and documented to protect the system from attacks of unscrupulous elements. Before introducing an EDP application in place of certain manual procedure, parallel run of both the systems should be done for a reasonable period to ensure that all aspects of security, reliability and accessibility of data are ensured in EDP application. [Para 9.5.4]

54. In order to ensure that the EDP applications have resulted in a consistent and reliable system for inputting, processing and generation of output of data, the following checks should be introduced:-

(i) tests to identify erroneous processing,

(ii) tests to assess the quality of data,

(iii) tests to identify inconsistent data,

(iv) tests to compare data with physical forms and

(v) confirmation of data with outside sources. [Para 9.7]

55. Major factors which lead to security violations in computers are inadequate or incomplete system design, programming errors, weak or inadequate logical access controls, absence or poorly designed procedural controls, ineffective employee supervision and management controls. These loopholes could be plugged by

(i) strengthening physical, logical and procedural access to systems,

(ii) introducing standards for quality assurance and periodically testing and checking them and

(iii) screening employees prior to induction into EDP application areas and keeping a watch on their behavioural pattern.

[Para 9.9.2]

56. While engaging the outside agencies, banks should ensure to incorporate the clause of visitorial rights in the contract, so as to have the right to inspect the process of application and also ensure the security of the data/inputs given to such outside agencies. Contractual arrangements with any outside agency should be made after taking into account the financial stability of such agency, and other aspects like protection available to the bank, bank's right to use the program in the event of nonfulfilment of contract, suitability of hardware and software used by the agency to meet the current as well as future processing needs etc.

[Para 9.10.2]

57. Audit of work entrusted to outside agencies should consider the costs associated with such operations. It should also evaluate

losses likely to be incurred on account of errors/delays/ non-completion of required work entrusted to outside agencies. It should also evaluate the risk of destruction or loss of files/ records and clearly indicate the responsibility of the outside agency under such eventualities. It should also critically examine the ownership of programs developed/used by the outside agency and ensure that such programs will not fall into the hands of unscrupulous elements. [Para 9.10.3]

58. There is a need for formal declaration of system development methodology, programming and documentation standards to be followed by the bank, in the absence of which quality of system maintenance/improvement would suffer. EDP auditors should verify compliance in this regard. [Para 9.10]

59. Entire domain of EDP activities(from policy to implementation) should be brought under scrutiny of Inspection and Audit Department. Financial outlay as well as activities to be performed by EDP department should be reviewed by senior management at periodical intervals. [Para 9.10]

60. Efforts should be made to develop a team of competent and motivated EDP personnel. It is beneficial to have a collective development of system consisting of many persons instead of a few in order to take care of situation of exodus of key personnel. EDP auditors' technical knowledge should be augmented on a continuing basis through deputation to seminars/conferences, supply of technical periodicals and books etc.. [Para 9.10]

61. Whenever outside vendor's help is sought by banks for software development, the relationship and role of EDP department with outside software vendors need to be clearly defined. Also, it needs to be ensured that, these packages developed by outside vendors conform to standards and specifications and meet all requirements of audit. In order to bring about uniformity of software used by various branches/offices there should be a formal method of incorporating changes in standard software and it should be approved by senior management. Inspection and Audit Department should verify such changes from the view point of control and for its implementation in other branches in order to maintain uniformity. [Para 9.10]

62. Contingency plans/procedures in case of failure of system should be introduced/tested at periodic intervals. EDP auditor could put such contingency plan under test during the audit for evaluating the effectiveness of such plans. [Para 9.10]

63. The inspectors/auditors should verify whether the systems and procedures existing at branches, controlling offices and Central Office departments for handling and controlling different types of transactions have been devised/suitably modified taking into account the details of frauds, modus operandi and the preventive steps advised by the Reserve Bank of India. It should be verified whether any employee is allowed to handle the same set of books/operations continuously for long periods. A proper system of checks and counter-checks and periodical rotation of duties go a long way in prevention/early detection of frauds, if not their

64. The systems and procedures prescribed by the banks for various transactions are quite adequate and what is needed is adherence to them scrupulously by rank and file so as not to facilitate unscrupulous elements to get an opportunity to perpetrate the frauds. Therefore, in order to effectively combat the growing menace of frauds/malpractices, the imspectors have to be vigilant and alert while performing their duties. [Para 10.5.1]

65. Inspectors/auditors have to verify whether the following precautions are taken by branches while handling demand drafts in payment of which frauds could be perpetrated:-

(i) Drafts which are paid without advice are properly marked and receipts of advices are ensured so to ascertain their genuineness.

(ii) Drafts tendered for payment are subjected to scrutiny in all respects.

(iii) Specimen signatures of authorised officials issuing drafts are kept safely and updated regularly. [Para 10.5.2]

66. Non-observance of prescribed systems and procedures have been mainly responsible for many frauds taking place in the area of advances. The unscrupulous borrowers could commit frauds in this area mainly on account of the lapses on the part of the officials such as misutilisation/overstepping of lending powers, failure to comply with the terms of sanction, inadequate and ineffective post sanction follow-up and supervision. [Para 10.5.2]

67. Following precautions should be taken by banks to safeguard themselves against perpetration of frauds in the area of advances.

(i) Confidential enquiries should be made by interacting with local people to know the background and integrity of the prospective borrowers.

(ii) The assets and liabilities declared by the borrowers should not be accepted as it is and they should be verified with the relevant documents of title as well as by personal visit to know the genuineness.

(iii) Apart from satisfying the transferability and marketability of the securities offered to the bank, borrower's ability to carry on the business, infrastructure available to the unit, technical feasibility of the unit, marketability of the product etc., should also be thoroughly scrutinised.

(iv) Branch Manager should exercise powers within his lending limit.

(v) All prescribed documents should be properly executed and all set-out procedures should be meticulously followed.

(vi) Cases have been noticed where borrowers have fraudulently tampered with the share scrips and with the aid of chemicals increased the number of shares shown therein. In order to ensure genuineness of share certificates, corroborative documents like allotment letters, dividend warrant intimations etc., should be verified.

(vii) After disbursing the amount, post-sanction inspection should be conducted immediately within a reasonable time and verify the end-use of funds.

(viii) Renewal of credit facilities should not be a ritual. Unsatisfactory features should be highlighted in the renewal proposals. [Para 10.5.2]

68. Banks should ensure while allowing advances against bills(irrespective whether they are clean or documentary, usance or demand) that they represent genuine trade transactions and not accommodation bills. Banks should be wary against tendering of lorry receipts(LRs) of only a particular lorry company, consignment showing full loads, bills for round sums, drawing bills on the same party or confined to few parties, drawing bills disproportionate to borrower's business standing, bills not accompanied by pucca invoices, weight lists etc., long delay in retirement of bills by drawees, frequent instructions of the drawees to deliver documents free of payment and frequent return of bills. [Para 10.5.2]

68. The only way to prevent frauds in the area of inter-branch reconciliation is to ensure that arrears do not build in reconciliation of inter-branch transactions. Debit entries outstanding should be given utmost attention. [Para 10.5.2]

70. Banks must take appropriate action when there is failure on the part of any of their officials to comply with the prescribed systems/procedures not only as a punitive measure but also from preventive angle. While an official committing an irregularity is

answerable, the official charged with the responsibility of checking the relative entry or transaction is equally responsible for default, if he fails to detect the irregularity.

