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Role of Audit Committee of Banks

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The Board of Directors of a company has the ultimate responsibility for the efficient and smooth running of the organization. Since running an organization entails a huge number of responsibilities, specific powers are delegated to Committees formed for different purposes. One such Committee is the Audit Committee (AC). The role of the AC in an organization can basically be summarized as:

- Keeping an oversight on the financial reporting process
- Ensuring that internal control systems are adequate and effective
- Acting as a bridge between the external auditors and the management
- Monitoring the risk management process
- Ensuring that any loopholes in the system/frauds get corrected/caught by making the whistle-blowing process safe and foolproof.

While the role of an AC is extremely important in any organization, it assumes further significance in a bank in the light of the following:

- Banks deal with large volumes of cash and cash substitutes on a daily basis.
- Banks have humongous volume of transactions on any given day. Not only do all these transactions need to be captured in the books of account fairly, they also make ruling out of fraud that much more difficult.
- These transactions are spread across huge geographical areas, making internal control a much more difficult process.
- Banks have a large variety of exposures, that can escalate at an extremely fast pace.
- Banks deal with a number of complex financial products. The risk associated with these products is not only difficult to identify, but once identified, difficult to measure.
- Increasing use of technology in banking operations exposes banks not only to higher possibility of fraud, but also to model risk.
- Preparation of financial statements of banks involves a much higher degree of value judgements and management estimates than in the case of other organizations.
- An increasingly large number of processes related to banking operations are increasingly getting outsourced, reducing the effectiveness of the internal control system.

As a part of its responsibilities, the AC needs to interact with many other entities within the organization, e.g. the internal auditors, the external auditors, the Risk Management Committee and the management. In order that the AC can execute these responsibilities effectively, it is essential that its role vis-à-vis these entities is clearly laid out. It avoids conflicts between the various entities and increases the effectiveness of their operations.

AC's Role vis-à-vis Internal Auditors

While the actual audit process is carried out by the internal auditors, the AC's role is to focus on the internal audit processes and systems and the follow-up procedures, to ensure that they are effective, efficient and robust. Internal audits should be flexible in terms of coverage and timing. Focus areas where concurrent and thematic audit can be effective need to be identified. Implementation of CBS has made it possible to concentrate on these, by reducing the need for extensive audit of routine functions. Software- driven internal audit processes are a useful input in today's technology-rich operating environment.

While the internal audit team has a large role to play in ensuring fairness of financial reporting, its effectiveness is limited by its independence and competence. The role of the AC here is to examine the reporting arrangement and level of seniority of the head of the internal audit. Higher seniority and direct reporting either to the MD or the AC would increase the independence of the internal auditor.

The internal audit process should include a regular review of the internal and external environment through the year for timely recognition of emerging risks and the trend in the already identified ones. A regular flow of information between risk management and internal audit is essential for identification of key risk area and their regular monitoring. Since the AC oversees both the functions, it can play a major role in ensuring this flow.

The AC would need to monitor whether the issues being identified by the internal audit process are being reported to the management, and corrective actions are being taken in a timely manner. The AC can also see whether any other issues of concern can be identified that have been missed out by the internal audit team. The Annual Financial Inspection (AFI) report of the Reserve Bank can serve as an important input in this regard. The AC would need to concentrate of the areas of divergence, while differentiating between objective and subjective divergence.

Regular self-assessments and externally conducted quality assurance reviews of the audit process can serve to strengthen it. The AC can strengthen the internal audit process by ensuring that adequate resources are available to it at the right time. One way of attracting talent to the internal audit team is for the AC to insist that a stint in the internal audit team be made compulsory for promotions to senior management levels. Any specific skill set required for a particular job can also be made available, from within as well as outside the organisation. Regular interactions between the internal audit team and the AC would be essential for this purpose.

In case of banks having an international presence, the AC should oversee the functioning of the entire group including foreign branches and subsidiaries. In addition to the fact that multiple regulations need to be followed, consolidation of financial statements of such entities becomes additionally complicated. Geographical presence in other countries not only increases the types and quantum of risks faced by the bank, it also increases the risk of fraud and mistakes.

AC's Role vis-à-vis External Auditors

The AC acts essentially as a bridge between the external auditors on one hand, and the management and the full Board on the other. Its role is to ensure that the concerns raised by external auditors (whether a part of the formal report or not) are addressed by the management, and any unaddressed concerns are brought to the notice of the management. The AC also needs to ensure that the external auditors are able to fulfill their responsibilities without any interference from the management. For this, the AC should first evaluate the scope of external audit, and find out the limitations, if any, placed on them by the management. Ideally, the scope should be all inclusive and there should not be any limitations. The extent of the external auditor's interaction with branch auditors and the reactions to their findings should also be assessed. Discussing and studying the points raised by the external auditors in their reports is a major focus area for an AC. Any major points (in terms of amounts or areas) arising repeatedly should raise flags about the accounting process itself. The integrity of any estimates made by the management would need to be examined.

Pre-audit discussions between the AC and the external auditor can serve as a tool of effective audit process. The AC can also use the external auditor's expertise to do its own analysis of restructured assets to see if there has been a diminution in fair value or an improvement.

With increasing use of technology, tying up of stand-alone sub-systems with CBS is becoming an area of increasing concern. The role of the Information Systems audit (conducted by the external auditors) and the effectiveness of more frequent interaction between the AC, the external auditors and the Technology Committee become important in this context.

