



**Welcome**  
**To**  
**Heads / Members of Audit**  
**Committee of Boards of**  
**Banks**

# “Best Accounting Practices for Better Risk Management”

BY

**M G Sanghvi**

Chairman & Managing Director  
SyndicateBank

# Powers of Audit Committee:

The following are the powers of the audit committee .

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary

# Importance of Audit Committee:

- Audit Committee has thus become one of the main pillars of the corporate governance system in Indian Banking system.
- In steering companies through today's complex business environment, Boards need strong leadership from their Audit Committees.
- Expanding the field of vision, clearly defining who's tracking the Bank's risk radar, and taking a step back to re-evaluate its own performance are some of the important steps every Audit Committee need to consider.
- The audit committee is established with the aim of enhancing confidence in the integrity of an organisation's processes and procedures relating to internal control and corporate reporting including financial reporting.

# Importance of Audit Committee Contd..

- Audit Committee provides an 'independent' reassurance to the board through its oversight and monitoring role.
- Among many responsibilities the Boards entrust the Audit Committee with are the transparency and accuracy of financial reporting and disclosures, effectiveness of external and internal audit functions, robustness of the systems of internal audit and internal controls, effectiveness of anti-fraud, ethics and compliance systems, review of the functioning of the whistleblower mechanism.
- Audit Committee may also play a significant role in the oversight of the company's risk management policies and programs.

# Role of Audit Committee

The role of the audit committee shall include the following: Clause 49 gives specific powers to the audit committee to investigate any activity within its terms of reference, seeking information from any employee, and obtain outside legal or professional advice.

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and Credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
  - a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956

# Role of Audit Committee. Contd..

- b. Changes, if any, in accounting policies and practices and reasons for the same
  - c. Major accounting entries involving estimates based on the exercise of judgment by management
  - d. Significant adjustments made in the financial statements arising out of audit findings
  - e. Compliance with listing and other legal requirements relating to financial statements
  - f. Disclosure of any related party transactions
  - g. Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval
- 5A. Reviewing, with the management, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and the report submitted by the monitoring agency monitoring the utilization of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter.

# Role of Audit Committee. Contd

6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
8. Discussion with internal auditors any significant findings and follow up there on.

# Role of Audit Committee. Contd..

9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.
13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

# Review of information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory Auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

# The need for Independent Directors on the Board:

- Independent Directors in the Board can:
- Counter balance management weakness in a company.
- Ensure legal and ethical behavior at the company, while strengthening accounting controls.
- Extend the “reach” of a company through contacts, expertise, and access to debt and equity capital.
- Be a source of well-conceived, binding, long term decision for a company.
- Help a company survive, grow and prosper over time through improved succession planning through membership in the nomination committee etc.

# Responsibilities of Independent Directors:

- Prepare themselves thoroughly for the meeting.
- Be objective in forming sound decisions relating to the company and its business.
- Be open minded, free and frank in expressing their opinions and at the same time will be willing to engage in meaningful debates.
- Be committed to decisions made as a Board.
- Continuously seek information both from the within and if required outside professional knowledge to keep abreast with the latest developments in the areas of the Company's operations.
- Be informed on laws and regulations influencing their functioning as directors.
- Utilize the expertise they possess to the good advantage of the company.

# Listing Agreement & Companies Act

- Clause 49 of Listing Agreement elaborates about the scope, role, responsibilities, composition of Audit Committee.
- Section 292A of Companies Act, 1956 specifies the constitution, composition and scope of the Audit Committee.
- New Companies Bill (2011 / 2012) seeks to harmonize the provisions on Audit Committee due to existing disparity, particularly with regard to definition of “independent” director.
- The new Bill specifies that every listed and specified companies shall establish a vigil mechanism for directors and employees – similar to whistle blowing mechanism.

# Accounting Standards

- Major applicable Accounting Standards for banks in India – AS 1, 3, 5, 6, 9, 10, 11, 13, 15, 17, 18, 20, 21, 22, 25, 26, 27, 28, 29 etc.
- Adequate provisions for complying with AS 6, 13, 15, 22, and 29.
- Liability on account of staff expenditure to be properly disclosed - amount is very sensitive and predominant over other expenditures.
- Vigilant attitude on adequate provisioning on account of ensuing wage revision.
- Provisions made as per AS 15 towards terminal benefit to be provided as per actuarial valuation and to be disclosed appropriately in the Notes on Accounts.

# .....Accounting Standards

- All frauds to be reviewed at frequent intervals and adequate provisions to be made in books.
- Adequate tax provisioning - an important area - proper control and monitoring required at all times.
- Decisions of Supreme Court & High Courts on tax issues will have a bearing.
- Provisioning requirements - Standard Assets, NPAs, CDR Accounts & Restructured Accounts as per RBI Guidelines to be complied with.

