# NPA, Accounting, Auditing and Internal Control & ERM of Urban Co-operative Banks


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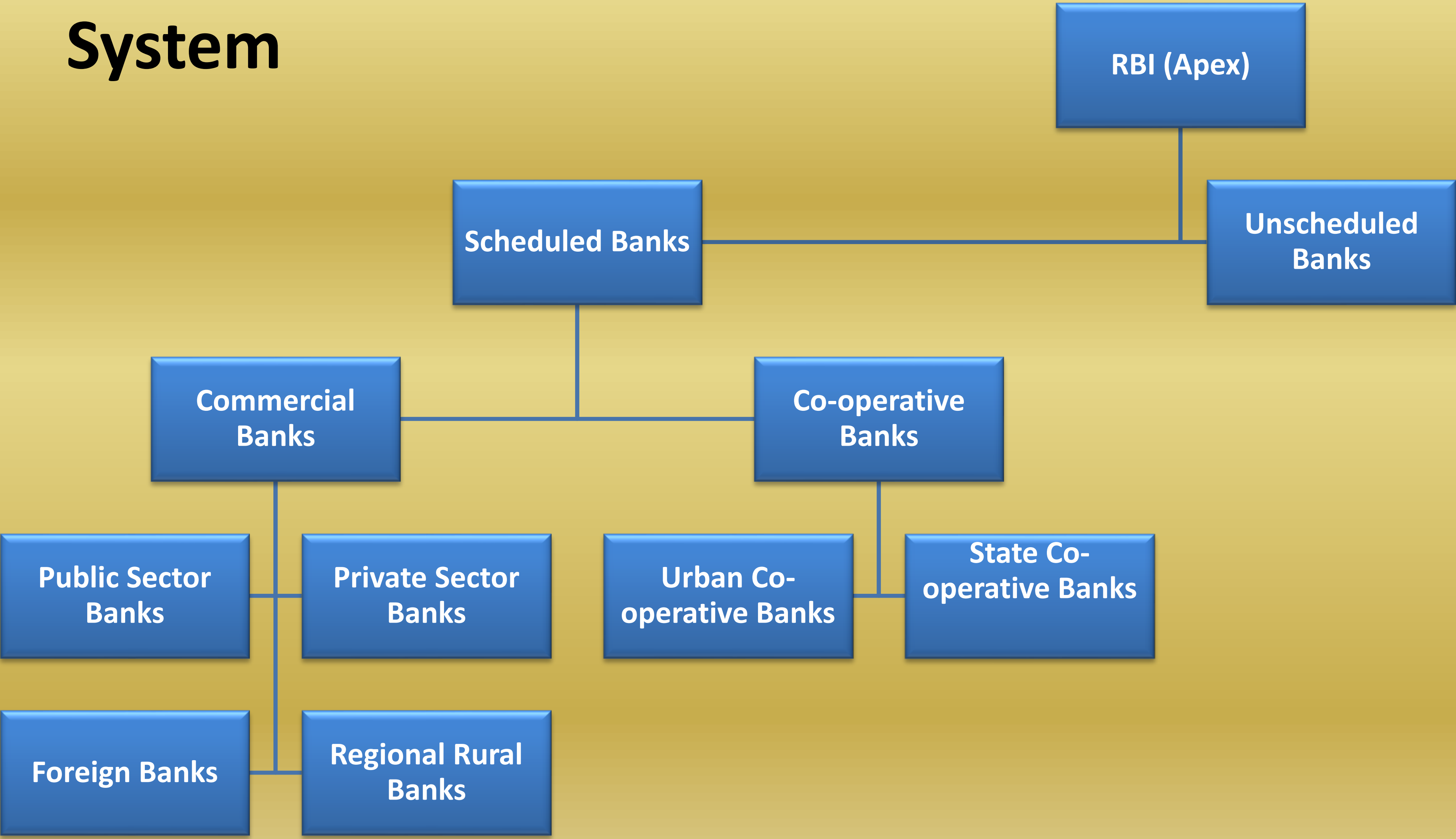
# Urban Co-operative Banks (UCBs)

- Urban Co-operative Banks (UCBs) refers to primary cooperative banks located in
- **Urban** and
- **Semi-urban areas**.

- Now, let us see the **Structure of Indian Banking Industry…………**

# Structure of Indian Banking System



# UCBs in India

1645 UCBs in India

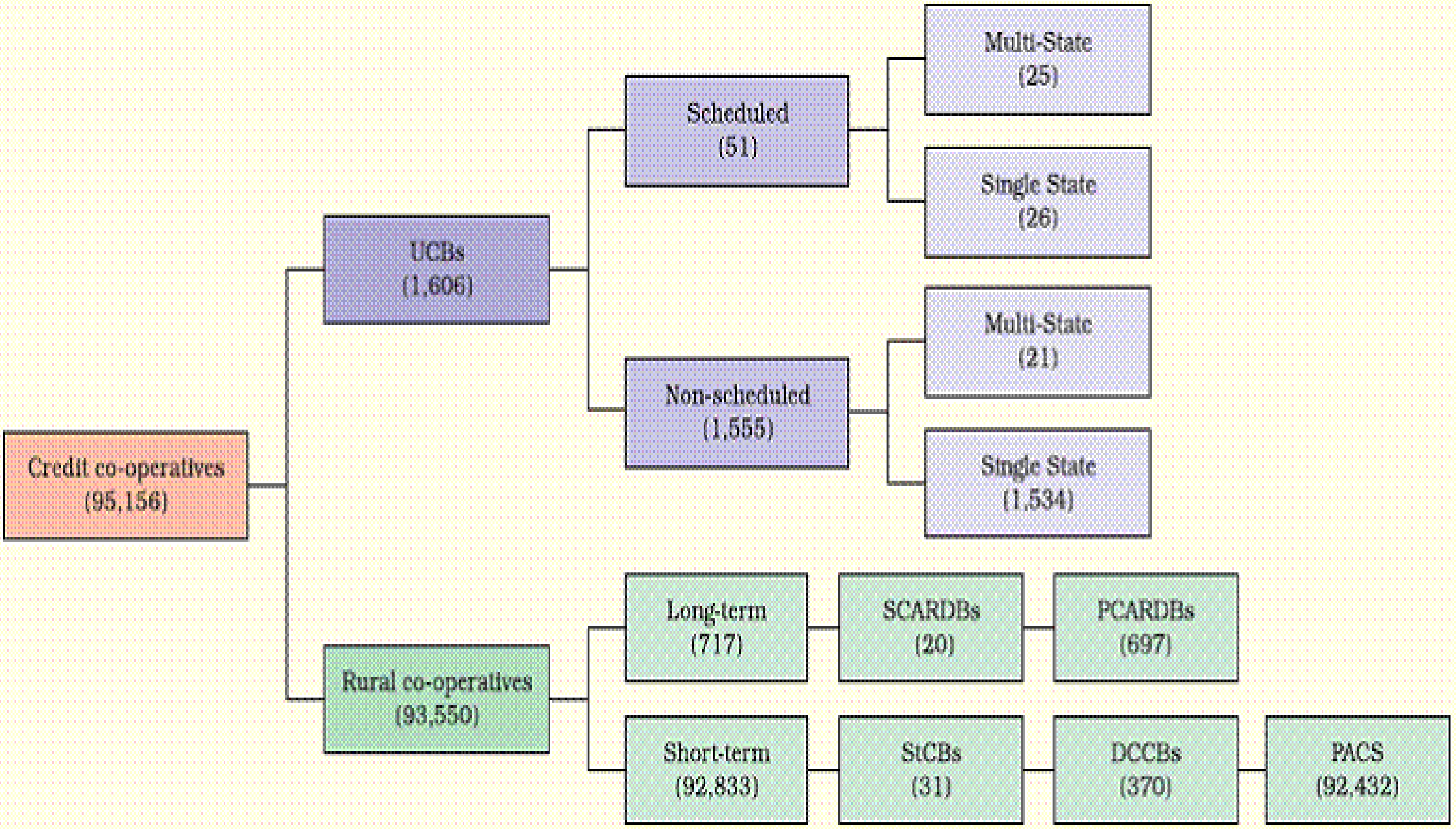
Spread Across with 8150 branches

Aggregate Deposits exceed Rs.

2 Lakh Crores

**Chart V.1: Structure of Co-operative Credit Institutions in India**

(As at end-March 2013)




StCBs: State Co-operative Banks; DCCBs: District Central Co-operative Banks; PACS: Primary Agricultural Credit Societies; SCARDBs: State Co-operative Agriculture and Rural Development Banks; PCARDBs: Primary Co-operative Agriculture and Rural Development Banks.

**Notes:** 1. Figures in parentheses indicate the number of institutions at end-March 2013 for UCBs and at end-March 2012 for rural co-operatives.

2. For rural co-operatives, the number of co-operatives refers to reporting co-operatives.

# Distribution of UCBs (as per RBI)

**Table V.1: Tier-wise Distribution of Urban Co-operative Banks**

(As at end-March 2013)

(Amount in ` billion)

| | **No. of banks** | | **Deposits** | | **Advances** | | **Assets** | |
|---|---|---|---|---|---|---|---|---|
| | **Number** | **% to Total** | **Amount** | **% to Total** | **Amount** | **% to Total** | **Amount** | **% to Total** |
| **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** |
| Tier I UCBs | 1,194 | 74.3 | 434 | 15.7 | 272 | 15.0 | 545 | 16.2 |
| Tier II UCBs | 412 | 25.7 | 2,335 | 84.3 | 1,538 | 85.0 | 2,827 | 83.8 |
| **All UCBs** | **1,606** | **100.0** | **2,769** | **100.0** | **1,810** | **100.0** | **3,372** | **100.0** |

**Note:** Data are provisional.

# Non Performing Assets (NPA)

- **An Asset that ceases to generate Income** (includes Leased Asset)
- **NPA is a Loan or an Advance that falls under certain category**
- **Classification of an asset as NPA should be based on the record of recovery**

# A non performing asset (NPA) is a loan or an advance where….

i. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii. the account remains ‘out of order’ in respect of an Overdraft/Cash Credit (OD/CC),

iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,

vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

vii. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

# Reasons behind NPA

1

- Lack of proper pre-enquiry by the bank for sanctioning a loan to a customer.

2

- Non performance of the business or the purpose for which the customer has taken the loan.

3

- Willful defaulter.

4

- Loans sanctioned for agriculture purposes.

5

- Change in govt. policies leads to NPA

# The NPA and Economy

- The Indian Economy has been much affected due to lack of infrastructure facilities, sticky legal system, cutting of exposures to emerging markets by FII's,etc.
- Under such a situation it goes without saying that banks are no exception and are bound to face the heat of a global downturn.
- Accumulation of Non-Performing Assets (NPA) to the tune of Rs 2 lakh crore.
- Rs 50,000 crore NPA is related to big borrowers who have borrowed over Rs 10 crore and above.

# Global Developments and NPA’s

- The core banking business is of mobilizing the deposits and utilizing it for lending to industry.
- Lending business is encouraged which helps in productive purposes which results in economic growth.
- However lending also carries credit risk, which arises from the borrower’s inability to repay it.

# The NPA issue with Banks

- **The NPA Management Issue** - Quality of managing credit risk by the banks concerned.
- **The Need** - Adequate preventive measures in place namely, fixing pre-sanctioned appraisal responsibility & having an effective post-disbursement supervision.
- **Identifying the Potential** - Banks concerned should continuously monitor loans to identify accounts that have potential to become non-performing.

# Effects of NPA on Banks

- Restriction on cash flow by bank due to provisions of fund made against NPA.
- Drain of profit.
- Bad effect on goodwill.
- Bad effect on equity value.