[Para 10.6.1]

71. Banks should complete enquiries expeditiously and bring to book the delinquent staff so as to deter others from perpetrating frauds and malpractices. To complete enquiries quickly, banks may segregate charges where Central Bureau of Investigation/Police have been entrusted with investigation of the case so that charges of non-criminal nature could be inquired departmentally without delay. Banks should also keep in touch with CBI/Police authorities so that the latter are provided with all assistance to complete the investigations early. Above all, banks should strengthen their vigilance machinery and review its working once in six months at the level of the Board. [Para 10.6.2]

72. Details of frauds detected during inspection and other matters involving malafides, corrupt practices/gross indiscipline on the part of the staff etc., could be reported in the inspection/audit report itself or separately in the form of special report depending upon the gravity of the matter. Banks should devise a standard format of the special report in order to streamline the procedure of submission of special reports. The special report should be treated as closed only after the related issues are fully dealt with. [Para 10.7]

73. Banks should scrupulously follow the norms prescribed by the

Reserve Bank of India to calculate capital risk assets ratio(CRAR). Over estimation of CRAR by wrong assignment of risk weights to certain assets such as PSU bonds, Post Office deposits, financial guarantees etc., incorrect evaluation of assets and exclusion of certain items of assets for assigning risk weight should be avoided. Failure to take into account erosion in provisions and reserves due to loan and other losses also leads to over estimation of CRAR. Inspecting officers while conducting inspection of Head Office Departments should ensure that the above aberrations do not creep in, in calculation of capital adequacy ratio. [Para 11.2.2]

74. In order to ascertain the correctness of the information compiled/furnished by branches regarding income recognition, asset classification, provisioning and quantum of NPAs in conformity with the prescribed norms, there should be regular checking by the inspectors/ auditors. During the inspection/audit, if any discrepancy has been found out, the same should be informed to the Branch Manager and got rectified on the spot. It should also be ensured that correct information is furnished by the branches to their respective controlling offices. [Para 11.3.3]

75. At individual bank's level, appropriate measures/strategies should be initiated to reduce the NPA component comprising of sub-standard, doubtful and loss assets. Banks may take following precautions/steps to prevent the accumulation of NPAs and inspectors should specifically comment on adequacy of steps taken.

(a) Interest/instalments recovery should be done on war-footing basis for which existing strategies need a fresh look. Involvement of staff members besides the Branch Managers has to be increased. Recovery performance of all concerned officials should be critically evaluated and outstanding performance should be appropriately recognised.

(b) Recovery through rehabilitation of sick units is always desirable provided these projects are viable. For effective rehabilitation, speedy decisions relating to formulation and implementation of rehabilitation package should be taken. For this purpose, there should be decentralisation of authority.

(c) Banks should invariably undertake timely review exercise and assess properly the borrowing/non-borrowing limits so as to prevent the possibility of accounts slipping into NPA category. However, banks should not merely sanction additional limits with the objective of regularising the accounts and upgradation of the asset status of the accounts by this process is not permitted.

(d) Compromises or negotiated settlements with the borrowers is another strategy to reduce NPAs. Guidelines prescribed by Reserve Bank of India in this regard should be followed by banks meticulously. All write-off decisions should be judicious and in the best interests of the bank.[Para 11.4.2]

76. Inspectors/auditors undertaking inspection of Investment Department at Head Office/Corporate Office should comment whether the bank has framed a suitable investment policy with the approval of the Board to ensure that operations in securities are conducted

in accordance with sound and acceptable business practices and in accordance with RBI guidelines. [Para 11.5]

77. Bank's Top Management should guide inspectorate to be vigilant against the abuse of the stockinvest scheme by branches since violations committed in the operation of the scheme may be viewed seriously by the regulatory authorities and may attract levy of penalties by them. [Para 11.6]

78. Irregularities committed in opening and operation of NRE accounts have enabled the account holders and others to resort to money laundering. Banks should, therefore, issue suitable instructions to their branches/operational staff to comply with the Exchange Control provisions fully in this regard and also to be careful when there are frequent operations on a particular NRE account. Suitable guidelines may also be issued to inspecting officials in this regard. In case, they suspect bona fides of the transaction, the matter should be reported with full details through the appropriate level to the Reserve Bank of India. [Para 11.7.2]

79. Presence of unadjusted entries in inter-branch accounts makes quite vulnarable; it could enable unscrupulous people to take advantage of the situation and cuase grevious harm to banks. Originating debits require more attention than originating credits. Inspectors should make a special mention of long outstanding debit entries in the inspection report. It is generally perceived that originating debits are comparatively more

fraud prone Besides inter-branch reconciliation, there are many other miscellaneous accounts such as clearing differences, suspense and draft payable account, 'Nostro' accounts etc., where entries are outstanding for long periods and these need to be tackled on the emergency basis [Para 11.8.1]

(RASHID JILANI)
CHAIRMAN

(G.H. DEOLALKAR)
MEMBER

(K.C. CHOWDHARY)
MEMBER

(K.N. GUPTA)
MEMBER

(UDAY M. CHITALE)
MEMBER

(G.P. MUNIAPPAN)
MEMBER-SECRETARY

Place: Bombay

Date: September 20, 1995

ANNEXURE I

S.P. Talwar
Deputy Governor

Reserve Bank of India
Central Office
Bombay.

D.O.No.DoS 1307/16.13.026/95
February 7, 1995

Dear Shri Jilani,

Working Group to review the internal control and inspection and audit system in banks

As you are aware, the serious irregularities which had taken place in the recent past in the securities transactions of banks have brought to light a number of deficiencies and inadequacies in the internal control and inspection/audit systems in banks. No doubt, the banks have also in the recent times issued a number of instructions/guidelines to all banks to streamline their inspection and audit machinery, introduce concurrent audit, monitoring treasury operations etc. With the new apprcach on bank supervision through off-site monitoring in addition to on-site inspection, it becomes necessary for the Reserve bank to depend more on the internal control and the inspection/audit function within the banks to throw up reliable data and feedback. The reliability of internal control in banks would help statutory auditors as well as Reserve Bank Inspectors. Against this back-drop it is considered necessary to set up a Working Group to review the internal control and inspection and audit system in banks in order to focus on the deficiencies and suggest remedial measures.

The Working Group will consist of the following members.

1.	Shri Rashid Jilani	Chairman & Managing Director, Punjab National Bank, New Delhi [CHAIRMAN OF THE COMMITTEE]
2.	Shri Uday M. Chitale	Chartered Accountant, Bombay
3.	Shri K.N. Gupta	Chartered Accountant, New Delhi
4.	Shri G.H. Deolalkar	Director, N.I.B.M. Pune
5.	Shri K.C. Chowdhary	Executive Director, Central Bank of India, Bombay
6.	Shri V.Sethumadhavan	Addl.Chief Officer, Department of Supervision, Reserve Bank of India, Bombay [MEMBER-SECRETARY]

The terms of reference of the Group are listed in the Annexure. While the Member-Secretary will get in touch with you in regard to the modalities of the Committee work, may I take this opportunity to welcome you to this Working Group and look forward to your valuable contribution in completing the task, preferably by end March 1995.

With Regards,

Yours sincerely.

(S.P. Talwar)

Shri Rashid Jilani,
Chairman and Managing Director,
Punjab National Bank,
Head Office, New Delhi.

Terms of reference

The Group will review :

(i) set up of the internal inspection and audit departments in banks - computerisation of Inspection Department.

(ii) Inspection - scope and coverage, periodicity, criteria for selection of branches, format for reporting, different types of inspections, inspections/audit of service branches, administrative officers/controlling offices, whether inspections and vigilance should be under the charge of same executive or should be separated.

(iii) staffing of inspection department - selection system, incentives, training, etc.

(iv) system of follow-up and compliance of inspection reports.