# ICAAP Policy

- Banks must ensure they identify and assess all risks may or may not be exposed to (i.e., not only Pillar I risks) but maintain sufficient capital to face emerging risks and to develop better use of risk management techniques in monitoring and managing risks.
- Points to ponder over:
  1. Capital to Risk Weighted Assets Ratio (CRAR)
  2. Quality of Capital:  
Ratio of Tier I to Tier II and Ratio of Debt to Equity.
  3. Growth in capital funds vis a vis growth in risk weighted assets.
  4. Capital Cost

# Asset Quality

- **Areas of observance**

Percentage of net NPA to net Advances, gross NPA, recovery / upgradation of NPAs, aggregate amount of restructured standard assets, % of sub standard assets to NPAs, Advances Portfolio – which includes quality of pre sanction appraisal of credit and efficiency of post sanction supervision, rating and pricing of loans, adherence to prudential norms on exposure limits, credit risk management system, system of stress testing / identification of potential NPAs, Divergence in asset classification and provisioning, off balance sheet exposure.

- **Exposure Norms**

- plays important role in mitigating credit risk.

- **Credit concentration** to be assessed to ensure that bands prescribed by regulators are not exceeded.

# Types of Risk

- Risk is faced by a Bank both from the investment and advances portfolio.
- Usually in banking parlance, risk is categorized into three:
  - ❖ Credit Risk – possibility of losses being incurred on account of deterioration in quality of borrowers in a portfolio.
  - ❖ Market Risk -
  - ❖ Operation Risk
- Management of risk encompasses the following:
  - ✓ Identification of Risk
  - ✓ Assessment of Risk
  - ✓ Monitoring of Risk
  - ✓ Control and Mitigation of Risk

# Sophistication of Risks: Basel I to Basel II & III

- Rule Based Approach to Model Based Approach
- Models to be validated by Internal Auditors and External Auditors
- Understanding of Risks & Assumptions of Models: models output depends upon proper & adequate identification and measurement of risks and assumptions used
- Use Test of Models for internal decisions: ensuring that models are properly understood by all in the organization and model output is used for internal decisions including pricing
- Disclosures under Pillar III of Basel II w.r.t scope of application, capital, risk exposures, risk assessment processes and capital adequacy are duly verified and does not conflict with requirement of accounting standards
- Management to decide which disclosures are relevant based on the materiality
- Pillar III disclosures are not required to be audited unless otherwise required by AS

# Sophistication of Risks

- **Credit Risk: Two Methods**
  - Standardized Approach- Rule Based (Risk Weight as per External Rating)
  - Advanced Approach: Internal Model Based
    - FIRB (Estimate PD internally, LGD & EAD provided by regulator)
    - AIRB (Estimate PD, LGD, EAD & Maturity internally)
- **Market Risk: Two Methods**
  - The Standardized Approach – Specific Risk (as per external rating) & General Risk (as per defined movement of yield and duration)
  - Internal Measurement Approach – VaR Models

## ... Sophistication of Risks

- Operational Risk: Three Methods
  - Basic indicator Approach: fixed %age of three years average of positive annual gross income.
  - The Standardised Approach: fixed %age of average three years gross income for each business line (8 Business Lines).
  - Advanced Measurement Approach: Estimate unexpected losses based on internal & relevant external data, scenario analysis and internal control factors.

# Risk and its Accounting & Management

- Risk remains intangible and invisible until it materialize into losses.
- In financial business, money is a predominant factor - risk is inevitable.
- Risk and Returns go hand in hand.
- No risk – No Return on money pumped in.
- Risk - uncertainty resulting in adverse variations of profitability or losses.
- Risk - better controlled if properly understood and properly accounted for.
- Entity to analyse and evaluate risks on a continuing basis.

## .....Risk and its Accounting & Management

- Risk Appetite & Tolerance
  - Depends on capacity & willingness to take risk.
  - To decide about risk appetite, bank needs systems & estimations of risk inputs, to estimate Probability of Default (PD), Loss Given Default (LGD) and Exposure At Default (EAD).
- Risk appetite can be decided by the level of capital maintained over and above the regulatory capital prescribed by RBI.

# .....Risk and its Accounting & Management

- Accounting – a continuous process.
- Accounting often plays varying roles in success or failure of all businesses.
- Key objects of finance (stocks, bonds, deposits, derivatives) entirely defined by accounting, and do not exist independent of their accounting.
- Accountants understand risk. They embrace norms of risk management & show overwhelming support for several effective risk management tools.
- Accountants value support they provide to decision - makers as a means to help them manage risk.