# Factors affecting NPA

**External**

- Ineffective legal framework & weak recovery tribunals
- Lack of demand / economic recession or slowdown
- Change in Govt. policies
- Wilful defaults by customers
- Alleged political interferences

# Factors affecting NPA

**Internal**

- Defective Lending process
- Inappropriate / non –use of technology like MIS , Computerization
- Improper SWOT analysis
- Inadequate credit appraisal system
- Managerial deficiencies
- Absence of regular industrial visits & monitoring
- Deficiencies in re-loaning process
- Alleged corruption
- Inadequate networking & linkages b/w banks

# Reasons - Becoming NPA Account

| BORROWER-SIDE | BANKER – SIDE |
|---|---|
| Lack of Planning | Defective Sanction |
| Diversion of Funds | No post-sanction supervision |
| No own contribution | Delay in releases |
| No modernization | Directed lending |
| Improper monitoring | Slow decision making process |
| Lack of Industrial Relations | |
| Natural Calamities | |

(Per cent of gross advances)

| Year (end-March) | Urban Co-operative Banks (UCBs) | Rural Co-operative Banks | | | | |
|---|---|---|---|---|---|---|
| | | Short-Term Structure | | | Long-Term Structure | |
| | | StCBs | DCCBs | PACS | SCARDBs | PCARDBs |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| 1994-95 | 13.9 | - | - | 33.9 | - | - |
| 1995-96 | 13.0 | - | - | 34.7 | - | - |
| 1996-97 | 13.2 | - | - | 34.9 | - | - |
| 1997-98 | 11.7 | 12.5 | 17.8 | 35.3 | 18.6 | 16.5 |
| 1998-99 | 11.7 | 12.6 | 17.8 | 35.0 | 19.2 | 16.1 |
| 1999-00 | 12.2 | 10.7 | 17.2 | 35.4 | 18.7 | 20.0 |
| 2000-01 | 16.1 | 13.0 | 17.9 | 34.9 | 20.5 | 24.3 |
| 2001-02 | 21.9 | 13.4 | 19.9 | 32.4 | 18.5 | 30.2 |
| 2002-03 | 19.0 | 18.2 | 21.2 | 38.2 | 20.9 | 33.8 |
| 2003-04 | 22.7 | 18.7 | 24.0 | 36.8 | 26.7 | 35.8 |
| 2004-05 | 23.2 | 16.3 | 19.9 | 33.6 | 31.3 | 31.9 |
| 2005-06 | 18.9 | 16.8 | 19.7 | 30.4 | 32.7 | 35.6 |
| 2006-07 | 18.3 | 14.2 | 18.5 | 29.1 | 30.3 | 35.4 |
| 2007-08 | 15.5 | 12.8 | 20.5 | 35.7 | 34.5 | 53.7 |
| 2008-09 | 13.0 | 12.0 | 18.0 | 44.8 | 30.1 | 39.0 |
| 2009-10 | 10.1 | 8.8 | 13.0 | 41.4 | 45.1 | 51.9 |
| 2010-11 | 8.4 | 8.5 | 11.2 | 25.2 | 32.3 | 40.6 |
| 2011-12 | 7.0 | | | | | |

# NPAs with Co-operative Banks

- Non-Performing Assets of Co-operative Banks is 7% of Gross Advances (Year End 2011-12 / RBI, Sep 2013)

# Master Circular on Income Recognition, Asset Classification, Provisioning and Other Related Matters – UCBs Notification no. RBI/2014-15/25 dated July 1, 2014

**Tier I Banks** were permitted to classify loan accounts including gold loans and small loan upto `1 lakh as NPAs based on 180 days delinquency norm instead of the extant 90 days norm upto 31$^{st}$ March 2009.

- All UCBs shall classify their loan accounts as NPA as per 90-day norm with effect from 1 April 2009.
- Banks having deposits below `100 crore, operating in a single district.
- Banks with deposits below `100 crore operating in more than one district, provided the branches are in contiguous districts and deposits and advances of branches in one district separately constitute at least 95% of the total deposits and advances respectively of the bank.
- Banks with deposits below `100 crore, whose branches were originally in a single district but subsequently, became multi-district due to reorganization of the district.
- The deposits and advances as referred to in the definition may be reckoned as on 31st March of the immediate preceding financial year.

# Master Circular

- **Identification of Assets as NPAs should be done on an ongoing basis**
- **Charging of Interest at monthly rests**
- **Treatment of Accounts as NPAs**
  - Record of Recovery
  - Treatment of NPAs - Borrower-wise and not Facility-wise
  - Agricultural Advances - Default in repayment due to Natural Calamities
  - Housing Loan to Staff as NPA only on Default
  - Credit facilities backed by guarantee of the Central Government though overdue should not be treated as NPA

# Prudential Guidelines on Restructuring of Advances

- **Asset Classification Norms**

(a) before commencement of commercial production / operation;

(b) after commencement of commercial production / operation but before the asset has been classified as 'sub-standard';

(c) after commencement of commercial production / operation and the asset has been classified as 'sub-standard' or 'doubtful'.

**The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring.**

# Prudential Guidelines on Restructuring of Advances

- **Income Recognition Norms**

Interest income in respect of restructured accounts classified as 'standard assets' will be recognized on accrual basis and that in respect of the account classified as 'non performing assets' will be recognized on cash basis.

# Prudential Guidelines on Restructuring of Advances

- **Provisioning Norms**
  - Normal Provision - Banks will hold provision against the restructured advances as per the existing provisioning norms.
  - Provision for Diminution in the Fair Value of restructured Advances

# Prudential Guidelines on Restructuring of Advances

- **Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL)**
  - Asset Classification Norms
  - Income Recognition Norms

# Prudential Guidelines on Restructuring of Advances

- **Special Regulatory Treatment for Asset Classification**

The special regulatory treatment for asset classification will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions. Such treatment is not extended to the following categories of advances:

(i) Consumer and personal advances including advances to individuals against the securities of shares / bonds / debentures etc

(ii) Advances to traders

# Prudential Guidelines on Restructuring of Advances

- **Elements of Special Regulatory Framework**

The special regulatory treatment has the following two components :

(i) Incentive for quick implementation of the restructuring package.

(ii) Retention of the asset classification of the restructured account in the pre restructuring asset classification category

# Prudential Guidelines on Restructuring of Advances

- **Asset Classification**

Banks should classify their assets into the following broad groups, viz. -

(i) Standard Assets
(ii) Sub-standard Assets
(iii) Doubtful Assets
(iv) Loss Assets

# Prudential Guidelines on Restructuring of Advances

- **Doubtful Assets Provisioning – Tier I and II banks**

Tier I and Tier II Banks

| Period for which the advance has remained in 'doubtful' category | Provision Requirement |
|---|---|
| Up to one year | 20 per cent |
| One to three years | 30 per cent |
| Advances classified as 'doubtful for more than three years' on or after April 1, 2010 | 100 percent |

# Prudential Guidelines on Restructuring of Advances

- The standard asset provisioning requirements for all UCBs are summarized as under :

| Category of Standard Asset | Rate of Provisioning | |
|---|---|---|
| | Tier II | Tier I |
| Direct advances to Agriculture and SME sectors | 0.25 % | 0.25% |
| Commercial Real Estate (CRE) sector | 1.00 % | 1.00 % |
| All other loans and advances not included in (a) and (b) above | 0.40% | 0.25% |

# Additional reasons for NPA in Co-operative banks

- **Poor resource base** is the main constraint of the urban co-operative banks.
- Most of the UCBs follow **conservative credit policy.**
- Another problem, which vitiates co-operative movement, is the **interference of the politicians in the organization**
- Urban co-operative banks are suffering from the **lack of professional management** and in most of the cases approach is very much casual.

# Statistics on NPA in Banks

As per Arcil, total 2 lakh crores NPA of banks, 70k crore (1/3) is locked in legal battle, as on 30/09/2013 there were 4085 cases involving Rs 70,637 crores were in courts as per all India bank employees association.

**1st Maharashtra : tops 1076 cases of rs 26921 crores**

**2nd Delhi, 484 cases, 10000 cr**

**3rd Andhra Pradesh 413 cases, 6525 crores**

According to RBI, **total NPA was 9.8% of total loans or 5.5 trillion at the end of F.Y 2014** .

About 49% loans are restructured through CDR.

# Defintion of NPA
# under
# The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 – Sec 2(1)(o)

**"non-performing asset"** means an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset,--

(a) in case such bank or financial institution is administered or regulated by any authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;

(b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank;

# Definition of NPA under section 2(1)(O)

Definition classifies different institutions (60 in total) under two groups –

- those under the purview of the RBI and
- those regulated by other agencies.

- Gujarat High Court rules SARFAESI Act amendment unconstitutional, clips powers of other regulators of NPA classification – April 2014
- RBI can determine classification of NPAs by banks and various types of financial institutions – NBFCs, LIC, state finance companies among others

# Resolving the NPA Issue

- Reluctancy to make new loan to industrial or commercial enterprises as **NPA’s have strained their resources**.
- Unavailability of new loans **hinders economic growth and development.**
- Assisting local banks resolve their problems with NPA’s by **facilitating the financing of SPV’s** and other mechanisms designed to acquire and service such assets.
- As a result local banking system **set to focus on its core operations and provide financing to productive sectors of economy.**
- Assisting distressed companies in their **restructuring & rehabilitation efforts.**

# NPA management Strategy

**Preventive Management**

- Developing ‘Know Your Client’ profile (KYC)
- Monitoring Early Warning Signals
- Installing Proper Credit Assessment and Risk Management Mechanism
- Reduced Dependence on Interest
- Generating Watch-list/Special Mention Category

# NPA management Strategy

**Curative Management**

- Re-phasement of loans
- Pursuing Corporate Debt Restructuring (CDR )
- Encouraging rehabilitation of potentially viable units
- Encouraging acquisition of sick units by healthy units
- Entering compromise schemes with borrowers / Entering one time settlement
- Using Lok Adalats for compromise settlement for smaller loans in "doubtful" and "loss" category.
- Using Securitization & SARFAESI Act
- Using Asset Reconstruction Company (ARC)
- Circulation of Information of Defaulters Strengthening Database of Defaulters

# Reducing NPAs

- Provision of bad debts from net profit.
- Implementation of Securitisation Act 2002.
- Increasing the share of Retail business i.e., personal loans, vehicle loans, home loans, credit cards, etc.
- Increasing the deposits.
- Increase lending share to priority sector.

# Credit Risk and NPA

- NPAs are a result of past action whose effects are realized in the present
- Credit risk is a much more forward-looking approach and is mainly concerned with managing the quality of credit portfolio before default takes place

# Asset Reconstruction Company - ARC

- System-wide clean up of NPAs result in creation of **Asset Reconstruction Company**
- Governments may also provide special powers to ARCs that are not otherwise available to banking system

# ARC Objectives

- Convert NPA into performing assets
- Act as nodal agency for NPA resolution
- Create a vibrant market for NPA estructured debt
- Re-energize the financial sector.

# ARC- International Examples

- In 1980s, U.S. used government sponsored ARC - Resolution Trust Corporation (RTC) to overcome thrift crisis. RTC acted as a “bad bank” and functioned as an effective sales mechanism for disposal of assets

- In early 1990s Mexico and Sweden demonstrated successful use of ARC mechanism (Fobaproa and Securum respectively) as a “bad bank” and to clean and reprivatise/ recapitalise the banks

- Korea used KAMCO as the nodal agency for acquiring and disposing NPAs. KAMCO has used securitisation and joint venture route for investor participation in the assets

# Managing NPA

- There are two issues, which, if tackled properly, would efficiently solve the problem of NPAs viz.

(i) ‘STOCK’ ( accumulation of NPAs) problem and

(ii) ‘FLOW’ ( accretion ) problem.

# Managing NPA Models

- Globally there have been two models:

(i) A central disposition agency which takes bad loans from all financial institutions or

(ii) An entity specific to a particular bank or a group of banks e.g. Arcil.

# Resolving NPA Models

There are primarily two strategies

(I**) Loan Management Strategy**

- Restructuring of loan on sustainable debt considerations
- Maximise overall recovery value
- Fair treatment to all stakeholders
- One Time Settlement

# Resolving NPA Models

(II) **Asset Management Strategy**

- Disposition by strip sale
- Change in management
- Takeover of assets
- Legal route / Foreclosure

# Managing NPA in India

- The Indian system envisages multiple **ARCs(Asset Reconstruction Company)** as non government entities with equity support of promoters.
- The ARCs in India are not supported by through Govt. funding and are not structured like a Central disposition agency.