(v) system and criteria regarding rating of branches and monitoring of poorly and unsatisfactorily rated branches.

(vi) system of reporting and follow-up of very serious irregularities observed during inspection - system of fixing accountability on inspectors for failure to detect and report serious irregularities.

(vii) concurrent audit - functioning of the system, follow-up and its impact on fraud prevention and detection.

(viii) inspection and control of subsidiaries of banks.

(ix) computer/ALPMS audit - training of officers in computer audit.

(x) inspection/audit of overseas branches.

(xi) role of external auditors in strengthening internal control system in banks.

(xii) Surveillance over new deposit accounts opened.

ANNEXURE - II

Names of banks which have responded to the questionnaire

A. Public Sector Banks

1) Bank of India
2) Bank of Maharashtra
3) Dena Bank
4) Syndicate Bank
5) Canara Bank
6) Punjab National Bank
7) United Bank of India
8) Union Bank of India
9) Oriental Bank of Commerce
10) UCO Bank
11) Vijaya Bank
12) Indian Overseas Bank
13) Central Bank of India
14) Bank of Baroda
15) State Bank of India
16) State Bank of Mysore
17) State Bank of Bikaner & Jaipur
18) Corporation Bank
19) State Bank of Hyderabad
20) Punjab & Sind Bank

B. **Private Sector Banks**

1) Karur Vysya Bank Ltd.
2) Catholic Syrian Bank Ltd.
3) Tamilnad Mercantile Bank Ltd.
4) Ratnakar Bank Ltd.
5) Punjab Co-operative Bank Ltd.
6) Nedungadi Bank Ltd.
7) Dhanalakshmi Bank Ltd.
8) Lord Krishna Bank Ltd.
9) Karnataka Bank Ltd.
10) Laxmi Vilas Bank Ltd.
11) Federal Bank Ltd.
12) Vysya Bank Ltd.

C. **Foreign Banks**

1) Abu Dhabi Commercial Bank Ltd.
2) Banque Indosuez
3) Credit Lyonnais
4) ABN Amro Bank
5) Bank of Nova Scotia
6) British Bank of Middle East
7) Hongkong & Shanghai Banking Corporation
8) American Express Bank
9) Oman International Bank
10) ANZ Grindlays Bank
11) Standard Chartered Bank

ANNEXURE - III

Names of banks whose responses to questionnaire have been taken into account

A. Public Sector Banks

1) Bank of India (BoI)
2) Bank of Maharashtra (BoM)
3) Dena Bank
4) Syndicate Bank
5) Canara Bank
6) Punjab National Bank (PNB)
7) United Bank of India
8) Union Bank of India (UBI)
9) Oriental Bank of Commerce (OBC)
10) UCO Bank
11) Vijaya Bank
12) Indian Overseas Bank (IOB)
13) Central Bank of India (CBI)
14) Bank of Baroda (BoB)
15) State Bank of India (SBI)

B. **Private Sector Banks**

1) Karur Vysya Bank Ltd.
2) Catholic Syrian Bank Ltd.
3) Tamilnadu Merchantile Bank

C. **Foreign Banks**

1) Standard Chartered Bank
2) American Express Bank
3) ANZ Grindlays Bank P.l.C.
4) Hongkong & Shanghai Banking Corporation
5) ABN Amro Bank

ANNEXURE - IV

Summary of views of select banks prepared on the basis of their replies

Q.1 What is the organisational structure of Inspection/Audit Department at Head Office? Indicate by a functional chart.

Copies of charts showing the organisational structure of inspection/audit departments of various banks were received.

Q.1.2 Whether audit and inspection functions could be segregated? If so, advantages and disadvantages of the same.

a) 15 banks have said that audit and inspection functions should not be segregated.

Reasons:

i) Would require more staff.
ii) Clear picture would not be obtained.
iii) Existing system is working well.
iv) Thin distinction exists between audit and inspection.
v) Might dilute the scope of inspection.
vi) Will result in duplication of work and cost on account of overlapping.

b) 3 banks have advocated separation of audit and inspection.

Reasons

i) It will ensure speedier completion of work and qualitative excellence could be achieved.
ii) Segregation could be done in respect of
  * branches having advances of 25 lakhs and above which are subjected to revenue audit;
  * branches with specialised activities which are put under concurrent audit.
  * No further dilution in functions.

Q.1.3 Do you have centralised/decentralised system in respect of audit and inspection ?

a) 11 banks are having centralised system of audit and inspection.

b) 7 banks are having decentralised system of audit and inspection.

Q.1.4 If you have decentralised system, what is the set up at zonal level ?

i) Bank of India: It has 13 audit zones, 9 headed by AGM and 4 headed by CM, all are reporting to GM through DGM (Audit and and Inspection).

ii) Bank of Maharastra: It has 10 Regional Inspection Cells headed by CM and RVO reporting to Inspection and Audit Department at Head Office. Inspection assignments are, however, received directly from Head Office.

iii) Central Bank of India: It has zonal audit cells in each zone headed by Scale IV or Scale V officer.

iv) State Bank of India: Zonal inspecting officers are considered as extended arm of Central Inspection & Audit Department. Zonal Zonal Inspection Office is headed by GM.

Q.1.5 How independence of inspection functionaries at Zonal Office/Divisional Office level is maintained ?

i) Zonal Audit chief directly reports to Head Office. Individual inspectors/auditors report to Zonal Inspector/Audit-in-Charge and to Zonal-in-Charge.

ii) Through Zonal Audit Committee, zonal audit chief can veto the decision of the Zonal Manager to close the audit file of a branch, if he feels so. (BoI)

iii) Performance review of inspection staff as well as heads of Zonal Audit/Inspection Cell is done by executive heading the Central Inspection Department.

Q.1.6 How co-ordination between inspection and operational departments at ZO/DO level is ensured ?

Co-ordination between inspection and operational departments at ZO/DO level is ensured through

i) Periodical meetings and exchange of information among various functionaries.
ii) Audit Follow-up Cells at RO/ZO level.
iii) Sending of extracts of serious irregularities to departments concerned.
iv) Zonal Audit Committee.
v) Monthly review of rectification of irregularities.

Q.1.7 Do you experience any ambiguity or overlapping in role and and responsibility of audit/inspection functionaries at Zonal and Head Office level ? If yes, state in which areas the same is observed ?

16 banks have stated that there is no ambiguity or

overlapping in role and responsibility of audit/inspection functionaries at Zonal level and Head Office level.

2 banks viz., Catholic Syrian Bank and Bank of Baroda have stated that ambiguity overlapping is felt to limited extent.

Q.1.8 The extent of computerisation in the inspection - Is the department computerised for -
a) Programming.
b) Inspection Formats.
c) Monitoring.
Do you have computerised track record of branch rating(i.e. trend/performance analysis) of performance, analysis of performance or grading of branches as per inspection reports of past, say 5 years ?

i) Eight banks have responded that the department has not been computerised.

ii) Six banks have replied that the department is in the process of computerisation.

iii) In some banks, this area is partly computerised i.e. at Head Office level.

iv) SBI : Department is computerised and stores data captured from inspection reports.
- PCs are used for monitoring.
- On experimental basis note book computers have been inducted for site data capture.

Q.2 AUDIT COMMITTEE

Q.2.1 To co-ordinate and supervise overseas audit/inspection function and formulate policy guidelines, do you have the Audit Committee of directors in your bank ?

All banks have responded that they have Audit Committee of directors.

