

**INTERNATIONAL AUDITING
PRACTICE STATEMENT 1006**

AUDITS OF THE FINANCIAL STATEMENTS OF BANKS

(This Statement is effective)

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International Auditing Practice Statement (IAPS) 1006, “Audits of the Financial Statements of Banks” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the application and authority of IAPSs.

This Statement has been prepared by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants. The IAPC bank audit sub-committee included observers from the Basel Committee on Banking Supervision (the Basel Committee).^{*} The document was approved for publication by the IAPC at its meeting in October 2001. It is based on ISAs extant at October 1, 2001.

^{*} The Basel Committee on Banking Supervision is a committee of banking and supervisory authorities that was established by the central bank governors of ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located.

Introduction

1. The purpose of this Statement is to provide practical assistance to auditors and to promote good practice in applying International Standards on Auditing (ISAs) to the audit of banks' financial statements. It is not, however, intended to be an exhaustive listing of the procedures and practices to be used in such an audit. In conducting an audit in accordance with ISAs the auditor complies with all the requirements of all the ISAs.
2. In many countries, banking supervisors require that the auditor report certain events to the regulators or make regular reports to them in addition to the audit report on the banks' financial statements. This Statement does not deal with such reports, the requirements for which often vary significantly between countries. IAPS 1004, "The Relationship Between Banking Supervisors and Bank's External Auditors" discusses that subject in more detail.
3. For the purpose of this Statement, a bank is a type of financial institution whose principal activity is the taking of deposits and borrowing for the purpose of lending and investing and that is recognized as a bank by the regulatory authorities in any countries in which it operates. There are a number of other types of entity that carry out similar functions, for example, building societies, credit unions, friendly societies, savings and loan associations and thrift institutions. The guidance in this Statement is applicable to audits of financial statements that cover the banking activities carried out by those entities. It also applies to the audits of consolidated financial statements that include the results of banking activities carried out by any group member. This Statement addresses the assertions made in respect of banking activities in the entity's financial statements and so indicates which assertions in a bank's financial statements cause particular difficulties and why they do so. This necessitates an approach based on the elements of the financial statements. However, when obtaining audit evidence to support the financial statement assertions, the auditor often carries out procedures based on the types of activities the entity carries out and the way in which those activities affect the financial statement assertions.
4. Banks commonly undertake a wide range of activities. However, most banks continue to have in common the basic activities of deposit taking, borrowing, lending, settlement, trading and treasury operations. This Statement's primary purpose is the provision of guidance on the audit implications of such activities. In addition, this Statement provides limited guidance in respect of securities underwriting and brokerage, and asset management, which are activities that auditors of banks' financial statements frequently encounter. Banks typically undertake activities involving derivative financial instruments. This Statement gives guidance on the audit implications of such activities when they are part of the bank's trading and treasury operations. IAPS 1012, "Auditing Derivative

Financial Instruments” gives guidance on such activities when the bank holds derivatives as an end user.

5. This Statement is intended to highlight those risks that are unique to banking activities. There are many audit-related matters that banks share with other commercial entities. The auditor is expected to have a sufficient understanding of such matters and so, although those matters may affect the audit approach or may have a material effect on the bank’s financial statements, this Statement does not discuss them. This Statement describes in general terms aspects of banking operations with which an auditor becomes familiar before undertaking the audit of a bank’s financial statements: it is not intended to describe banking operations. Consequently, this Statement on its own does not provide an auditor with sufficient background knowledge to undertake the audit of a bank’s financial statements. However, it does point out areas where that background knowledge is required. Auditors will supplement the guidance in this Statement with appropriate reference material and by reference to the work of experts as required.
6. Banks have the following characteristics that generally distinguish them from most other commercial enterprises:
 - They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
 - They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.
 - They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks’ vulnerability to adverse economic events and increases the risk of failure.
 - They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.
 - They generally derive a significant amount of their funding from short-term deposits (either insured or uninsured). A loss of confidence by depositors in a bank’s solvency may quickly result in a liquidity crisis.



- They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. They therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.
- They engage in a large volume and variety of transactions whose value may be significant. This ordinarily requires complex accounting and internal control systems and widespread use of information technology (IT).
- They ordinarily operate through networks of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions, with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).
- They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.
- They are regulated by governmental authorities, whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.
- Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.
- They generally have exclusive access to clearing and settlement systems for checks, fund transfers, foreign exchange transactions, etc.
- They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.
- They may issue and trade in complex financial instruments, some of which may need to be recorded at fair values in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models

selected, access to reliable current and historical market information, and the maintenance of data integrity.