# Managing NPA through ARC

- ARCs are governed by the provisions of Securitisation Act 2002 and operates within the perview of RBI guidelines.
- The salient features of the Securitisation Act in respect of ARCs are as follows:
- Unfettered right to the lenders acting in majority (> 75% by value) to enforce security rights without judicial intervention

# Measures For Reconstruction

- Rescheduling of payment of debt

- Enforcement of security interest in accordance with the Act

- Settlement of dues payable by the borrower

- Taking possession of secured assets in accordance with the Act

# Issues before ARCs

- Valuation of NPA
- Debt Aggregation
- Legal & Regulatory

## Report of the Expert Committee to examine Three Tier Short Term Cooperative Credit Structure (ST CCS) dated 15th January 2013

- 2/3rds of the deposits with State CBs are deposits made by CCBs in the form of term deposits for maintenance of their SLR and CRR requirements.
- Division of a state into two or more independent states should not be a compelling reason for the division of a well-functioning StCB and the possibility of converting such StCB into a multistate federal cooperative bank must be explored.
- Large number of CCBs and some StCBs do not have adequate capital to meet even the relaxed licensing norm of 4% CRAR.
- Most of the CCBs and StCBs will also have to take concrete steps to improve their internal systems, human resources, and technology adoption.

# Recommendations I

1. **Autonomous Cooperative Election Authority** to conduct elections for StCBs and CCBs
2. Amendments in the State Cooperative Societies Act that any **director on the Board of these banks remove**d or superseded by RBI for any financial irregularity or if the bank incurs losses in any three years during their term of five years **may be barred from contesting elections to any CCB or StCB** for a period of five years.
3. **State Cooperative Societies Acts to be amended** so as to provide the **authority to StCBs and CCBs** in taking business decisions.
4. CCBs and StCBs to be **covered by the banking Ombudsman** or a similar mechanism .
5. An independent organisation may be set up by CCBs and StCB in each state for providing **support services.**

# Recommendations II

6. The management should **keep NPAs under control** and reduce the net NPAs to the expected level so that the bank does not fall in lower category.
7. It should adopt the **strategies at two stages**, i.e. Pre-sanction in depth scrutiny and Post-sanction supervision and follow up.
8. It is advised to the management **to develop more effective credit appraisal policy** and **loan recovery strategy.**
9. The bank needs to prepare a **comprehensive perspective plan** for product diversification to maintain a competitive edge in the market.
10. The urban co-operative banks, with their new formed emphasis on prudential norms, need a **high degree of professionalism in management**

# ACCOUNTING

# FOR

# CO-OPERATIVE SOCIETIES/BANKS

# Preface to the Statements of Accounting Standards

- **According to Para 3.3 the Preface**
  - Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting
  - which are subject to the attest function of the members of the ICAI
  - **Accounting Standards apply in respect of any enterprise** (whether organised in corporate, **co-operative** or other forms) **engaged in commercial, industrial or business activities**, irrespective of whether it is profit oriented or it is established for charitable or religious purposes.

# Preface to the Statements of Accounting Standards

- **Accounting Standards will not, however, apply** to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people)

# Preface to the Statements of Accounting Standards

- **Exclusion of an enterprise from the applicability of the Accounting Standards** would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature.

- Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the **Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature**

# Accounting Standards issued by ICAI

1. Accounting Standard 1: Disclosure of Accounting Policies
2. Accounting Standard 2: Valuation of Inventories
3. Accounting Standard 3: Cash Flow Statements
4. Accounting Standard 4: Contingencies and Events Occurring after the Balance Sheet Date
5. Accounting Standard 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6. Accounting Standard 6: Depreciation Accounting
7. Accounting Standard 7: Construction Contracts
8. Accounting Standard 9: Revenue Recognition
9. Accounting Standard 10: Accounting for Fixed Assets
10. Accounting Standard 11: The Effects of Changes in Foreign Exchange Rates

# Accounting Standards issued by ICAI

11. Accounting Standard 12: Accounting for Government Grants
12. Accounting Standard 13: Accounting for Investments
13. Accounting Standard 14: Accounting for Amalgamations
14. Accounting Standard 15: Employee Benefits
15. Accounting Standard 16: Borrowing Costs
16. Accounting Standard 17: Segment Reporting
17. Accounting Standard 18: Related Party Disclosures
18. Accounting Standard 19: Leases
19. Accounting Standard 20: Earnings Per Share
20. Accounting Standard 21: Consolidated Financial Statements
21. Accounting Standard 22: Accounting for Taxes on Income

# Accounting Standards issued by ICAI

22. Accounting Standard 23: Accounting for Investments in Associates in Consolidated Financial Statements
23. Accounting Standard 24: Discontinued Operations
24. Accounting Standard 25: Interim Financial Reporting
25. Accounting Standard 26: Intangible Assets
26. Accounting Standard 27: Financial Reporting of Interests in Joint Ventures
27. Accounting Standard 28: Impairment of Assets
28. Accounting Standard 29: Provisions, Contingent Liabilities and Contingent Assets
29. Accounting Standard 30: Financial Instruments: Recognition and Measurement
30. Accounting Standard 31: Financial Instruments: Presentation
31. Accounting Standard (AS) 32, Financial Instruments: Disclosures

# Applicability of Accounting Standards

- Enterprises
  - Level I
  - Level II
  - Level III

# Applicability of Accounting Standards

- For the purpose of applicability of Accounting Standards, enterprises are classified into three categories, viz., Level I, Level II and Level III.
- Level II and Level III enterprises are considered as SMEs.

# Level I Enterprises

Enterprises which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs.10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

# Level II Enterprises

Enterprises which are not Level I enterprises but fall in any one or more of the following categories are classified as Level II enterprises:

(i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include ‘other income’.

(ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.

(iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period

# Level III Enterprises

- Enterprises which are not covered under Level I and Level II are considered as Level III enterprises.

# Accounting Standards and Co-operative Sector

Accounting Standards are applicable to the Co-operative Societies their recognition, measurement and disclosure criteria will depend on, the level to which the society belongs.

# Essential Points in the accounting of Co-operative Sector

1. **AS 1 Disclosure of Significant Accounting policies** –
   1. Attention to fundamental accounting assumptions Going concern, Consistency and Accrual should be very carefully exercised.
   2. The accounting method the society is following should be clearly ascertained
   3. Special attention is required in case of Co-op Banks to whom NPA provisioning applies
   4. Does the society recognise the interest on Fixed Deposits, Locker Rent, Commission exchange and brokerage as per the method of accounting usually you find most of the above items are accounted for as and when it is paid/received in spite of accrual system of accounting.
   5. No leave encashment is provided for.
   6. No retirement benefits are provided for.

# AS 2 Valuation of Inventories

- Valuation in case of the following societies to be considered
  - Dairy societies.
  - Sugar factories.
  - Spinning mills
  - Consumers' societies.
  - Agricultural process societies.

  Cost of purchase, Cost of conversion and other Cost to be considered.

# AS 6 Depreciation Accounting

- Correct method of following Accounting Standard is to arrive at ascertaining Useful life and Depreciable amount.
- In almost all the cases rates as per Income Tax Act, 1961 are observed
- Co-operative Act does not specify rates
- Is depreciation schedule disclosed correctly?

# AS 9 Revenue Recognition

- Statement on how the interest portion on Substandard, Doubtful and loss assets are recognized should be given wherever application of RBI norms are compulsory
- In case of co-operative credit societies this issue is dealt by treating it income as and when earned a suitable comment is necessary in this case when interest as per AS9 is to be recognized on time proportion basis taking in to account outstanding balance and rate of interest

# Accounting for Fixed Assets AS 10

- **Non-monetary Consideration** - When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident.
- **Revaluation of Fixed Assets -** Increase in net book value arising on revaluation of fixed assets is normally credited to revaluation reserve, decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement .

# Accounting for Fixed Assets AS 10

- But sometimes an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease.

# AS 14:
# Accounting for Amalgamation

- Applicable to multi state co-operative bank. Eg., Annapurna Mahila Sahakari bank, Manasa Co-op Urban, Co-op bank of Ahmedabad, Unnati Co-op Vadodara.
- Multi state Co-operative banks fall under **Level I** enterprises, therefore it is more important for them to observe AS 14.

# AS 15: Employee Benefits

- Employee benefits are all forms of consideration given by an enterprise in exchange for service rendered by employees

- Post-employment benefits include: Retirement benefits – e.g.. Gratuity and pension

- Other benefits – e.g. post-employment life insurance and post-employment medical care Post-employment benefit plans are formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees

- Co-operative societies should ensure that employees' benefits are provided for as explained in AS 15.

# AS 17:Segment Reporting

- Applicable in respect of
  - Multistate Co-operative Banks ,
  - Milk and Milk product societies having bigger scale of operations such as (Gujarat Cooperative Milk Marketing Federation Ltd.) where the issue of reporting as per primary and secondary segments needs to be looked into.
  - Rest of the societies caters to local market

# AS 22: Accounting for Taxes on Incomes

- AS 22 is applicable to Tax Paying Societies ever since AS 22 became mandatory.
- Co-operative banks also fall under the net of tax paying entities

# AS 24:
# Discontinuing Operations

- Piecemeal Disposal and Termination are possible in case of Co-operative Societies
- Tax gains and losses on disposal of assets, their method of computation and expense incurred to be considered appropriately

# AS 28:Impairment of Assets

- The Statement aims to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount.
  - Rule 49 A as per the MCS Rules 1961 there appears to be a confusion in the meaning of appropriation as commonly understood
  - Given that Co-operative Banks are governed by RBI they are liable to follow the stipulations

# AS 28:Impairment of Assets

- prudential norms of classification and provisioning of advances the non- consideration of interest unrealised on Substandard, doubtful and loss assets be clarified in the notes to account vis-à-vis requirements of AS 9
- Method of recognition of Interest on overdue deposits and its impact to be determined
- Co-operative credit societies which are controlled by registrar of co-operation consider the interest on advances only on realization.