Q.2.2 If yes, (i) what is the constitution ?
(ii) what are the objectives of Audit Committee?
(iii) are these objectives in your opinion achieved? and
(iv) please offer changes,if any, needed in overall working of the Audit Committee keeping in view your bank's experience.

i) In almost all the banks, the Committee consists of Chairman/Managing Director, Executive Directors and 3 Directors. In Bank of India, it is ensured that one of the directors is a Chartered Accountant. In some of the banks RBI nominee to the Board is also included in meeting.

ii) To overview the inspection/audit conducted in the bank, their periodicity, coverage and quality as also to ensure effective internal control.
   - To review follow-up action on the reports, particularly of "unsatisfactory" branches, specialised branches and branches classified by the banks as Extra Large Branches (ELBs)
   - To ensure compliance with inspection/audit reports of RBI and reports of statutory auditors including Long Form Audit Reports and management letters of latter.
   - To ensure accountability for unsatisfactory compliance of inspection reports, delay in compliance and non-rectification of deficiencies.
   - To see whether there is any omission on the part of inspecting officers to detect serious irregularities (which come to light later).
   - To take up periodical review of accounting policies/ systems in the bank with a view to ensuring greater transparency in the bank's accounts and adequacy of accounting controls.
   - To give directions in respect of lacunae observed in performance reports and other reports etc., wherever necessary.

iii) In the opinions of most of the banks the objective of the Committee are achieved. However, a few banks have expressed that as the Committee has been formed recently, it would be premature to form an opinion.

iv) Almost all banks do not propose any change.

<u>Q.2.3</u> In how many occasions has the Committee met during 1994-95 and 1993-94 ?

- In 1993-94 the Committee was existent only in 3 banks and on an average 3-4 meetings were held in 3 banks.

- In 1994-95 the Committee was formed in all banks. On an average 2-4 meetings were held in 1994-95. In Vijaya Bank the Committee has yet to meet.

<u>Q.2.4</u> What are the functions entrusted to the Committee (i.e. the types of reports reviewed by it, the nature of directions issued, whether operational health of the branches in groups(viz. zone-wise/state-wise/category-wise) is reviewed?

Functions entrusted to the Committee are:-
- Review of inspection and control systems in the bank so as to bring in improvement in the system.
- Review of accounting policies.

- Compliance with RBI reports/statutory audits/LFAR and special audit reports.
- Review and monitor poorly rated branches.
- Monitoring of rectification/ regularisation of irregularities pointed out in the report.
- Issue of guidelines to avoid recurrence of irregularities.

Q.2.5 What is the system followed for following up the directions of the Committee and whether compliance of the directions is reported to the Committee ?

In majority of banks directions/decisions of the Committee are minuted and sent to concerned Regional/Zonal Inspection/Audit Cell and progress of compliance is placed before the Committee.

- Where the directions are for revamping systems and procedures, the same would be examined by the concerned department at Central Office.

- In some of the banks compliance to Committee's directions is being monitored by senior executives/ executives secretariat.

Q.2.6 In addition to Audit Committee of Directors, do you have Committees of Executives at H.O./Z.O. level? If so, do such Committees consider any matters relating to audit/inspection ?

Barring Dena Bank and State Bank of India, all banks have Committee of Executives at H.O. or Zonal level to consider matters relating to audit/inspection.

Q.3 VIGILANCE

Does your GM, Inspection/Audit also look after the Vigilance Department ?

In all banks, except in PNB, SBI and UCO Bank, General Manager(Inspection/Audit) holds the charge of Vigilance Department.

Q.4 SCOPE, COVERAGE, PERIODICITY ETC.

Q.4.1.1 Does the bank have a manual of inspection for the guidance of inspection staff? When was it last updated? In addition to Manual of Inspection, does your bank have other tools/kits for guidance of inspecting officers?

Barring Tamilnad Mercantile Bank Ltd., all banks have their Manual of Instructions for audit/inspection staff. In most of the banks these manuals are getting updated periodically. However, the updation work is overdue in some of the banks, e.g. -

Bank of Maharashtra	updated last in 1979
Central Bank of India	updated last in 1983
State Bank of India	updated last in 1988

Manuals of instructions are supplemented by compendium of circulars, list of major irregularities, historical data on interest rates/service charges and check list for foreign exchange business/documentation on advances/staff matters.

Q.4.1.2 Regular inspection of branches etc..

a) What is the size and composition of the typical inspection team for different sizes of branches?

Size of the inspection team largely depends on size of the branch and scale of operations. However, on an average, it consists of

i) Small and medium - 2 officials
ii) Large - Team Leader + 2 officials
iii) VLB/ELB - Team Leader + 2-5 officials

b) Do you ensure that the senior member of the team is one scale higher than the scale of the Manager of the branch/ office.

Ensured wherever possible. Difficult to maintain in case of inspection of VLB/ELB.

c) What is prescribed average/normal duration of inspection of branches?

Type/branch	Prescribed Duration - Days (exclusive of holidays)	Average Duration Actually days taken
Small	5 - 7	
Medium	8 - 12	
Large	20 - 35	
Very Large	60 - 70	
Exceptionally Large	100 - 120	

On an average mandays prescribed are followed up.

d) Do the inspectors normally adhere to the time limit prescribed for completing the inspection of a given branch? Usual reasons for delay, if any.

Generally mandays prescribed are adhered to.

e) Whether the prescribed duration leads to compromise in quality - please give your comments in this regard.

No compromise in quality is observed. Extension in mandays is granted on specific requests of inspectors.

Q.4.1.3 FREQUENCY OF INSPECTION

a) What is the frequency prescribed for regular inspection of different types of branches/offices/departments
- Small, Medium, Large, VLB, EL Branch,
- Service branches, Unsatisfactory branches, Specialised branches, Treasury/dealing room operations, Merchant Banking Department, EDP Cell

On an average, in most of the public sector banks, the frequency of audit is as under :

i) All branches including service branches - Once in 12-15 months.
In SBI - Once in 18 months.

ii) Unsatisfactory branches - 6-9 months
In SBI - 12 months.

iii) Specialised branches - Once in 12 months.
Besides, majority of these branches are under concurrent audit.

Treasury/dealing room operations:- 1-3 months for treasury operations, in most of banks, the department is under concurrent audit. Dealing room is audited once in a quarter.

Merchant Banking Dept. - 2-3 years.

EDP Cell - 2-3 years.

b) Whether you have been able to complete the inspection of all branches as per prescribed periodicity. Please indicate the position for the year April 1994- March 1995.

In almost all banks, audit/inspection of all branches has been carried out as per prescribed periodicity. There was, however, backlog in a few banks as under :

Name of bank	Backlog as on 31.3.1995 -	Out of - Total branches No.of branches
i) Syndicate Bank	25	1558
ii) United Bank	58	1086
iii) OBC (Srinagar)	1	

iv)	UCO Bank	Good No.of branches
v)	SBI	243

c) **If backlog is there, reasons therefor.**

Main reasons are;
- Shortage of manpower
- Increase in business
- Location of branches in far flung and disturbed areas.

In case of SBI, out of 243 branches in arrears, 50 are in Kashmir Valley, 89 are in North Eastern States.

d) Do you consider the present frequency of inspection reasonable?
If no, please indicate the reasonable frequency as well as the additional staff requirement, if needed.

All banks consider present frequency of inspection/audit as reasonable. However, in the opinion of some of the banks, audit rating should not be a criterion for deciding frequency of audit.

e) Do you feel the necessity to differentiate branches in this regard based on rating/criticality etc. i.e. giving a holiday for highly rated branch and increasing the frequency for poorly rated branch.

Many banks consider necessary to give holiday for highly rated branches.