## .....Risk and its Accounting & Management

- Essence of risk management - accountants understand that it is better to explain a range of possible outcomes from certain course of action than to detail the most likely outcome.
- Organisations to identify potential risks so that they can avoid them or limit their impact when they materialise.
- Excellent opportunity for accountants here - to exert a much greater positive influence; i.e. it is simply a question of how they use it.
- Accountants are already risk people - they understand risk & risk management.
- They value support they can provide to decision-makers by presenting risk management as part of everyday business decision-making.

# .....Risk and its Accounting & Management

- A study was conducted on over 2,000 ACCA members from 109 countries, wherein respondents included CFOs, finance directors, financial controllers and financial accountants from all types and sizes of organisation.
- One of the study's key findings was that, while a lot was being done already, accountants felt they can do a lot more
  - to improve ethical behavior
  - to identify or drive a superior decision-making culture
  - to instill a more integrated approach to risk management within the organisations they work
  - to control and minimise dysfunctional behaviour among key decision-makers.
- Results revealed overwhelming support for a series of six decision-making practices and behaviours which should form the basis for achieving best practice in risk management; these are:
  - Questioning proposals regardless of the seniority of those that originated them
  - Recognising uncertainties, and measuring and managing them
  - Making unbiased decisions irrespective of personal interests
  - Acting ethically and encouraging an ethical culture
  - Acting legally and challenging a failure to do so
  - Thinking carefully while using applicable quantitative techniques.

# Factoring Risk

- One of the simplest way of calculating risk is by extrapolating likelihood with the consequence.

$$\text{Risk} = \text{Likelihood} \times \text{Consequence.}$$

- Level of risk may be categorised into extreme, high, moderate or low - Risks to be ranked to establish management priorities.
- For developing a risk accounting system – organization to deploy its risk management team in each operating department to interact with operating personnel.
- Together, they can develop risk scores that represent the department's exposure to risk & the risk mitigation effectiveness of each of the business processes that comprise their operating environment.
- Risk scores and / or risk weightings are determined for each business process based on three sets of standardized tables & templates that relate to risk drivers present in all business processes; viz. exposure, value and risk mitigation.

## ... Factoring Risk

- Resulting risk scores and weightings are applied in a scorecard where operational metrics are computed, consolidated and aggregated.
- Financial institutions have to find a way of accounting and reporting consolidated and aggregated cross-enterprise risk exposures as they accumulate.
- The challenge they face is analogous to the one they faced a generation or more ago as businesses evolved from legal entity-based profit centers within sovereign states into globalized lines of business.
- Earlier, financial controllers had to learn how to tag transactions with business unit, unit cost, market segment, product and customer codes to drive cross-enterprise management performance analysis and reporting.

## ... Factoring Risk

- The new challenge is to learn how to tag those same transactions with risk-weighted exposure measures and risk-weighted financial values to produce a risk exposure metric that is additive and to do it within a framework that can actually track the value of risk mitigation efforts and drive cross-enterprise risk analysis and reporting.
- Recognizing that risk exposures are first triggered upon transactions entering the operating environment, it follows that risk exposure measurement for risk accounting and reporting purposes must be transaction based and occur at a financial institution's transaction gateway at precisely the same points that financial (general ledger) and management accounting interfaces are positioned.

## ... Factoring Risk

- Risk accounting represents an extension of financial reporting to embrace a new risk metric, exposure to risk.
- It links changes in reporting of traditional Value at Risk (VaR) measures to changes in business activity and the reporting of operational and performance metrics in order to make them more effective, timely and more meaningful to stakeholders as in this formulation of the enterprise's overall risk where the sum of the diversified effects of operational, market, credit and liquidity risk capital.

## ... Factoring Risk

- The risks inherent in financial operating environments can be represented by three standardized, interrelated and additive risk metrics:
  - **Inherent risk**, which is a representation of the risk-weighted size of a financial operating environment expressed in Risk Units (RUs).
  - **Risk Mitigation Index (RMI)**, which is a dynamic measure on a scale of 1 to 100 of the effectiveness of the risk management systems and controls that mitigate risk where 100 represents best practice.
  - **Residual risk**, which is expressed in Risk Units (RUs) and it is the inherent risk minus the risk mitigation effects of risk management systems and controls as represented by the RMI.
- The RMI can be immediately adjusted when changes in the underlying causal factors occur, thereby causing residual risk to be a dynamic measure of a financial enterprise's exposure to risk.