# Audit of Banks (UCBs)

# Procedures before starting a Bank Audit

- Identify risk areas
- Issues to be included
- Present a list of details required and the specific timeline for receiving the same
- Audit Approach should be based on a 80: 20 rule

# Accounting System in Banks

- Maintenance of primary books esp. subsidiary books like customers ledger becomes extremely important.
- Entries in personal ledgers are directly made from vouchers and not from the books of prime entry. This is called the Slip System of Ledger Posting. Entries are first made into the customer’s accounts and then a day book is written. Finally the day book is matched with customers account
- The trial balance of general ledger is extracted and tallied every day

# Inputs from Bank Manager on the following aspects

- SWOT analysis of the banks and its branches
- Risk Areas
- Interrelated Bank Audit Function
- Previous year LFAR and MOCs
- Perusal of list of concurrent audit and other reports
- Instruction manuals and policies (HO)

# Issues in Bank Audit

- **General Issues in the Areas of**
  - Fema Compliance
  - System Audit
  - Investments
  - Loans and Advances
  - Fixed Assets
  - Deposits
  - Issues in Treasury
  - Forex Derivates

# Issues pertaining Bank Audit

- Branch Auditors reports is forwarded to the Central Auditors and to the management
- The branch auditor is required to submit what is called the LFAR to management and to the central auditors

# Issues pertaining Bank Audit

- Banking business takes place at the Branch Office, while the administrative function is taken care by the HO.
  - Specific risk associated with transactions involved by a bank
  - The scale and range of banking operations and related exposure
  - Excessive dependence on Information Technology for real time processing of banking transactions
  - Detailed statutory and regular audit requirements
  - New banking services and practices getting introduced
- Areas not dealt with in the branch office
  - Provisioning for Gratuity, Taxation, Audit Fees, Pension and other retirement funds
  - Depreciation on premises and other fixed assets
  - Transfer to reserves
  - ividend declaration

# Points specific to the bank branch audit

- Audit at branch is once a year ritual and at a very short span of time
- Its huge both in terms of volume and value, hence only trained people can finish the audit at a short span
- Up to date RBI regulation and guidelines is essential

# Applicability of Accounting Standards

- **ICAI** has issued 32 Accounting Standards till date
- (a) AS 13, Accounting for Investments, does not apply to investments of banks.
- (b) AS 11, “The Effects of Changes in Foreign Exchange Rates”, does not apply to accounting of exchange difference arising on a forward exchange contract

# Legislature

Bank Audit covered under

- Banking Regulation Act 1949 ,
- Reserve Bank of India Act 1934
- Banking Companies (Nationalization of Undertakings) Act, 1970
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- Negotiable Instruments Act 1881
- State Bank of India Act, 1955

# Legislature

- State Bank of India (Subsidiary Banks) Act, 1959
- Regional Rural Banks Act, 1976
- Companies Act, 1956
- Co-operative Societies Act, 1912 or the relevant state Co-operative
- Information Technology Act, 2000
- Prevention of Money Laundering Act, 2002
- Credit Information Companies Regulation Act, 2005
- Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

# Inspection & Audit in UCBs

- Master Circular by Reserve Bank of India
- Recommendations of the Ghosh Committee (under Mr. A Ghosh – Then Deputy Governor)
- Internal Audit Machinery – inspection dept head to report to chairman
- Internal Audit Periodicity – atleast once in 12 months and should be of surprise character

# Inspection & Audit in UCBs

COVERAGE

– internal inspection report to specifically comment, on the position of irregularities pointed out in the inspection report of Reserve Bank of India
– critically analysis and in-depth study of the corruption/fraud prone areas
– Verification and Comments on system of off balance sheet transactions recording
– Proper inventory subject to surprise checks

# Inspection & Audit in UCBs

- Check compliance with prudential norms - income recognition, asset classification and provisioning
- supplemented with Supplementary Inspections/ Audit in addition to Internal Audit. Eg . Revenue Audit, Credit Portfolio Audit
- Specific measures in case of Investment portfolio audits

# Inspection & Audit in UCBs

CONCURRENT AUDIT

– introduced in all scheduled and other primary (urban) co-operative banks with deposits over Rs.50 crore later extended to all UCBs based on the recommendations of the Joint Parliamentary Committee (JPC)

– concurrent audit system - part of a bank's earlywarning system – Board required to review this system once in year

– individual banks' managements to decide the details of the concurrent audit system

# Inspection & Audit in UCBs

CONCURRENT AUDIT

– concurrent auditors to certify that the investments held by the bank as on the last reporting Friday of each quarter as reported to the RBI are actually owned / held by it

– Specifically to verify RBI instructions regarding transactions in Govt. Securities

– Serious irregularities brought out in the concurrent audit report – immediate reporting to the Regional Office concerned of this department

# Inspection & Audit in UCBs

– EDP (Electronic Data Processing) audit system

– Information System (IS) Audit – from 01.04.2014
  – may adopt an IS audit policy
  – appropriate systems and practices for yearly IS audit
  – Prior to Statutory Audits
  – IS Audit Report to be placed before Board

# Inspection & Audit in UCBs

- APEX AUDIT COMMITTEE – of Board of Directors
- overseeing and providing direction to the internal audit/inspection machinery
- consist of the Chairman and three/four Directors, one or more of such Directors being Chartered Accountants or persons having experience in management, finance, accountancy and audit system

# Internal Control and Enterprise Risk Management (ERM) of Urban Co-operative Banks(UCBs)

# WHAT IS INTERNAL CONTROL ?

"A process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievements of objectives in the following categories:

- Effectiveness & efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations."

# What is External Control?

Various measures that affect a company's operations,

- **which are not enacted by the company**
- **but rather by the government or other organizations.**

External control includes any

- rule or regulation
- which has an effect on the actions of the company, and
- can include tax laws enacted by the government which affect the flow of money,
- a lease which restricts what a company can or can not do with their office space, and
- laws which prevent discrimination in the company's hiring procedure.

# Evolution of Internal Control

- Chanakya – 300 BC
- English Audit Specialist - Lawrence Dicksee – 1905
- COSO – 1992
- SOX - 2002

# Today's organizations are concerned about:

- Risk Management
- Governance
- Control
- Assurance (and Consulting)

# Why Internal Control?

- Management and control of risks
- Safeguarding the assets of the company
- Achievement of overall objectives of the organisation
- Effective and efficient operations
- Reliable and correct financial information (internal as well as external)
- Prevention and detection of fraud and errors

1. **Internal control is a *process*.**
2. **It is a means to an end, not an end in itself.**
3. **Internal control is effected by *people*.**
4. **It's not merely policy manuals and forms, but people at every level of an organization.**
5. **Internal control can be expected to provide only *reasonable assurance*, not absolute assurance, to an entity's management and board.**
6. **Internal control is geared to the achievement of *objectives* in one or more separate but overlapping categories.**

# The System of Internal Control

- The control environment
- Risk assessment
- The control activities and procedures
- Accounting, information and communication
- Monitoring and self assessment

# Components Of Internal Control

- Control Environment.
- Risk Assessment.
- Control Activities.
- Information & Communication.
- Monitoring.

# Limitations of Internal Control

- Judgement.
- Breakdowns.
- Management override.
- Collusion.
- Costs Versus Benefits.


Information & Communication
Monitoring
Control Activities
Risk Assessment
Control Environment

# What Internal Control Can Do?

It can

- Help achieve performance & profitability targets.
- Help prevent loss of resources.
- Help ensure reliable financial reporting.
- Help ensure compliance with laws.
- Help an entity get to where it wants to go and avoid pitfalls and surprises along the way.

# What Internal Control Cannot Do?

It cannot

- ensure success.
- ensure the reliability of financial reporting.
- ensure compliance with laws and regulations.

**Internal controls, no matter how well designed and operated, can provide only REASONABLE ASSURANCE to management regarding achievements of an entity's objectives.**

# Internal Control and Internal Audit

- Internal audit is a part of internal control

- Internal audit provides an objective, independent review of the organization's activities, internal controls, and management information systems to help the board and management monitor and evaluate internal control adequacy and effectiveness.

***Who is accountable for assurance that appropriate internal controls are in place?***

The Management!!!!

***Who's responsible for the performance of internal control activities?***

Everyone!!!!!!

# *Types of Internal Controls*

- ***Directive Controls*** – encourage good behavior, it's the right thing to do
  - Incentive plans
  - Recognition awards
  - Training
  - Policies and Procedures
  - Promotions

# *Types of Internal Controls*

- ***<u>Preventative Controls</u>*** – prevent undesirable events from occurring
  - Knowledge that someone is reviewing your work
  - Segregation of duties
  - Limited access
  - Levels of authorization
  - Security badges
  - Business rule set-up in automated systems

# *Types of Internal Controls*

- ***<u>Detective Controls</u>*** – detect and correct undesirable events after they occur.
  – Reconciliations
  – Auditing
  – Confirmations
  – Exception reports
  – Reviews done on a regular basis

# *Types of Internal Control*

- ***Mitigating Controls*** – Mitigate for the lack of an expected control.
  - Cash handling – lack of adequate staff for proper segregation of duties – sharing with another area
  - Software security/access – regular monitoring of access for certain employees when software security is not adequate because of functional constraints.

# *IT Access Limitation Controls*

- To create a record
- To change a record
- To approve a transaction
- By allowing read-only
- By requiring passwords
- Requiring time out limits
- By installing firewalls

# *Control Tools (Partial Listing)*

- Formal Compliance programs
- Checklists
- Inspections
- Exception reports (i.e. Performance appraisals not completed, excessive overtime, duplicate payments etc.)
- Forms control (pre-numbered documents, filing by and verifying integrity of numerical sequence)
- Performance standards
- Physical safeguards (safes, locks, access cards, dual control over sensitive assets, cameras, alarms, guards, ID badges etc.)
- Simulated disaster recovery drills

# *Which of the following are examples of an internal control?*

- Segregation of duties
- Passwords
- Bonus plans
- Reconciliations
- Staff Meetings
- Training on a new system
- Training in group dynamics
- Directions on how to complete expense reports
- Requiring original receipts for expense reports
- Managers being scrupulous in completing their own expense reports
- Managers telling employees to be scrupulous in completing their expense reports
- Standard price lists, with sales people allowed a maximum of 10% variance for negotiation

What happens when internal controls are not in place or break down?

# FRAUD!!!

# Internal Control Framework - Many models to choose from……….

- COSO
- COCO
- Cadbury Report
- Deming Award
- TQM
- 12 Attributes
- Deep Learning Framework
- ISO 9000
- Kings Report
- Treadway Commission

# Internal Control Frameworks and Codes – International Scenario

- Foreign Corrupt Practices Act (1977),
- Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission Report, 1987);
- The Report on ‘Internal Control – *Integrated Framework*’, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), in 1992
- Internal control frameworks presented by the Cadbury Committee Report (Cadbury Report, UK);

# Internal Control Frameworks and Codes – International Scenario

- **I**nternal Control: Guidance for Directors on the Combined Code (1999)
- The Criteria of Control Committee (CoCo Report, Canada)
- The King Committee (King Report, South Africa)
- The Report on 'Enterprise Risk Management – *Integrated Framework'*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), in 2004

# Who Developed Models?

- **COSO:** The major accounting and audit professional organizations issued COSO in 1992.
- **12 Criteria**: The Canadian Comprehensive Auditing Foundation published Effectiveness Reporting and Auditing in the Public Sector in 1987.
- **COCO:** In November 1995, The Canadian Institute of Chartered Accountants (CICA) published Guidance on Control.
- **ISO 9000** developed by the International Organization for Standardization (ISO)

# Different Frameworks Same Goals

- Frameworks provide a way of understanding our organizations.
- By having different groupings, each highlights some aspects of control more than others.
- The criteria in the frameworks provide a basis for understanding control in an organization and for making judgment about the effectiveness of control.

# Different Frameworks Same Goals

- Frameworks provide a systematic step by step method of evaluating and addressing the adequacy of controls in multiple dimensions of a business.
- Frameworks provide a standard review process.
- Frameworks provide a tool that helps management and audtiors evaluate the adequacy of controls in multiple dimensions of the business.  It helps give a picture of how well all of the controls in all of the dimensions are working.

# Using These Frameworks

- Gives a picture that focuses on what is important to users, that keeps things in perspective, and that is sensitive to ‘shades of gray’.
- Flexibility is allowed and creativity is required.
- Nothing magical about them--but they can allow you to have seemingly magical insights.