Q.4.1.4 Inspection Report Format

a) Do you have prescribed/structured format of inspection report?

All banks have prescribed/structured format of inspection report.

b) If yes, is the inspection report format reviewed from time to time? When was it last done?
Please suggest changes, if any, in the present format in respect of size,structure,contents.

Most banks have reviewed their formats during last 2 years. In the opinion of majority of banks size and structure to the existing format should be adequate to cover all areas of inspection.

c) Has it been attempted in your bank to spell-out generally nature of major and minor irregularities for the purpose of reporting? Is a check-list of such irregularities provided to the inspection staff?

Except Bank of Baroda and UCO Bank, all banks have the system of reporting major and minor irregularities separately and check-list is provided to inspectors/ auditors.

d) Does your format incorporate any ratio analysis - say for profitability, NPA and recovery, productivity and other key performance areas?

In all banks, barring Union Bank, UCO Bank and Vijaya Bank, ratio analysis is incorporated in inspection/audit report format.

Q.4.2 Besides regular inspection, what are the other types of inspection/audit prevalent in your bank? Please submit a write up on different types of inspection and audit describing the coverage, periodicity etc. If any format is prescribed, copies of the formats may be enclosed.

Besides regular inspection, following types of inspection/ audit are conducted in most of the banks.

i) Concurrent audit - In ELB/VLB/Poorly rated branch/ Specialised branch/Investment Dept. Foreign Exchange Dept., covering nearly 50% of bank's business is done.

Concurrent audit is carried out through outside firms of Chartered Accountants or bank's internal inspectors.

ii) Revenue/Income audit - Conducted once in a year usually through outside firms of Chartered Accountants.

iii) Computer audit - Done for ensuring control over computer data/assets, ensure data integrity and effectiveness. This is done through specially trained inspectors.

iv) Short/spot audit - To carry out special exercise where frauds/malafides are suspected.

v) Statutory audit - To comply with statutory requirements.

Q.4.3 Is there a system of inspection of Head Office Departments and Administrative/Controlling offices? If so, please submit a write up on coverage, periodicity, constitution of inspection team etc. If there are any guidelines and formats prescribed for inspection of such offices, copies of the formats and guidelines may be enclosed.

In almost all banks Head Office department and administrative/controlling offices are subjected to inspection/audit at a periodicity of 2-3 years. Normally, the team is headed by a senior executive from Audit/Inspection Department.

Q.4.4 In your view, is there overlapping in the areas of coverage under different types of internal inspection and audit? If so, please indicate the areas of overlapping and give suggestions for streamlining the system of multiple inspection/audit.

All banks, except UCO Bank and UBI, have expressed that there is no overlapping in the areas of coverage under different types of internal inspection and audit. In the opinion of UCO Bank and UBI the overlapping takes place in the area of concurrent audit and normal inspection/audit.

Q.4.5 Quality of Inspection

Q.4.5.1 What is your assessment of the quality of inspection and reporting in your bank measured in following terms?
V. good/Good/Satisfactory/Poor

In most of the banks, assessment ranges from Good to Satisfactory.

Q.4.5.2 For improving the quality, what are your suggestions?

Suggestions for improving quality
- Posting officers with adequate exposure to all areas of banking and aptitude
- Adequate training to keep abreast of developments.
- The department should not be a dumping ground for unwanted/unsuccessful officers.

Q.4.5.3 On the basis of the inspection reports of branches, is there any system to make a qualitative assessment of the performance of the branches, and other important areas such as incidence of frauds, deficiencies in house keeping etc. Zone-wise/Region-wise? If so, whether such reviews are placed before the Audit Committee/Board.

Such qualitative assessment is usually done in the banks and placed before Audit Committee of Board/Committee of Executives at RO/ZO/HO.

Q.4.5.4 Do you conduct any evaluation/review study of irregularities commonly pointed out in inspection reports?

Yes.

Q.4.5.5 Does it get reflected in issuing fresh guidelines for preventing recurrence? If yes, please quote some recent instances.

Yes. Suitable guidelines are issued through circulars.

Recent instances

i) Punching of correct series and numeral cage of demand drafts.

The precautions to be taken in case of newly opened accounts.

iii) Abolition of advice in case of draft below Rs.1 lakh.

iv) Prohibiting use of ERAZ-EX (correction fluid).

v) In case of duplicate DD/TDR issued, original vouchers to be kept along with documents obtained.

Q.4.5.6 Has the study, if conducted, been found useful in preventing occurrence of such irregularities.

The study conducted is found useful.

Q.5. Staffing of Inspection Department, selection of inspectors etc.

Q.5.1 Whether the Inspection and Audit Dept. is having sufficient complement of manpower resources required for completion of various types of inspections and follow-up. If not, please spell out constraints and suggestions

Most banks have opined that the complement of audit/ inspection staff is adequate. However, a few banks have expressed shortage of manpower due to
- changed periodicity of inspection as per Ghosh Committee recommendations
- increased volume of business.

Q.5.2 What are the procedure and criteria for selection and posting of officers to Inspection Department?

Following are the considerations :
- Officers having exposure in operational areas of banking
- Aptitude
- Proven integrity and clearance from vigilance angle.
- Professional qualifications CA/ICWA/CAIIB preferred.
- In some banks, working as branch Manager/ABM is precondition.

Q.5.3 Have you prescribed any tenure for service in the Inspection Department?

Normally 3-5 years.

Q.5.4 Are any financial or other incentives given to officers posted to the Inspection Department? Is any weightage given for inspection experience when an officer is considered for promotion?

No special financial incentives or weightage is given. However, in SBI, 3 years of inspection is treated as equivalent to 2 years of independent line assignment which is a precondition for promotion to certain grades.

Q.5.5 Do you think such incentives are necessary; if so, why?

Most of the banks have recommended giving weightage to inspection/audit experience while considering for promotion. The opinions are equally divided on issue of giving incentives.

Q.6. TRAINING OF INSPECTORS

Q.6.1 After selection does your bank organise any formal training for inspectors? If so, is it done internally or externally or both.

All banks, except Catholic Syrian Bank impart training to inspectors on induction. This training is organised internally.

Q.6.2 Do you conduct refresher programme for inspectors?

Refresher courses are conducted by all banks except SBI, Canara Bank, Syndicate Bank and Dena Bank.

Q.6.3 How do you ensure that the inspectors conducting inspection/audit of specialised branches/activities such as computerised branches, service branches, overseas branches, merchant banking activities, treasury operations etc., have got the required technical knowledge for the purpose? Please indicate the nature of specialised training for such inspectors, internal or external.

Training in specialised areas of banking is given to inspectors inspecting these areas. In some banks like SBI, persons having work experience and training are associated with inspection team. The training in specialised areas like computer, credit, foreign exchange, etc. is organised internally or through institutions like NIBM/BTC.

Q.6.4 Is there any system for sending the officers posted to the Inspection Department as understudy with the main inspection team initially for 2/3 branches?

The system is in vogue in all banks except UCO Bank and

Syndicate Bank.

Q.6.5 Do you feel that there is a need for organising regular programmes, seminars/conferences to be held for inspection personnel by NIBM, BTC, etc.,on topics of common interest? Need for seminar etc. is felt at all banks.

Q.7. Follow-up of the Inspection/Audit Report

Q.7.1 What is the average time prescribed to branches and actually observed for issuing full rectification certificate?

	Time prescribed	Time actually observed
Small		
Medium		
Large		
VLB		
ELB		

Average time prescribed for full rectification certificates is 3 to 6 months.
Average time actually taken for full rectification certificate is 6 to 12 months.