7. Special audit considerations arise in the audits of banks because of matters such as the following:
 - The particular nature of the risks associated with the transactions undertaken by banks.
 - The scale of banking operations and the resultant significant exposures that may arise in a short period.
 - The extensive dependence on IT to process transactions.
 - The effect of the regulations in the various jurisdictions in which they operate.
 - The continuing development of new products and banking practices that may not be matched by the concurrent development of accounting principles or internal controls.
8. This Statement is organized into a discussion of the various aspects of the audit of a bank with emphasis being given to those matters that are either peculiar to, or of particular importance in, such an audit. Included for illustrative purposes are appendices that contain examples of:
 - (a) Typical warning signs of fraud in banking operations;
 - (b) Typical internal controls, tests of control and substantive audit procedures for two of the major operational areas of a bank: treasury and trading operations and lending activities;
 - (c) Financial ratios commonly used in the analysis of a bank's financial condition and performance; and
 - (d) Risks and issues in securities operations, private banking and asset management.

Audit Objectives

9. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" states:

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
10. The objective of the audit of a bank's financial statements conducted in accordance with ISAs is, therefore, to enable the auditor to express an opinion on the bank's financial statements, which are prepared in accordance with the applicable financial reporting framework.

11. The auditor's report indicates the financial reporting framework that has been used to prepare the bank's financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards). When reporting on financial statements of a bank prepared specifically for use in a country other than that under whose rules it is established, the auditor considers whether the financial statements contain appropriate disclosures about the financial reporting framework used. Paragraphs 101–103 of this Statement discuss the auditor's report in more detail.

Agreeing the Terms of the Engagement

12. As stated in ISA 210, "Terms of Audit Engagements":

The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

13. Paragraph 6 lists some of the characteristics that are unique to banks and indicates the areas where the auditor and assistants may require specialist skills. In considering the objective and scope of the audit and the extent of the responsibilities, the auditor considers his own skills and competence and those of his assistants to conduct the engagement. In doing so, the auditor considers the following factors:
- The need for sufficient expertise in the aspects of banking relevant to the audit of the bank's business activities.
 - The need for expertise in the context of the IT systems and communication networks the bank uses.
 - The adequacy of resources or inter-firm arrangements to carry out the work necessary at the number of domestic and international locations of the bank at which audit procedures may be required.
14. In addition to the general factors set out in ISA 210, the auditor considers including comments on the following when issuing an engagement letter:
- The use and source of specialized accounting principles, with particular reference to:
 - Any requirements contained in the law or regulations applicable to banks;
 - Pronouncements of the banking supervisory and other regulatory authorities;
 - Pronouncements of relevant professional accounting bodies, for example, the International Accounting Standards Board;

- Pronouncements of the Basel Committee on Banking Supervision; and
- Industry practice.
- The contents and form of the auditor's report on the financial statements and any special-purpose reports required from the auditor in addition to the report on the financial statements. This includes whether such reports refer to the application of regulatory or other special purpose accounting principles or describe procedures undertaken especially to meet regulatory requirements.
- The nature of any special communication requirements or protocols that may exist between the auditor and the banking supervisory and other regulatory authorities.
- The access that bank supervisors will be granted to the auditor's working papers when such access is required by law, and the bank's advance consent to this access.

Planning the Audit

Introduction

15. The audit plan includes, among other things:
- Obtaining a sufficient knowledge of the entity's business and governance structure, and a sufficient understanding of the accounting and internal control systems, including risk management and internal audit functions;
 - Considering the expected assessments of inherent and control risks, being the risk that material misstatements occur (inherent risk) and the risk that the bank's system of internal control does not prevent or detect and correct such misstatements on a timely basis (control risk);
 - Determining the nature, timing and extent of the audit procedures to be performed; and
 - Considering the going concern assumption regarding the entity's ability to continue in operation for the foreseeable future, which will be the period used by management in making its assessment under the financial reporting framework. This period will ordinarily be for a period of at least one year after the balance sheet date.