# One More Tool in the Tool box

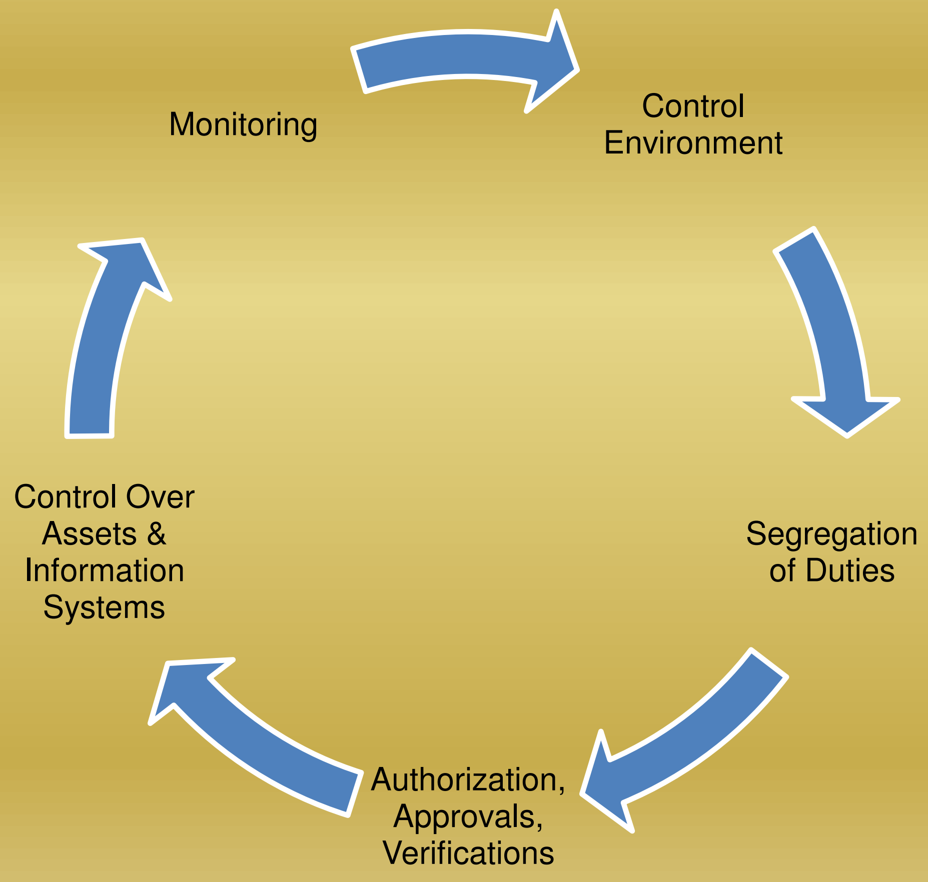
- CSA (Controlled Self Assessment)
- Questionnaires
- Unobtrusive Measures
- Structure Interviews
- Document Reviews
- Regression Analysis
- Integrated Control Frameworks
- And many more!

# COSO

Monitoring
Information and Communication
Activities
Risk
Assessment
Environment

# Coso ERM Framework

# Key Control Activities



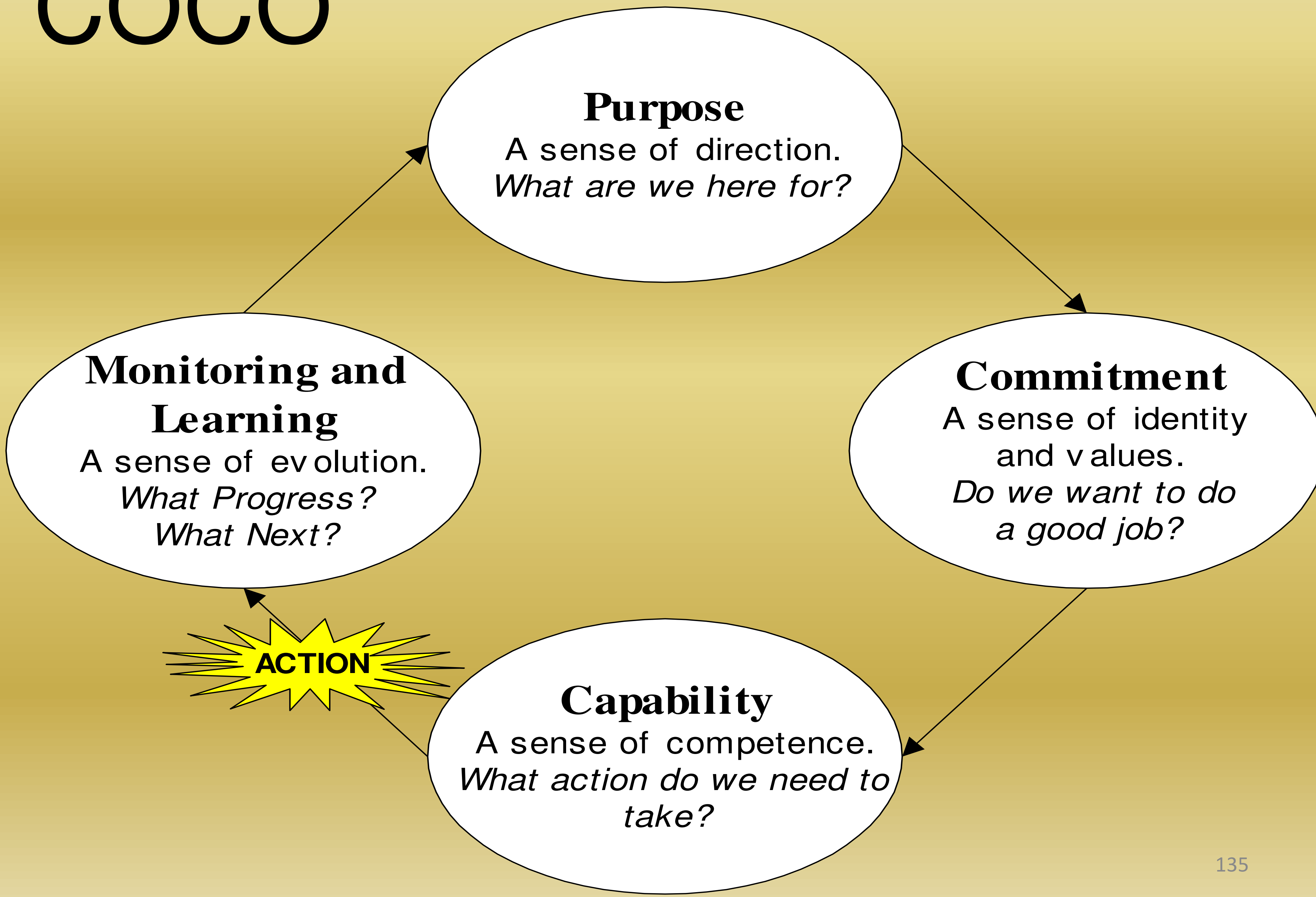
# CRIME

- Control Activity
- Risks
- Information
- Monitoring
- Environment

# COSO Matrix

| | Operations | Financial Reporting | Compliance With Laws and Regulations |
|---|---|---|---|
| Control Environment | | | |
| Risk | | | |
| Control Activities | | | |
| Information and Communication | | | |
| Monitoring | | | |

# COCO


Purpose
A sense of direction.
What are we here for?
Commitment
A sense of identity and values.
Do we want to do a good job?
Capability
A sense of competence.
What action do we need to take?
Monitoring and Learning
A sense of evolution.
What Progress?
What Next?
ACTION

# COSO and COCO's Definition of Internal Control

As per COSO, Internal Control is:

- a process,
- effected by an entity's board of directors, management, and other personnel,
- designed to provide reasonable assurance regarding the achievement of objectives.

As per COCO, Internal Control is

- those elements of an organization (including its resources, systems, processes, culture, structure and tasks) that, taken together, support people in the achievement of the objectives.

# Objectives of Internal Controls

Per COSO, organization's

- effectiveness and efficiency of operations;
- reliability of **financial** reporting; and
- compliance with applicable laws and regulations.

Per COCO

- effectiveness and efficiency of operations
- reliability of **internal and external** reporting; and
- compliance with applicable laws and regulations and **internal** policies.

# Key COSO and COCO Concepts

- Internal Control is a process.
- Internal Control is effected by people.
- Internal Control can be expected to provide only reasonable assurance.
- Internal Control is geared to the achievement of objectives.

# What's More Important?

- Segregation of duties or ethical employees?
- Well written and thorough policy and procedures manuals or competent employees?
- Clear delineation of roles and responsibilities or a group of employees dedicated to accomplishing the organization's mission?

## Common Characteristics

| **Hard controls *tend to be:*** | **Soft controls *tend to be:*** |
|---|---|
| formal | informal |
| objective | subjective |
| Quantitatively measurable | intangible |
| the 'map" | the real terrain |

# Examples

| ***Hard* Controls** | ***Soft* Controls** |
|---|---|
| **Policy/procedure** | **Competence** |
| **Organizational structure** | **Trust** |
| | **Shared Values** |
| **Bureaucracy** | **Strong Leadership** |
| **Restrictive formal processes** | **High expectations** |
| | **Openness** |
| **Centralized decision making** | **High ethical standards** |

# The Regulations

- Clause 49 of the Listing Agreement in India
- Sarbanes Oxley Act 2002 in US
- The Combined Code on Corporate Governance 2003 in UK
  – Guidance for Directors on the Combined Code, Turnbull Committee (C.2 and C.3)

# Clause 49 – Corporate Governance

- Board of Directors
- Audit Committee
- Subsidiary Companies
- Disclosure of Contingent Liabilities
- Disclosures
- CEO/CFO certification
- Report on Corporate Governance
- Compliance

# SOX

- Focus only on
  - Financial reporting
  - Information filed with SEC
- Section 404
- Section 302
- Setting up of independent audit committees
- Codes of conduct, whistle blowing procedures
- Greater involvement of the Board and the audit committees in control activities

# The Combined Code

Maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets. (Principle C.2)

# Guidance for Directors on Combined Code

- The Turnbull Guidance
- Helps the directors to:
  - assess how the Company has applied Code principle C.2
  - implement the requirements of Code provisions C.2.1 and C.3.5
  - report these matters to the shareholders in the annual report and accounts

# The European framework

- The European Economic Reform White Paper of 2002 defines internal controls as creating standards for five key control elements:
  - Control environment
  - Performance and risk management
  - Information and communication
  - Control activities
  - Audit and evaluation

# What is ERM?

**ENTERPRISE (E)** → **GOALS (ORGANIZATION)**

**RISK (R)** → **EVENTS (OUTCOME)**

**MANAGEMENT (M)** → **ACTION (PRECAUTION)**

# ERM

- Enterprise – “ Organization”, “Company”, “Institution”, “Business Set Up”
- Risk – “Danger”, “Loss”, “Obstacle”
- Management – “Handling”, “Getting what you want”, “Practical solution to the given circumstance”, “Avoiding a collapse”

# RISK

Risk, in traditional terms, is viewed as a ‘negative’.

Webster’s dictionary, for instance, defines risk as “exposing to danger or hazard”.

The Chinese give a much better description of risk

- The first is the symbol for “danger”, while
- the second is the symbol for “opportunity”, making risk a mix of danger and opportunity.

# RISK MANAGEMENT

Risk management is an attempt

- to identify,
- to measure,
- to monitor and
- to manage uncertainty.

# Risk management…

- Risk management is present in all aspects of life
- It is about the everyday trade-off between an expected reward and a potential danger
- It is universal, in the sense - it refers to human behavior in the decision making process