Q.7.2 What is the approximate and average percentage quantum of irregularities not rectified and carried in the next inspection report.

Average percentage quantum of irregularities not rectified and carried in the next inspection report ranges between 25-30%.

Q.7.3 Please discuss reasons, if any, for longer time taken for follow-up of inspection report.

Reasons are
- want of co-operation from borrowers
- delay in registration of charges with ROC/RTO
- indifference at branches
- delay at DICGC and other Govt. agencies
- low priority accorded to audit/inspection follow-up.

Q.7.4 In your bank, do inspectors guide branches in rectification of irregularities besides ensuring maximum rectification during their stay at the branch. Is this fulfilled? Please offer suggestions, if any, in this regard.

Yes, in all banks.

Q.7.5 What kind of irregularities are not rectified or there are delays in rectification.

Matters involving
- documentation
- technical/legal issues
- balancing of books
- reconciliation
- recovery of revenue
- claiming reimbursement of pension
- claims in respect of DICGC/Currency Chest.

Q.7.6 It is expected that regional/divisional office has to oversee the rectification work at branches and offer necessary support/guidance. How far this expectation is fulfilled in your bank?
Please offer, suggestions if any, in this regard.

Performance of RO/Divisional Office in monitoring of rectification is by and large found satisfactory.

Q.7.7 Who is the competent authority, to order closure of the inspection reports of different types of branches, Administrative Offices etc.?

In most of the banks, inspection/audit In-charge at Zonal level is empowered to close the file

- in OBC GM(Audit and Insp.) is empowered
- in Central Bank of India there is no system of closure of file.

Q.8. INTERNAL AUDIT

Q.8.1 Is there an internal Audit Manual drawn up?

Q.8.2 What kind of staff is deputed for Audit-composition of the team?

Q.8.3 What is the objective set for audit as opposed to inspection and external statutory audit?

Q.8.4 How frequently internal audit is done in respect of Small, Medium, Large, VL and EL Branch

Q.8.5 Is there standardised format for reporting.

In most of the banks, there is no separate internal Audit Department. Hence most of the functions of audit are carried out by Inspection Department

In other banks, audit and inspection functions are combined in to one Department.

Q.8.6 Other questions after inspection, to be answered in respect of matters like making Executive Summary, report to higher authorities, including Audit Committees and watching clearance of audit objections, are attended to by internal audit.

Executive summary is prepared in case of reports involving very serious irregularities and special reports.

Q.9. Engagement of External Auditors for inspection/audit work

Q.9.1 Does your bank depend on external audit firms to conduct regular inspection? If so, extent of dependence
- Total number of branches inspected during 1994-95 and volume of business (deposits and advances) covered.
- Out of the above, no.of branches inspected by external auditors and volume of business covered.

No bank engages services of external auditors for conducting inspection/audit except United Bank of India and Punjab National Bank.
i) United Bank of India:- 598 branches out of 1028 branches
ii) Punjab National Bank:- 829 branches out of 3016 branches

Q.9.2 In addition to regular inspection have you employed external auditors for any other type of internal inspection or audit? If so, the nature of inspection/ audit entrusted to them and the number of such branches.

Branches covering 50% of volume of bank's business are placed under concurrent audit. A majority of such branches is concurrently audited by firms of Chartered Accountants. SBI does not engage Chartered Accountant firms for concurrent audit.

Almost all banks are engaging services of firms of Chartered Accountants for carrying out revenue/income audit.

Inspection/audit conducted by the external auditors vis-vis-vis inspection/audit done internally State -
- Whether Satisfactory /Not Satisfactory
- At par/Below par/Better than bank`s own inspection staff

Most banks find performance of Chartered Accountants firms as 'not satisfactory or below average'.

Q.9.4 What is the system of follow-up of LFAR? Any review of rectification of the deficiencies pointed out in LFAR is being submitted to the Audit Committee/Board.

LFAR rectification is followed up by Regional/Zonal Audit Follow-up Cell and progress is placed before Audit Committee of the Board.

Q.9.5 Briefly comment on the extent of coordination and interaction between the statutory auditors of the bank and branches and the bank's own internal inspectors and auditors.

There is no co-ordination between external auditors and internal inspectors/auditors. However, reports of internal inspectors/auditors are made available to external auditors. There is good co-operation between external auditors and branch functionaries.

Q.10. Rating of branches

Q.10.1 Do you have a system of rating of branches on the basis of inspection reports?

Yes.

Q.10.2 Is it based on scoring of marks for different criteria. Please list out the criteria adopted for evaluation and the weightage given for each criterion.

In all banks except PNB, Dena Bank, IOB, OBC and SBI, rating is based on marks scored on various parameters. In the above five banks, rating is based on grades. The parameters for awarding marks/grades are :
- Deposits,- Credit Management, - Housekeeping, - Customer Service, - Judicious exercise of lending power, - Marketing of services

Q.10.3 Who does the rating?
Initially confirmation or review of rating, if any, by Inspector
Zonal/Regional level officer
Head office
Inspection Dept.

In all banks except OBC, rating is awarded by inspector/ auditor and subsequently reviewed/confirmed at Regional/ Zonal/H.O. inspection/audit cells. In case of OBC rating is awarded by AGM(Inspection and Control) and confirmed by GM (I & C)

Q.10.4 Do you have a system of rating of inspection staff? If so, please explain criteria.

No rating of inspection staff is done.

Q.10.5 Do you have the system of preparing an Executive Summary of the report? If yes, who prepares it?

Yes. Usually prepared by ZO/HO audit/inspection cells.

Q.10.6 Please indicate the authority to whom the `Executive Summary` is submitted?

Placed before AGM/DGM/GM(Insp.)/GM of concerned department depending on size of branch or gravity of irregularity.

Q.10.7 Is there any system of preparing summary of inspection report of unsatisfactorily rated branches for submission to Chairman/Chief Executive Officer/Audit Committee/Management committee. Please indicate the system prevalent for follow-up of such reports and upgradation of branches.

Yes. Placed before Audit Committee of the Board/Committee of Executives.

Q.11. Reporting of serious irregularities

Q.11.1 Are inspectors required to submit flash/special report to the Top Management in respect of very serious irregularities in the areas of bills portfolio, suspected frauds, asset classification etc., surfaced during the course of inspection? If so, please briefly describe the procedure followed and how far this system has been effective.

Yes. Special/flash reports are submitted to Board/MD/ED/ top management depending on extent of seriousness. The system is found to be effective.

Q.12. Concurrent Audit

Q.12.1 Have you introduced concurrent audit?

All banks except Tamilnad Mercantile Bank have introduced concurrent audit.

Q.12.2 a) Do you engage the external audit firms for conducting the concurrent audit or whether concurrent audit is conducted by inspection/audit wing only?

- In SBI, it is done only through their internal inspectors.

- In all other banks, concurrent audit is conducted partly through external audit firms and partly through their internal inspectors.

b) If yes, what is the proportion of internal and external concurrent auditors in terms of (i)branches and (ii) volume of business.

On an average 60-70% of branches kept under concurrent audit, are assigned to firms of chartered accountants. However, in Syndicate Bank this percentage is 10%.

c) What is the remuneration paid to external concurrent auditor ?

There is no uniformity prevailing in fees paid to chartered accountants firms for concurrent audit. However, fees structure of 3 banks is reproduced as an indicative sample.