AC's Role vis-à-vis Risk Management Committee

An increasing number of companies these days establish Risk Management Committees (RMC). While overlap between the AC and RMC in terms of common members and regular interactions should be encouraged, overlap in terms of roles of the two committees should be avoided. The role of a RMC is to lay down risk management policies, procedures and limits; while the role of an AC is to review their implementation and effectiveness, and to bring any divergences and loopholes to the Board's notice. In this context, it is important to note that the AC should remain a *staff function*, and not act like a line function. Its responsibility is to identify weak areas and follow it up with the line functions like RMC and the Board, rather than to identify and implement solutions.

An AC, in order to fulfill this responsibility, needs to understand the concept of risk, its measurement and management. It would need to identify the risks that exist across the various components of the balance sheet, and multiple risks associated with the same product. Two focus areas here can be business-model specific risks (e.g. those arising from niche-banking) and model risks. Emergence of new concepts like Value-at-Risk and Economic Capital is leading to new models being developed for their valuation. A variety of models are also available for valuing exotic products. These models have their own limitations and hence need to be continuously reviewed and redefined to ensure that they reflect the risks and product values realistically. Random certification of such models by external auditors and their regular back-testing would ensure the integrity of data output. Any abnormal trends can sensitize the Committee to possible weaknesses, and further explanations can be called for.

Risk-based supervision is a forward looking process that lets an AC identify emerging risks early in the day, so that they can be monitored and provided for in a timely manner. An assessment of Pillar II risks using the ICAAP model is important for going beyond the perception of risk based on the current performance of advances, and in sensitizing the board to the *potentia*l risks that could be faced by the bank. Various inspection and audit reports like Long Form Report, Annual Financial Inspection report and concurrent audit report are available to the AC to help it fulfill its responsibility. This information can be further built upon by using specific documents and processes. The risk template is one such important document that lists out the level and trends in the various components of risk being faced by a bank. The AC should analyse it to see if there are any apparent inconsistencies that can be further questioned, and check that risk limits are being adhered to.

Another instrument for identifying risky areas is stress test report. Also, a comparison of current financial results with the previous quarter's and previous year's results, as also with other banks' results could be made. Any major variances could point to areas of concern.

Adequate systems to monitor and control frauds are essential for any bank. The AC's role is to differentiate between 'system failure' and 'failure to adhere to the system', and take follow-up measures accordingly.

The AC also needs to find out if the company properly documents identified risks and the related policies. Proper documentation enables awareness of risks and consistent policies. The risk culture of the company should be studied to see whether awareness and identification of various risks are percolating to all levels, and whether systems are in place to ensure compliance of all regulations. The Committee should confirm that an effective whistle-blower policy is in place. The policy should enable and protect a complainant, and also create widespread knowledge of the process within the organization. It should also include penalties for misuse.

AC's Role vis-à-vis Management

The AC is the link between the Management and others, i.e. the full Board, the external auditors, the internal auditors and the RMC when it comes to financial and risk management matters. It not only smoothens out the differences between these entities, but also ensures that the concerns raised by one are looked into and addressed by the other. The AC also has the power to question the decisions taken by the management in these two areas and to convey its concerns to the full Board.

The AC can play a crucial role in ensuring the financial stability of a bank by focusing on certain operational aspects. It needs to ensure that the limits on exposure to group companies are followed. Cash Flows and group Balance Sheets of borrowers should be perused carefully. Timely analysis of information exchanged between banks should be stressed upon. Quick mortality accounts could be investigated to see if an unusually large percentage were takeover accounts. On the other hand, the percentage of takeover accounts featuring in the quick mortality list should also be looked into. The AC needs to ensure that the limits on sanctioning powers are being observed.

The AC's monitoring of the CDR process would ensure that the facility is not exploited either by banks or the borrowers. Monitoring of the ageing process of advances can serve as an important tool here. The AC needs to analyze if any major findings of the internal, external or

RBI audit reflect upon the quality of the accounting process, and review the corrective action taken. CAMELS can serve as an effective tool for the AC.

The efficacy of any subjective judgements, estimates and assumptions made by the management as a part of the accounting process can be measured by back testing. The management can be asked to provide a statement of identified deviations from laid-down policies and such deviations can be segregated into financial and procedural variations. An abnormally high number of financial variations can point to either disregard of policies, or of a genuine need for a change in the policies.

The AC often gets very less time to review the information placed in front of it before it goes to the Board. The AC needs to differentiate between deficiencies in processes and systems on one hand, and key issues like sensitive loans and advances on the other. The former affects the integrity of the data more strongly than the latter and hence need to be focussed upon throughout the year. Frequent meetings of the AC and regular interaction with RMC, Internal Auditor and External Auditor could help in this regard. The latter can be focused upon at the time of finalization of accounts. Also, the AC meeting could start at the closure of the markets at the beginning of a weekend, thus giving it enough time for discussion.

The role of the ACB is going to become even more crucial in the coming days as risk-based supervision takes prominence and the risk management processes and practices of banks come under increased focus. Some new practices are emerging that can make the AC more effective. AC meetings without any pre-determined agenda enabling discussion of specific risks, and Chairmen of various ACs meeting each other to discuss emerging concerns are a couple of them.

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