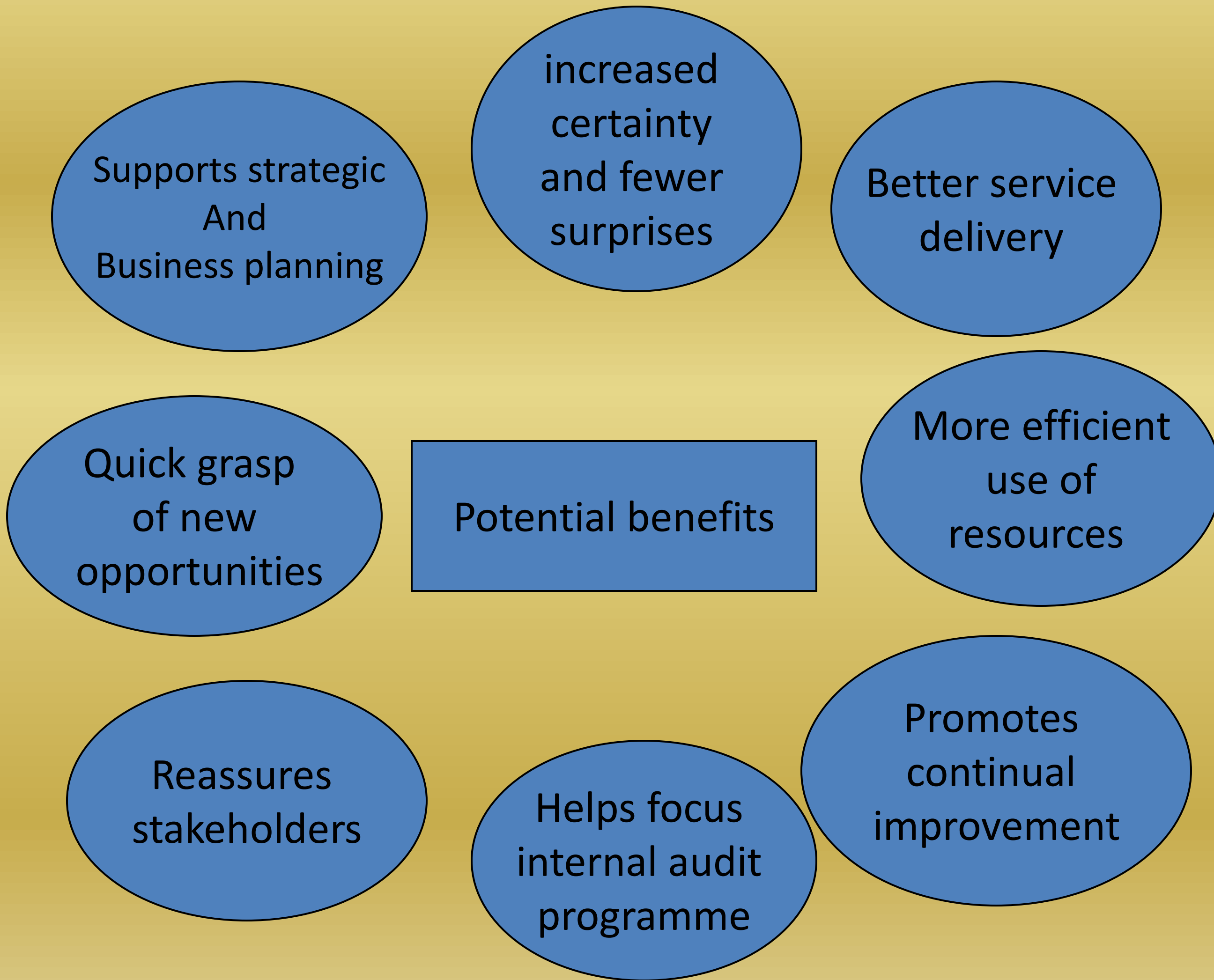
No Risk

…

No

Gain!

# Benefits of risk management



# Definition of ERM

*“Enterprise risk management is a*

- ***process,***
- ***effected** by an entity’s board of directors,_management and other personnel,*
- ***applied** in strategy setting and across the enterprise,*
- ***designed***
- ***to identify** potential events that may affect the entity, and*
- ***manage risk** to be within its risk appetite,*
- *to provide reasonable **assurance***
- *regarding the achievement of **entity objectives**.”*

COSO (Committee of Sponsoring Organizations of the Treadway Commission) defines ERM

# ERM

- ERM is an ongoing process
- ERM is an Integral part of how an organization operates
- ERM applies to all organizations, not just financial organizations.
- Risk applies broadly to all things threatening the achievement of organizational objectives
- Risk is not limited to threats, but also refers to opportunities.
- The goal of an organization is not “risk minimization”, but seeking an appropriate “risk-return position”.

# Enterprise – Entity's Objective

**Entity's Objectives** - 4 categories

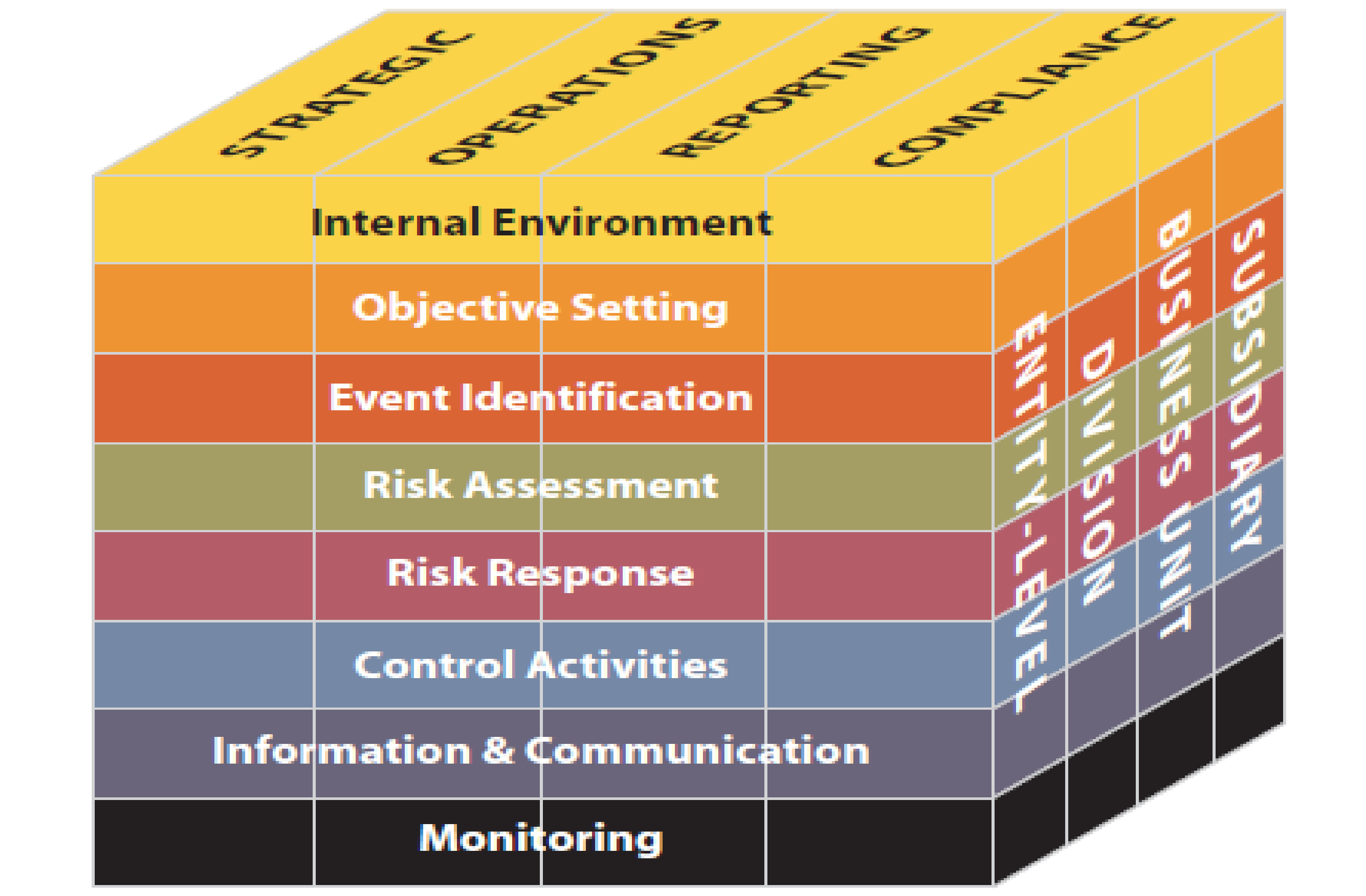
– **Strategic** – high-level goals, aligned with and supporting its mission

– **Operations** – effective and efficient use of its resources

– **Reporting** – reliability of reportin

– **Compliance** – compliance with applicable laws and regulations

# 8 Components of ERM



# 8 Components of ERM

1. Internal Environment
2. Objective Setting
3. Event Identification
4. Risk Assessment
5. Risk Response
6. Control Activities
7. Information and Communication
8. Monitoring

# Internal Environment

- Establishes a philosophy regarding risk management. It recognizes that unexpected as well as expected events may occur.
- Establishes the entity’s risk culture.
- Considers all other aspects of how the organization’s actions may affect its risk culture.

# Objective Setting

- Is applied when management considers risks strategy in the setting of objectives.

- Forms the risk appetite of the entity — a high-level view of how much risk management and the board are willing to accept.

- Risk tolerance, the acceptable level of variation around objectives, is aligned with risk appetite.

# Event Identification

- Differentiates risks and opportunities.
- Events that may have a negative impact represent risks.
- Events that may have a positive impact represent natural offsets (opportunities), which management channels back to strategy setting.

# Event Identification

- Involves identifying those incidents, occurring internally or externally, that could affect strategy and achievement of objectives.

- Addresses how internal and external factors combine and interact to influence the risk profile.

# Risk Assessment

- Allows an entity to understand the extent to which potential events might impact objectives.

- Assesses risks from two perspectives:
  - Likelihood
  - Impact

- Is used to assess risks and is normally also used to measure the related objectives.

# Risk Assessment

- Employs a combination of both qualitative and quantitative risk assessment methodologies.
- Relates time horizons to objective horizons.
- Assesses risk on both an inherent and a residual basis.

# Risk Response

- Identifies and evaluates possible responses to risk.
- Evaluates options in relation to entity's risk appetite, cost vs. benefit of potential risk responses, and degree to which a response will reduce impact and/or likelihood.
- Selects and executes response based on evaluation of the portfolio of risks and responses.

# Control Activities

- Policies and procedures that help ensure that the risk responses, as well as other entity directives, are carried out.
- Occur throughout the organization, at all levels and in all functions.
- Include application and general information technology controls.

# Information & Communication

- Management identifies, captures, and communicates pertinent information in a form and timeframe that enables people to carry out their responsibilities.

- Communication occurs in a broader sense, flowing down, across, and up
the organization.

# Monitoring

Effectiveness of the other ERM components is monitored through:

- Ongoing monitoring activities.
- Separate evaluations.
- A combination of the two.

# Scope of ERM

- Aligning risk appetite and strategy
- Enhancing risk response decisions
- Reducing operational surprises and losses
- Managing multiple and cross enterprise risks
- Grabbing opportunities
- Improving deployment of capital

# Objectives of ERM

- Improve risk-based decision making
- More effective use of capital
- Comply with regulatory changes
- Improve shareholder value
- Anticipating problems before they become a threat
- Co-coordinating various risk management activities

# ERM- History…..

**1974**- Basel Committee on Banking Supervision

1988 - Basel Capital Accord setting forth a new framework for minimum risk based Capital requirements

1985 - COSO formed an independent commission to undertake a private sector study of factors that caused fraudulent financial reporting

1992- Following a series of high profile corporate frauds and accounting scandals, the London Stock Exchange introduced new regulations covering various aspects of Corporate governance

**1995**- Development of national standards on Risk Management began with Aus/NZ Risk Similar standards in Canada (Dey Report 1997) and Japan, and in the UK (2000)

**1996**- NAIC (National Association of Insurance Commissioners in United States) introduced risk based capital requirement for insurance companies.

**2002** - A string of corporate accounting scandals has profound implications in the US and worldwide and led to the passage of Sarbanes-Oxley Act

**2004 –** COSO Enterprise Risk Management Integrated Framework

**2009 –** ISO 31000 Risk Management Standard

**2010** –COSO Strengthening Enterprise Risk Management for Strategic Advantage

# ISO : 31000

– ISO 31000 was published in 2009 as an internationally agreed standard for the implementation of risk management principles
– ISO also produced Guide 73 ‘Risk management – Vocabulary – Guidelines for use in standards’.
– The definition set out in ISO Guide 73 is that risk is the “effect of uncertainty on objectives”.