<u>Bank</u>	<u>Criteria</u>	<u>Fees paid</u> Rs.
PNB	i) Deposit upto Rs.25 cr. and total business upto 50 cr.	7000/- pm
	ii) Deposit above Rs.25 cr. or total business for more than Rs.50 cr.	8500/- pm
	iii) Advances for more than Rs.50 cr. or total business for more than Rs.100 cr.	10000/- pm
CBI	Credit of the branch upto Rs.5 cr.	3000/- pm
	5 - 10 cr.	5000/- pm
	10 - 15 cr.	6000/- pm
	15 - 20 cr.	7500/- pm
	20 - 30 cr.	8500/- pm
	Above 30 cr.	10000/- pm
BoI	Large branch	5000/- pm
	Very Large branch	7500/- pm
	Exceptionally Large branch	10000/- pm

<u>Q.12.3</u> What is the system in your bank regarding subjecting the branches under concurrent audit to other types of audit such as revenue audit etc.

In majority of banks where concurrent audit is in vogue, regular inspection/audit and revenue audit are not conducted, separately. However, some banks conduct separate revenue audit and/or regular inspection/audit.

Q.12.4 Extent of coverage under concurrent audit in terms of business turnover and number of branches.

It is the endeavour of the bank to bring 50% of their business under the purview of concurrent audit.

Q.12.5 Are treasury operations/foreign exchange dealing operation subjected to concurrent audit?.

Yes; except in Tamilnad Mercantile Bank.

Q.12.6 Is concurrent audit found to be useful? Your suggestions for making it more effective may be given.

Yes. It is found useful provided
- rectification of irregularities is faster,
- recurrence of irregularities is avoided.

Some banks have opined that concurrent audit being a new concept it would take time to stabilise.

Q.12.7 Is there any structured format for concurrent auditors to report?

There is no structured format except in Syndicate Bank, United Bank of India, Vijaya Bank, OBC and BoB.

Q.12.8 What is the system of reporting, rectification and review of rectification etc. under concurrent audit?

List of irregularities are handed over to branch/controlling offices by the concurrent auditor for rectification and follow-up. The progress is monitored by Regional/Zonal inspection/audit department.

Q.12.9 Please suggest changes, if any, needed in the existing guidelines issued by the RBI on Concurrent Audit.

i) Branches having advances over Rs.10 crores or total business over Rs.50 crores should be covered under concurrent audit irrespective of percentage of bank's business covered.
ii) Business should not be sole criterion; other factors like advances, cost benefit, efficiency rating etc. should also be considered.
iii) Concurrent auditor should be advised to conduct annual audit to avoid overlapping.

Q.12.10 If concurrent audit is done departmentally, what is the set up and how costly it is?

Engaging external auditors for concurrent audit is found to be cheaper.

Q.13. Off-Site Audit- Monitoring by controlling offices

Q.13.1 Regional/Zonal offices are expected to scrutinise returns and statements filed by the branches for the purpose of obtaining feedback on the branch working, compliance of guidelines/norms and detecting irregularities/deviations if any. How do you assess the fulfillment of this expectation in your bank?

Very good	Good
Satisfactory	Poor

Performance of RO/ZO audit/inspection cell found to be satisfactory.

Q.13.2 Please offer suggestions if any, to strengthen this type of monitoring at Regional/Zonal Offices.

Multiplicity of statements to be reduced.
Data is to be computerised.

Q.13.3 If Regional/Zonal offices are not able to monitor the branches through these returns, the reasons therefor may be stated?

Not applicable, as performance of RO/ZO audit follow-up cell is found satisfactory.

Q.13.4 Do you think that the returns require any modification to serve the purpose better?

Yes. Returns need to be rationalised.

Q.14 Inspection and control of subsidiaries

Q.14.1 Please describe the system of inspection and other forms of control exercised by your bank over subsidiaries, if any.

Only 7 banks viz., BoI, BoM, Canara Bank, PNB, CBI, BoB and SBI are having subsidiaries. All subsidiaries are audited by external auditors. The question regarding forms of control have not been replied.

Q.14.2 Whether any MOU is entered into with subsidiaries as regards their performance?

No MoU is entered into.

Q.14.3 Is any NAV assessment in investment of your subsidiaries made?

Only Bank of India has assessed the NAV of BoI Mutual Fund and reported the same to the Board.

Q.15. COMPUTER AUDIT

Q.15.1 Have you set up any specialised group to audit branches having ALPMS and fully computerised operations? If so, whether this specialised group functions under Inspection Department or under EDP Department.

13 banks, out of 18 selected banks have specialised group for auditing ALPM/fully computerised branches.

Q.15.2 Have you prepared any checklists/guidelines for such audit?

Almost all banks have prepared the checklist.

Q.15.3 Have you got adequate trained personnel to undertake computer audit?

12 banks, out of 18 have replied that they are equipped with trained personnel.

Q.15.4 Please list out constraints/suggestions in this regard.

- EDP auditors, not being specialised post are subject to transfer to other departments. It is, therefore, difficult to replace if trained person is transferred.
- Training is not commensurate with the pace of change in technology.
- Systems and procedures are also not being reviewed/changed to take care of growing needs of information technology, customer service and controls.
- As more and more vendor developed software packages are being used, auditors cannot associate at design stage to incorporate control and audit view points.

Q.16. Cost of Inspection

Q.16.1 What is the approximate cost of inspection in your bank?

a) Per branch Rs.
b) Per Inspector (internal) Rs.
c) Per inspection day Rs.

The approximate cost differs from bank to bank. However, cost structure of three banks is enumerated below:

Bank	Type	Cost
PNB	Per branch	30,000/-
	Per Inspector (Internal)	1,80,000/- pa
	Per Inspection (Day)	800/-

CBI	Per branch	19,600/-
	Per Inspector (Internal)	1,46,700/-
	Per Inspection (Day)	600/-
Dena Bank	Per branch	20,000/-
	Per Inspector (Internal)	1,00,000/-
	Per Inspection (Day)	800/-

Q.16.2 How is the cost of audit by external audit firms compared to cost of audit by internal team per branch?

	Internal Rs.	External Rs.
Small		
Medium		
Large		
VLB		
ELB		

There is no standardisation, however, indicative trends are as below.

Bank	Branch	cost per branch Internal	cost per branch External
Dena Bank	Small	7000/-	3500/-
	Medium	12000/-	5000/-
	Large	15000/-	7000/-
	VLB	25000/-	9000/-
	ELB	40000/-	9000/-
PNB	Small	15000/-	6000/-
	Medium	20000/-	9000/-
	Large	57000/-	12000/-
	VLB	115000/-	16000/-
	ELB	160000/-	20000/-
United Bank of India	Small	5000/-	2000/-
	Medium	10000/-	2800/-
	Large	18000/-	3700/-
	VLB	28700/-	7000/-
	ELB	136000/-	12000/-

Q.16.3 What is the cost of inspection function (including the cost of inspection division at HO, ZO levels) as percentage to the non-interest expenses of the bank?

Minimum is 1% of non-interest expenses and Maximum is 2.6%.

Q.17 Management Audit

Q.17.1 Whether there is a system of management audit in your bank? If not when you have plans to start?

Out of 18 banks, there is no system of management audit in 7 banks viz., Karur Vysya Bank, Catholic Syrian Bank, Bank of Maharashtra, Syndicate Bank, Oriental Bank of Commerce, Vijaya Bank, Indian Overseas Bank. These banks intend to introduce the system of management audit.

Q.17.2 If yes, what has been the coverage. Please also indicate number of such audits done during 1994-95?

Bank	No.of management audits during 1994-95
Bank of Maharashtra	3
Dena Bank	12
Canara Bank	6
United Bank of India	5
Union Bank of India	2
UCO Bank	3
Indian Overseas Bank	3 (RRB)
Central Bank of India	16 (all Zones)
Bank of Baroda	2
State Bank of India	10

Q.17.3 Is your Inspection Department also subject to management audit?