## ... Factoring Risk

- In this way, potential for statistical correlation of measurements of exposure to risk and loss history is created, which, over time, will cause the risk metrics generated through the method to become inherently predictive.
- The application of the method in financial institutions to date has been focused primarily on transaction processing, which financial firms typically refer to as operations.
- Its primary aim has been to provide operations managers and their stakeholders with quantitative risk-based management information to complement the qualitative management information relating to the status of risks and controls that exists in the form of Audit Reports, Key Risk Indicators (KRIs) and Risk and Control Self Assessment (RCSAs).

# Value at Risk (VaR)

- VaR - a statistical technique used to measure & quantify the level of financial risk within a firm or investment portfolio over a specific time frame.
- It is used by risk managers in order to measure & control the level of risk which the firm undertakes. Risk manager's job - ensure that risks are not taken beyond the level at which the firm can absorb the losses of a probable worst outcome.
- Value-at-risk (VaR) is a category of risk metrics that describe probabilistically the market risk of a trading portfolio.
- Value-at-risk - widely used by banks, securities firms, commodity merchants, energy merchants, & other trading organizations. Such firms track their portfolios' market risk by using historical volatility as a risk metric.
- There are two broad types of VaR. One which is primarily used in risk management and the other for risk measurement.

## ... Value at Risk (VaR)

- A VaR measure is the procedure by which we arrive at a VaR measurement. It is a computational algorithm.
- A VaR metric is our interpretation of the VaR measurement.
- VaR is built around statistical ideas and probability theories.
- VaR can measure both individual risks —amount of risk contained in a single trader's portfolio, and firm wide risk, which it does by combining the VaRs of a given firm's trading desks and coming up with a net number.
- Top executives usually know their firm's daily VaR within minutes of the market's close.
- Commonly used parameters for VaR : 1% and 5% probabilities and one day and two week horizons – other combinations also used.
- Alternative metrics to a VaR risk metric - standard deviation, mean absolute deviation, expected shortfall and downside risk.

## ... Value at Risk (VaR)

- Banks use VaR model for managing market risk exposure in investments.
  - VaR limits can be fixed for HFT / AFS portfolios.
- Stress testing of VaR to be done. Bank to have a model for stress testing.
- Stress Testing to be validated by another dept.
  - Inspection Dept.
- Capability of stress testing may vary from bank to bank.

# The Think Tank

- Performing Variance Analysis of the current financials and analysis of significant ratios with corresponding figures for revealing financial strength & weakness.
- Impact of the Interest Income & Interest Expenditure on financials of a Bank being significant - to be analysed in detail.
- Other Income and Operating Expenditures also to be analysed for any undue variations over the period.
- Net Interest Margin (NIM) - an important parameter to assess Bank's profitability. Any wide fluctuations to be analysed in detail to ascertain reasons for the variation in NIM.
- Its all about an interplay of how best you present a fact and how best you are able to hide any deficiencies / inefficiencies. Even a worst case scenario can be presented in a better manner by applying prudent judgement.

## ... The Think Tank

- RBI guidelines in respect of disclosures on various items of financial statements in Notes on Accounts - to be fully complied with.
- More disclosures may also be made for sake of stakeholders in addition to mandatory disclosures.
- Transparency in management & disclosure of policies – hallmark of any management so as to present a healthy financial position of the entity & state of affairs.

## ... The Think Tank

- LFAR of the Bank - another area where comments on internal control & asset quality - analysed & reported in detail. Proper compliance will solve many future problems in respect of frauds, NPAs etc.
- Tax Audit Report reveals all irregularities in compliance of statutory requirements. Adequate steps to be taken to avoid all such irregularities in future in addition to rectification of present irregularities.
- AFI Report of RBI should be discussed in detail for any system deviations, policy deviations, lapse in internal control so that any possible future losses can be avoided.
- Any serious irregularities reported by bank's internal audit system / Concurrent Audit / IS Audit in various branches, specialized branches, treasury, international division etc. to be looked into.
- Any serious irregularities reported upon by RBI inspectors upon Branch inspection to be looked into.

## ... The Think Tank

- A regular review of the internal audit / internal review report of overseas branches required.
- IS Audit of data centre & information systems / software to be reviewed regularly.
- Review of offsite monitoring report for every quarter will enable the Bank to plug the holes in internal control system.
- Analysis of quick mortality accounts for every quarter enables management to take cautious outlook on the state of the account.
- Capital market exposure - to be reviewed every quarter to avoid exceedings and comply with RBI guidelines.
- Implementation of AML measures & adoption of KYC norms to be reviewed for compliance with RBI guidelines.
- Violation of discretionary powers at various managerial levels to be monitored at periodical intervals.

**THANK YOU ...**



**M. G. SANGHVI**