# ISO : 31000

- Guide 73 also states that an effect may be positive, negative or a deviation from the expected, and that risk is often described by an event, a change in circumstances or a consequence.
- Risk management is a central part of the Strategic Management of any a organization
- Risk Architecture , Strategy and Protocols

### Risk architecture

- Risk architecture specifies the roles, responsibilities, communication and risk reporting structure

### Risk strategy

- Risk strategy, appetite, attitudes and philosophy are defined in the Risk Management Policy

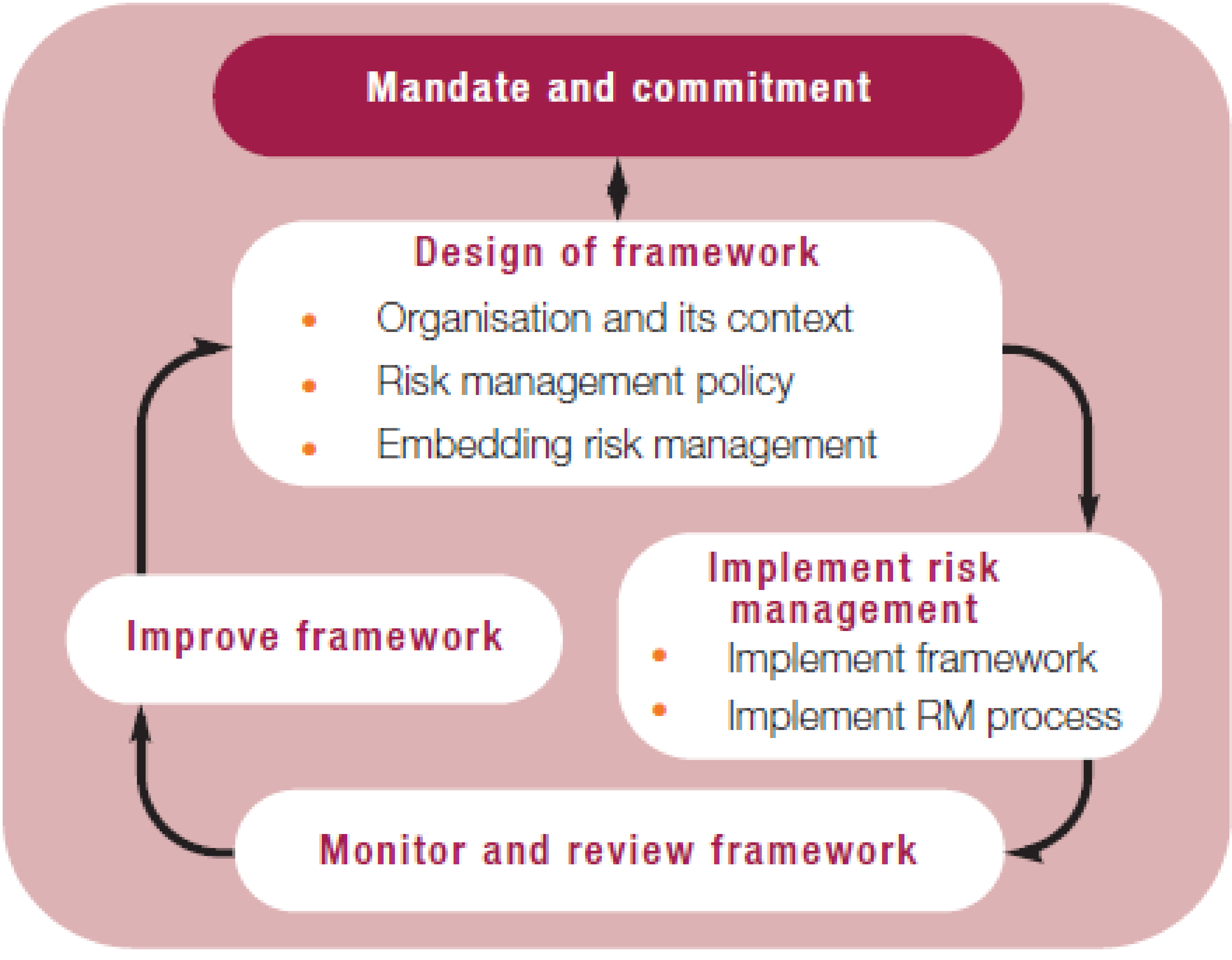
### Risk management process

### Risk protocols

- Risk protocols are presented in the form of the risk guidelines for the organisation and include the rules and procedures, as well as specifying the risk management methodologies, tools and techniques that should be used

# ISO:31000

- ISO 31000 does not recommend a specific risk classification system and each organisation will need to develop the system most appropriate to the range of risks that it faces.
- ISO 31000 describes a framework for implementing risk management, rather than a framework for supporting the risk management process.
- Information on designing the framework that supports the risk management process is not set out in detail in ISO 31000.
- Framework for managing risk as per ISO 31000



Mandate and commitment
Design of framework
Organisation and its context
Risk management policy
Embedding risk management
Implement risk management
Implement framework
Implement RM process
Monitor and review framework
Improve framework

# ISO:31000

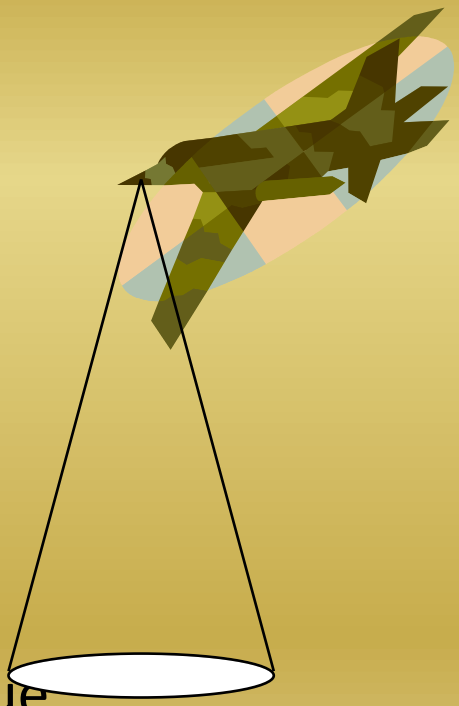
ISO 31000 recognizes the importance of feedback by way of two mechanisms.

- Monitoring and review of performance and
- Communication and consultation

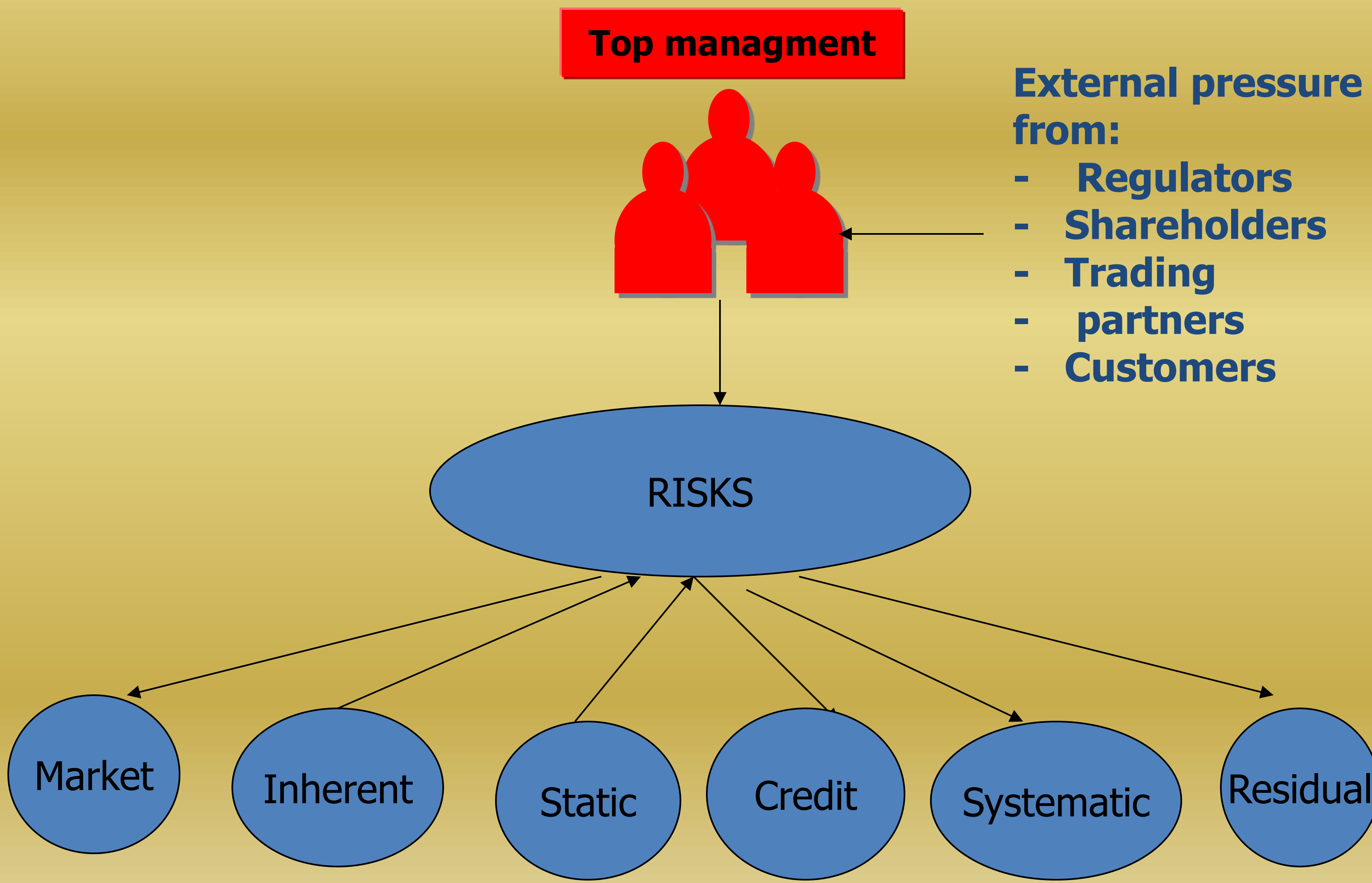
# RISKS vs. OPPORTUNITIES

- Risk is a possibility that an event will occur and adversely affect the achievement of objectives

- Opportunity is the possibility that an event will occur and positively affect the achievement of the organization's objectives and creation of value



# Types of Risks



# Developments in Enterprise Risk Management

Understanding risks is not new at all

There has always been an inherent understanding of risk ;

e.g. health and safety risk

Risk management concept has been around in investment, banking, insurance, artificial intelligence, and public policy processes

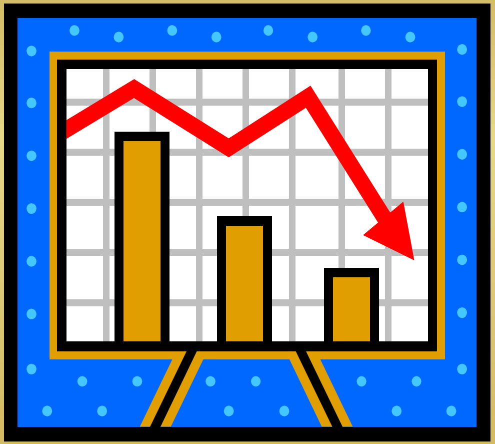
# Traditional risk management vs. ERM

- Traditional risk management is more related to financial and hazard risks i.e. transferable risks
- Traditional risk management requires more accounting type skills

- ERM stresses the management of operational and strategic risks
- ERM requires skill in strategic planning, process re-engineering, and marketing

# Market risk

**It is the risk that the value of on and off-balance sheet positions of a financial institution will be adversely affected by movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices resulting in a loss to earnings and capital.**



## Inherent risk

- A risk which it is impossible to managed or transferred away

## Static risk

-Risk which is unique to an individual asset

## Credit risk

-Failure to meet the obligated payments of counter parties on time

## Systematic risk

-The risk of holding Market Portfolio

## Residual risk

-That remains after the action to mitigate risk is taken

# Are You Prepared?

Too many businesses fail for the wrong reasons.

- They don't fail because their products are inferior, because they are bad at marketing, or because they are bad at controlling costs.
- They fail because they do not identify and manage risks.
- When a disaster happens — an incident they should survive — they aren't prepared. They didn't anticipate what could happen, and they certainly didn't plan for it.
- Unprepared businesses suffer badly or fail.