Only in CBI, IOB, SBI and Canara Bank, Inspection/Audit Department is subjected to management audit.

Q.17.4 Please offer suggestions, if any, to strengthen the management audit system in your bank.

Providing intensive training for audit staff in the area of management audit.
Complete involvement of management for this type of audit.
Speedier action taken on reports.

Q.17.5 What use is made of management audit report for the quality of management?

This being a very recent concept use of the management audit is yet to be felt.

Q.18. Inspection of foreign branches

Q.18.1 Please append a note on system of inspection and follow-up of foreign branches of your bank. Please also give suggestions for improvement in this area.

Q.18.2 Whether foreign branches are inspected/audited by India based staff or staff of unconnected foreign branch Indian staff or by foreign external agencies.

Out of 18 banks, following banks have foreign branches/offices.
UCO Bank, Syndicate Bank, Canara Bank, Indian Overseas Bank Bank of Baroda, State Bank of India,

Inspections are conducted once in 2 years. In SBI, officers who have worked previously in foreign offices will get preference. Support to the inspecting staff is given by associating selected officials having exposure in foreign exchange, credit, computer, dealing room operations. Officers on mobile duty are preferred. Selection of group leaders and support staff is done jointly by International Division at Central Office and Inspection and Audit Department with the approval of Chairman & Managing Director. Inspecting officers have been provided with Internal Control Questionnaire (ICQ) which gives a fair idea of branch prior to leaving the base office. It also enables inspectors to validate their various internal control procedures. ICQ covers General Banking credit, administration, correspondence, banking and representative functions.

Q.19. Surveillance over new deposit accounts

What are the guidelines/instructions issued in your bank for monitoring newly opened deposit accounts for prevention of frauds? If no specific guidelines have been issued, do you have any suggestions for monitoring operations in the newly opened deposit accounts for prevention of frauds?

All banks have issued the guidelines/instructions.

Q.20. Miscellaneous

A) Do you deploy award staff as inspection assistant? If not, reasons.

Except Bank of Maharashtra, IOB and SBI, no bank deploys award staff as inspection assistants, the reason being inadequate exposure, capacity and qualifications.

B) Do you think that mandays for inspection can be reduced by inducting award staff?

No

C) Among your department's duties, do they include
i) Conducting periodical customer service surveys,
ii) Handling and monitoring customer complaints,
iii) Preparing draft charge sheets for disciplinary action and cases
iv) Any other duties

No
No
No
No

D) Please offer other suggestions, if any, for strengthening the inspection function in your bank.

Strengthening the training machinery for supporting the audit.
Proper deployment of trained/qualified staff.
Officers with good track record and exposure in entire operational areas of banking only be considered for posting in Inspection Dept.
Computerisation of data collected and analysing the same for preventing recurrence of irregularities and improving the system from time to time.

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ANNEXURE V

Details of meetings held by the Working Group

Date	Place	Agenda
23-02-1995	Bombay	Inaugural meeting of the Working Group presided over by Deputy Governor Shri S.P. Talwar. Methodology to be adopted by the Working Group was also discussed
26-05-1995	Bombay	Responses received from selected public sector banks and private sector banks to the questionnaire fielded to them were examined by the Working Group. Members also discussed various issues relating to internal control and inspection/audit system in banks.
16-06-1995	Bombay	Some of the draft chapters of the report were discussed.
07-07-1995	Bombay	Remaining draft chapters of the report were discussed and suggestions and modifications were given by the Members.
24-07-1995	New Delhi	Final draft report with all suggestions/ modifications given by the Members was discussed.

Annexure VI
Precautions to be taken by banks in opening and operation of new accounts

Of late, many instances of fictitious accounts being opened and forged instruments collected through such accounts have been reported. In these cases, the account holders could not be traced when such frauds are unearthed by post facto inspection/scrutiny. This clearly indicates the need for greater vigilance on the part of the officers working in the branch about opening/operation of new accounts and monitoring of large credits to such accounts. Inspectors/auditors who conduct inspection/audit of branches should scrutinize all new accounts opened between the previous inspection till the date of current inspection and should satisfy themselves about the conduct of such new accounts. They should highlight in their report the irregularities noticed in conduct of such accounts and the lapse on the part of their officials which have resulted in conversions if any., during the inspection The Management should take stringent action against those officers/staff who have shown laxity/casualness in opening/ operating new accounts which has contributed to fraud so that it will act as a deterrent on other staff.

2. Exercise of control over new accounts is necessary from the view point of their being used as means for "money laundering". The expression "money laundering" covers every method used to cover the illegal origin of money gained from criminal activity so that it seems to have originated from legitimate source. Illegal frauds are derived from criminal activities such as drug

trafficking, organised and white collar crime, terrorism and tax evasion. Banks are typical targets for such "money laundering" practices.

3. The Group suggests that the following precautions should be taken by banks in opening/operating new deposit accounts to prevent frauds/malpractices:

i) The introducer should have/had dealings with the bank for at least six months and maintained sufficient balance in the account. Introducer should be required to call at the branch personally to furnish introduction, if the branch has no full information about the introducer or the introducer does not have dealings with the branch for sufficiently long period.

ii) Customers of the branch should be educated on the implication of introducing a new account without having sufficient knowledge of the parties involved.

iii) New accounts should be opened only with the photographs of the account holder/s. If the introduction is not proper, account should be opened only after thorough verification of antecedents of such parties.

iv) Staff members should be advised to introduce only those depositors whom they know personally for a long time.

v) New accounts should be opened by Branch Manager/Sub-Manager and not by other officials. Also, the parties should be present in the branch for opening new accounts.

vi) Documents connected with opening of all new accounts should be branded with a caution note/remark "Care-New Account" and such instruction should remain for at least six months. Cheque leaves of new accounts(at least 10 leaves in the cheque book) should be [illegible] the remark "New Account" for some time(at least six months). Loose cheque leaves should be issued to account holder only when he comes personally with requisition letter/pass book. Fresh cheque books should be issued only against production of duly signed requisition slip from previous cheque book. If the cheque book is to be issued against a requisition letter, the drawer should be asked to come personally to the branch or such cheque book may be sent by Registered Post to the account holder.

vii) Withdrawal in the new accounts against large amounts of credits should be scrutinised thoroughly. Utmost caution must be exercised whenever cheques/drafts of large amounts are deposited to new accounts and withdrawal is sought within a short time against these credits. While collecting DDs/cheques/warrants which are dated prior to the date of opening of account they may be sent for collection in order to ascertain the genuineness of ownership of such instruments. Whenever instruments of large value are received for collection through clearing, as for as possible they should be scrutinised through ultra violet lamp for chemical alterations if any,.As a matter of precaution, at least in the beginning, for making payment of instruments of Rs.1000 and above under new accounts, such instruments may be sent to Branch Manager/Sub-Manager for authentication.

viii) Cheques/DD's may not be sent for collection for direct credit of fixed deposit account. Instead, new SB/Current Account

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may be opened with proper introduction and proceeds of such instruments may be credited to such SB/Current account and thereafter, transfer to fixed deposit account may be effected

ix) While performing the duties of a paying bank, the branches should check with the collecting bank about the genuineness of high valued instruments.

x) Branch auditors should check the operations of new accounts and comment on the observance of rules by the branch in conduct of such accounts. Also, where a concurrent auditor is placed in a branch, he should monitor operations of such newly opened accounts.

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