Obtaining a Knowledge of the Business

16. Obtaining a knowledge of the bank's business requires the auditor to understand:
- The bank's corporate governance structure;

- The economic and regulatory environment prevailing for the principal countries in which the bank operates; and
 - The market conditions existing in each of the significant sectors in which the bank operates.
17. Corporate governance plays a particularly important role in banks; many regulators set out requirements for banks to have effective corporate governance structures. Accordingly the auditor obtains an understanding of the bank's corporate governance structure and how those charged with governance discharge their responsibilities for the supervision, control and direction of the bank.
18. Similarly the auditor obtains and maintains a good working knowledge of the products and services offered by the bank. In obtaining and maintaining that knowledge, the auditor is aware of the many variations in the basic deposit, loan and treasury services that are offered and continue to be developed by banks in response to market conditions. The auditor obtains an understanding of the nature of services rendered through instruments such as letters of credit, acceptances, interest rate futures, forward and swap contracts, options and other similar instruments in order to understand the inherent risks and the auditing, accounting and disclosure implications thereof.
19. If the bank uses service organizations to provide core services or activities, such as cash and securities settlement, back office activities or internal audit services, the responsibility for compliance with rules and regulations and sound internal controls remains with those charged with governance and the management of the outsourcing bank. The auditor considers legal and regulatory restrictions, and obtains an understanding of how the management and those charged with governance monitor that the system of internal control (including internal audit) operates effectively. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" gives further guidance on this subject.
20. There are a number of risks associated with banking activities that, while not unique to banking, are important in that they serve to shape banking operations. The auditor obtains an understanding of the nature of these risks and how the bank manages them. This understanding allows the auditor to assess the levels of inherent and control risks associated with different aspects of a bank's operations and to determine the nature, timing and extent of the audit procedures.

Understanding the Nature of Banking Risks

21. The risks associated with banking activities may broadly be categorized as:

Country risk:	The risk of foreign customers and counterparties failing to settle their obligations because of economic, political and social factors of the counterparty's home country and external to the customer or counterparty.
Credit risk:	The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. Credit risk, particularly from commercial lending, may be considered the most important risk in banking operations. Credit risk arises from lending to individuals, companies, banks and governments. It also exists in assets other than loans, such as investments, balances due from other banks and in off-balance sheet commitments. Credit risk also includes country risk, transfer risk, replacement risk and settlement risk.
Currency risk:	The risk of loss arising from future movements in the exchange rates applicable to foreign currency assets, liabilities, rights and obligations.
Fiduciary risk:	The risk of loss arising from factors such as failure to maintain safe custody or negligence in the management of assets on behalf of other parties.
Interest rate risk:	The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.
Legal and documentary risk:	The risk that contracts are documented incorrectly or are not legally enforceable in the relevant jurisdiction in which the contracts are to be enforced or where the counterparties operate. This can include the risk that assets will turn out to be worth less or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and many or all other banks; and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transactions and when the legal right

	of a counterparty to enter into a transaction is not established.
Liquidity risk:	The risk of loss arising from the changes in the bank's ability to sell or dispose of an asset.
Modeling risk:	The risk associated with the imperfections and subjectivity of valuation models used to determine the values of assets or liabilities.
Operational risk:	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
Price risk:	The risk of loss arising from adverse changes in market prices, including interest rates, foreign exchange rates, equity and commodity prices and from movements in the market prices of investments.
Regulatory risk:	The risk of loss arising from failure to comply with regulatory or legal requirements in the relevant jurisdiction in which the bank operates. It also includes any loss that could arise from changes in regulatory requirements.
Replacement risk:	(Sometimes called performance risk) The risk of failure of a customer or counterparty to perform the terms of a contract. This failure creates the need to replace the failed transaction with another at the current market price. This may result in a loss to the bank equivalent to the difference between the contract price and the current market price.
Reputational risk:	The risk of losing business because of negative public opinion and consequential damage to the bank's reputation arising from failure to properly manage some of the above risks, or from involvement in improper or illegal activities by the bank or its senior management, such as money laundering or attempts to cover up losses.
Settlement risk:	The risk that one side of a transaction will be settled without value being received from the customer or counterparty. This will generally result in the loss to the bank of the full principal amount.
Solvency risk:	The risk of loss arising from the possibility of the bank not having sufficient funds to meet its obligations, or from the bank's inability to access capital markets to raise required funds.

Transfer risk: The risk of loss arising when a counterparty's obligation is not denominated in the counterparty's home currency. The counterparty may be unable to obtain the currency of the obligation irrespective of the counterparty's particular financial condition.