# Risk Management and Business Continuity

**Risk management is simply a practice of systematically selecting cost effective approaches for minimising the effect of threat realization to the organization.**

**Business Continuity Planning (BCP)** is a methodology used to create a plan for how an organization will resume partially or completely interrupted critical function (s) within a predetermined time after a disaster or disruption

# Challenges

- Data availability & integrity
- Data warehousing/ mining
- Building up processes & systems
- Developing Human Resources
- Strengthening skills
- Model validation – requires greater collaboration with regulator
- Cost - investment in risk analytics and risk technology – getting management buy-in
- Stress testing, scenario analysis – building capabilities

# Balancing the Hard and Soft side of Risk Management

**Hard Side**

- Measures and reporting
- Risk oversight committees
- Policies & procedures
- Risk assessments
- Risk limits
- Audit processes
- Systems

**Soft Side**

- Risk awareness
- People
- Skills
- Integrity
- Incentives
- Culture & values
- Trust & communication

# Implementation Of ERM

**The basic elements of an effective risk management program are:**

1. **Senior management and board level commitment**
2. **Risk management policies and procedures established in writing for the most prominent risks, with specific objectives and targets**
3. **Clearly defined responsibilities for managing and controlling risk**
4. **Ongoing employee training is essential**
5. **Testing and monitoring of all programs and procedures**
6. **Regular reports including independent audits prepared for review by senior management and board directors**

# Corporate Failures

WORLDCOM — Fudging revenue and capital accounts

hih INSURANCE — Mismanagement and poor decision making

ENRON — Off Balance sheet entities, SPV's, synthetic leases

parmalat — Mismanagement and poor decision making

Ahold — Accounting scandal, overstatement of revenues

vivendi — False and Misleading Financial Statements

# Limitations Of ERM

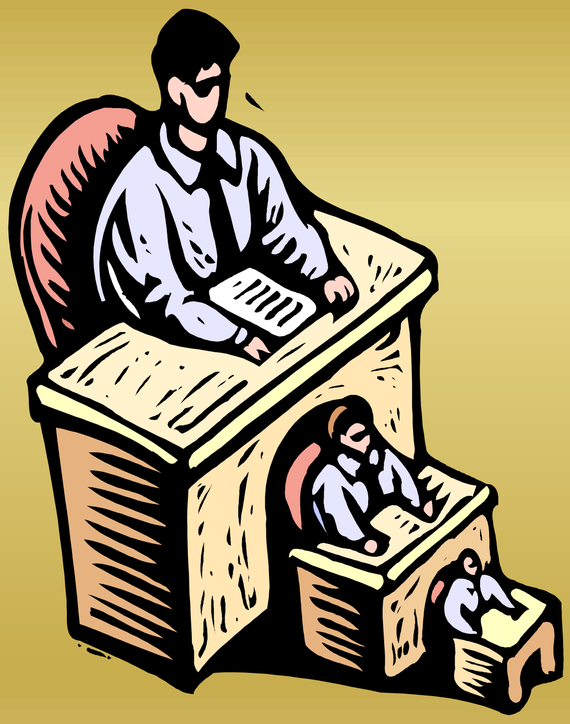
**The inherent limitations include :**

- **Realities that human judgment in decision making can be faulty**

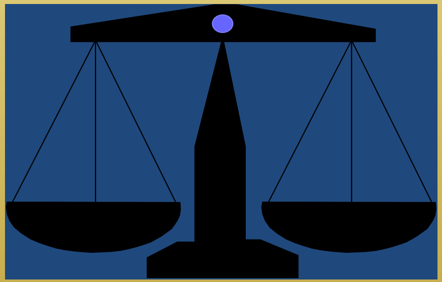
- Breakdowns can occur because of human failures such as a simple error or mistake

- **Controls can be circumvented by the collusion of two or more people**

- The management has the ability to override the ERM process



- Need to consider the relative costs and benefits of risk responses.



# ERM in Banking Sector

# Background – Basel II

- *Pillar I: Minimum Capital Requirement*
  - Banks may choose one of the many approaches to calculate capital for credit, market & operational risk

- *Pillar II: Supervisory Review Process*
  - **Contains the key principles according to which bank supervision should be done:**
    - Board and management
    - Risk management models and process
    - Internal control
    - Stress Testing
  - **One of the targets is also to try motivate banks to hold capital buffers in excess of the minimum requirement.**
  - **Financial Supervision should be proactive before bank capital goes under the minimum requirement**

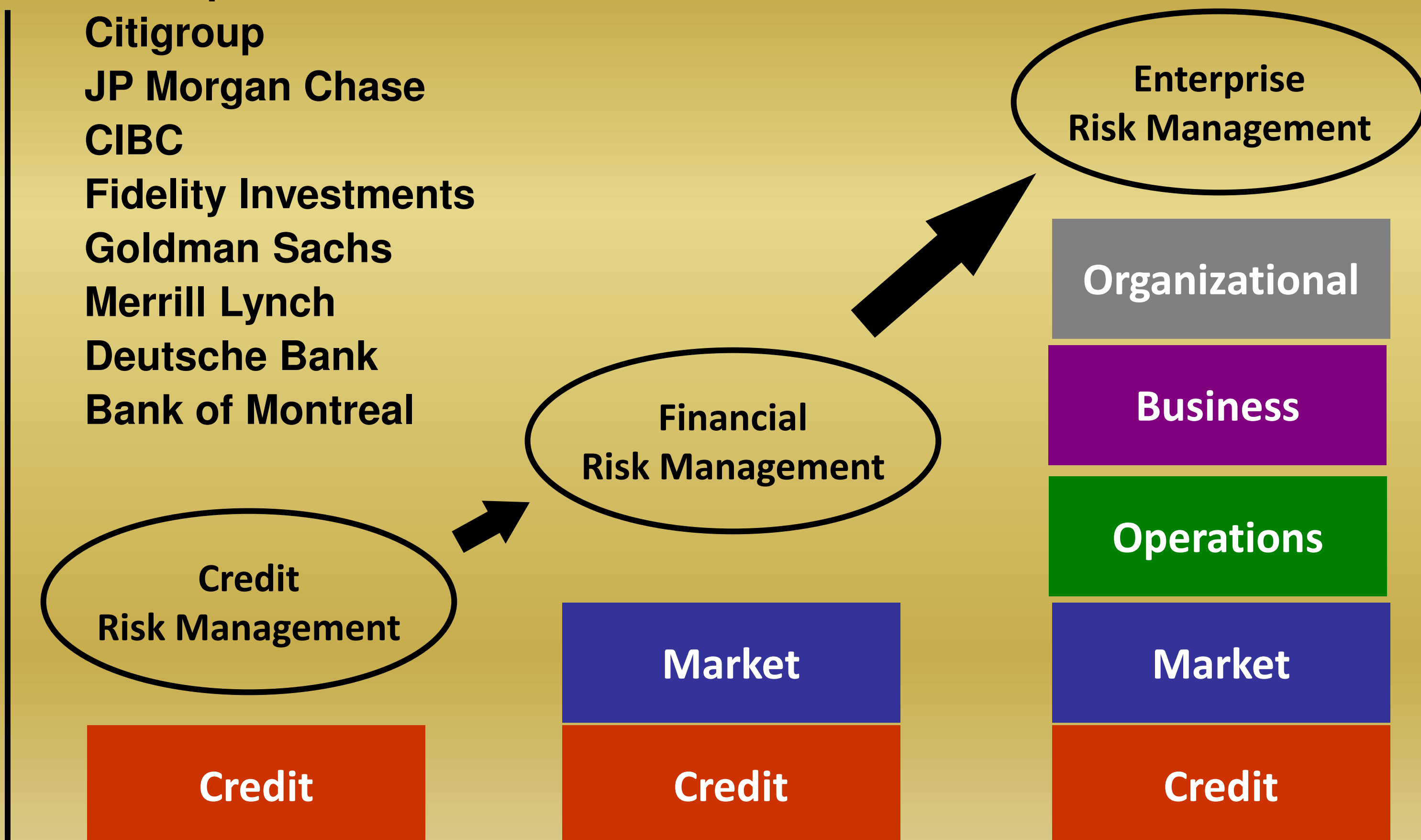
*Pillar III: Market Discipline*

- **Includes recommendations and requirements especially regarding disclosure information.**

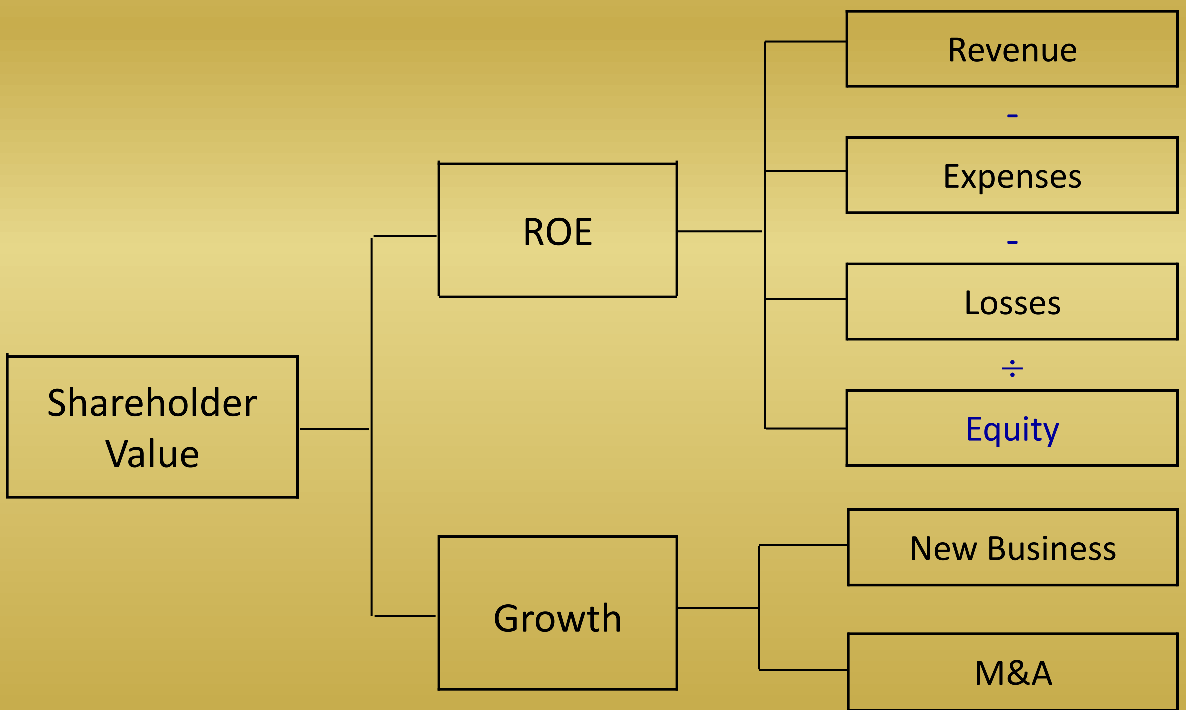
# Evolution of Industry Practices

***Early Adopters***

**Barclays**
**GE Capital**
**Citigroup**
**JP Morgan Chase**
**CIBC**
**Fidelity Investments**
**Goldman Sachs**
**Merrill Lynch**
**Deutsche Bank**
**Bank of Montreal**



# Banks should integrate ERM into Business Processes and Value Drivers




**Risk Management Impact**

- ✓ **1. Risk-based pricing**
- ✓ **2. Target customer selection**
- ✓ **3. Relationship management**
- ✓ **4. Risk oversight costs**
- ✓ **5. Insurance/hedging expense**
- ✓ **6. Credit, market operational write-offs**
- ✓ **7. Capital management**
- ✓ **8. Risk transparency**
- ✓ **9. New business development**
- ✓ **10. M&A/Diversification strategy**

✓ Risk Management by Silos (5, 6) → ✓ Integrated risk management (4–7) → ✓ Enterprise risk management (1-10)

# Basel III

– Basel III framework deals with capital framework and new buffers, leverage ratios, liquidity ratios, framework for dealing with failing banks, higher capital requirement for systemic banks
– Basel III will result in less available capital to cover higher RWA ( Risk Weighted Assets) requirements and more stringent minimum overage levels

# Conclusion

- Banks will have a different approach to ERM, but should understand each other's methods and terminology
- Each type of institution has various strengths that can benefit other industries
- Regulation can generate arbitrage opportunities, internationally or across industries