22. Banking risks increase with the degree of concentration of a bank's exposure to any one customer, industry, geographic area or country. For example, a bank's loan portfolio may have large concentrations of loans or commitments to particular industries, and some, such as real estate, shipping and natural resources, may have highly specialized practices. Assessing the relevant risks relating to loans to entities in those industries may require a knowledge of these industries, including their business, operational and reporting practices.
23. Most transactions involve more than one of the risks identified above. Furthermore, the individual risks set out above may be correlated with one another. For example, a bank's credit exposure in a securities transaction may increase as a result of an increase in the market price of the securities concerned. Similarly, non-payment or settlement failure can have consequences for a bank's liquidity position. The auditor therefore considers these and other risk correlations when analyzing the risks to which a bank is exposed.
24. Banks may be subject to risks arising from the nature of their ownership. For example, a bank's owner or a group of owners might try to influence the allocation of credit. In a closely held bank, the owners may have significant influence on the bank's management affecting their independence and judgment. The auditor considers such risks.
25. In addition to understanding the external factors that could indicate increased risk, the auditor considers the nature of risks arising from the bank's operations. Factors that contribute significantly to operational risk include the following:
 - (a) The need to process high volumes of transactions accurately within a short time. This need is almost always met through the large-scale use of IT, with the resultant risks of:
 - (i) Failure to carry out executed transactions within the required time, causing an inability to receive or make payments for those transactions;
 - (ii) Failure to carry out complex transactions properly;
 - (iii) Wide-scale misstatements arising from a breakdown in internal control;
 - (iv) Loss of data arising from systems' failure;
 - (v) Corruption of data arising from unauthorized interference with the systems; and

- (vi) Exposure to market risks arising from lack of reliable up-to-date information.
 - (b) The need to use electronic funds transfer (EFT) or other telecommunications systems to transfer ownership of large sums of money, with the resultant risk of exposure to loss arising from payments to incorrect parties through fraud or error.
 - (c) The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls. As a result:
 - (i) There is a risk that the bank's worldwide exposure by customer and by product may not be adequately aggregated and monitored; and
 - (ii) Control breakdowns may occur and remain undetected or uncorrected because of the physical separation between management and those who handle the transactions.
 - (d) The need to monitor and manage significant exposures that can arise over short time-frames. The process of clearing transactions may cause a significant build-up of receivables and payables during a day, most of which are settled by the end of the day. This is ordinarily referred to as intra-day payment risk. These exposures arise from transactions with customers and counterparties and may include interest rate, currency and market risks.
 - (e) The handling of large volumes of monetary items, including cash, negotiable instruments and transferable customer balances, with the resultant risk of loss arising from theft and fraud by employees or other parties.
 - (f) The inherent complexity and volatility of the environment in which banks operate, resulting in the risk of inappropriate risk management strategies or accounting treatments in relation to such matters as the development of new products and services.
 - (g) Operating restrictions may be imposed as a result of the failure to adhere to laws and regulations. Overseas operations are subject to the laws and regulations of the countries in which they are based as well as those of the country in which the parent entity has its headquarters. This may result in the need to adhere to differing requirements and a risk that operating procedures that comply with regulations in some jurisdictions do not meet the requirements of others.
26. Fraudulent activities may take place within a bank by, or with the knowing involvement of, management or personnel of the bank. Such frauds may include fraudulent financial reporting without the motive of personal gain, (for example, to conceal trading losses), or the misappropriation of the

bank's assets for personal gain that may or may not involve the falsification of records. Alternatively, fraud may be perpetrated on a bank without the knowledge or complicity of the bank's employees. ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements"¹ gives more guidance on the nature of the auditor's responsibilities with respect to fraud. Although many areas of a bank's operations are susceptible to fraudulent activities, the most common take place in the lending, deposit-taking and dealing functions. The methods commonly used to perpetrate fraud and a selection of the fraud risk factors that indicate that a fraud may have occurred are set out in Appendix 1.

27. By the nature of their business, banks are ready targets for those engaged in money laundering activities by which the proceeds of crime are converted into funds that appear to have a legitimate source. In recent years drug traffickers in particular have greatly added to the scale of money laundering that takes place within the banking industry. In many jurisdictions, legislation requires banks to establish policies, procedures and controls to deter and to recognize and report money laundering activities. These policies, procedures and controls commonly extend to the following:

- A requirement to obtain customer identification (know your client).
- Staff screening.
- A requirement to know the purpose for which an account is to be used.
- The maintenance of transaction records.
- The reporting to the authorities of suspicious transactions or of all transactions of a particular type, for example, cash transactions over a certain amount.
- The education of staff to assist them in identifying suspicious transactions.

In some jurisdictions, auditors may have an express obligation to report to the authorities certain types of transactions that come to their attention. Even where no such obligation exists, an auditor who discovers a possible instance of noncompliance with laws or regulations considers the implications for the financial statements and the audit opinion thereon. ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" gives further guidance on this matter.

¹ ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" was withdrawn in December 2004 when the revised ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" became effective.

Understanding the Risk Management Process

28. Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- Oversight and involvement in the control process by those charged with governance

Those charged with governance should approve written risk management policies. The policies should be consistent with the bank's business strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable. Those charged with governance are also responsible for establishing a culture within the bank that emphasizes their commitment to internal controls and high ethical standards, and often establish special committees to help discharge their functions. Management is responsible for implementing the strategies and policies set by those charged with governance and for ensuring that an adequate and effective system of internal control is established and maintained.

- Identification, measurement and monitoring of risks

Risks that could significantly impact the achievement of the bank's goals should be identified, measured and monitored against pre-approved limits and criteria. This function may be conducted by an independent risk management unit, which is also responsible for validating and stress testing the pricing and valuation models used by the front and back offices. Banks ordinarily have a risk management unit that monitors risk management activities and evaluates the effectiveness of risk management models, methodologies and assumptions used. In such situations, the auditor considers whether and how to use the work of that unit.

- Control activities

A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliations of positions and results, setting of limits, reporting and approval of exceptions to limits, physical security and contingency planning.

- Monitoring activities

Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by an independent risk management unit. Internal auditing should test the risk management process

periodically to check whether management policies and procedures are complied with and whether the operational controls are effective. Both the risk management unit and internal auditing should have a reporting line to those charged with governance and management that is independent of those on whom they are reporting.

- **Reliable information systems**

Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Development of an Overall Audit Plan

29. In developing an overall plan for the audit of the financial statements of a bank, the auditor gives particular attention to:

- The complexity of the transactions undertaken by the bank and the documentation in respect thereof;
- The extent to which any core activities are provided by service organizations;
- Contingent liabilities and off-balance sheet items;
- Regulatory considerations;
- The extent of IT and other systems used by the bank;
- The expected assessments of inherent and control risks;
- The work of internal auditing;
- The assessment of audit risk;
- The assessment of materiality;
- Management's representations;
- The involvement of other auditors;
- The geographic spread of the bank's operations and the co-ordination of work between different audit teams;
- The existence of related party transactions; and
- Going concern considerations.

These matters are discussed in subsequent paragraphs.

The Complexity of Transactions Undertaken

30. Banks typically have a wide diversity of activities, which means that it is sometimes difficult for an auditor to fully understand the implications of particular transactions. The transactions may be so complex that management itself fails to analyze properly the risks of new products and services. The wide geographic spread of a bank's activities can also lead to difficulties. Banks undertake transactions that have complex and important underlying features that may not be apparent from the documentation that is used to process the transactions and to enter them into the bank's accounting records. This results in the risk that all aspects of a transaction may not be fully or correctly recorded or accounted for, with the resultant risks of:
- Loss due to the failure to take timely corrective action;
 - Failure to make adequate provisions for loss on a timely basis; and
 - Inadequate or improper disclosure in the financial statements and other reports.

The auditor obtains an understanding of the bank's activities and the transactions it undertakes sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.

31. Many of the amounts to be recorded or disclosures made in the financial statements involve the exercise of judgment by management, for example, loan loss provisions, and provisions against financial instruments such as liquidity risk provision, modeling risk provision and reserve for operational risk. The greater the judgment required, the greater the inherent risk and the greater the professional judgment required by the auditor. Similarly, there may be other significant items in the financial statements that involve accounting estimates. The auditor considers the guidance set out in ISA 540, "Audit of Accounting Estimates."

The Extent to which any Core Activities are Provided by Service Organizations

32. In principle, the considerations when a bank uses service organizations are no different from the considerations when any other entity uses them. However, banks sometimes use service organizations to perform parts of their core activities, such as credit and cash management. When the bank uses service organizations for such activities, the auditor may find it difficult to obtain sufficient appropriate audit evidence without the cooperation of the service organization. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" provides further guidance on the auditing considerations and the types of reports that auditors of service organizations provide to the organization's clients.

Contingent Liabilities and Off-balance Sheet Items

33. Banks also typically engage in transactions that:
- Have a low fee revenue or profit element as a percentage of the underlying asset or liability;
 - Local regulations may not require to be disclosed in the balance sheet, or even in the notes to the financial statements;
 - Are recorded only in memorandum accounts; or
 - Involve securitizing and selling assets so that they no longer appear in the bank's financial statements.

Examples of such transactions are safe custody services, guarantees, comfort letters and letters of credit, interest rate and currency swaps and commitments and options to purchase and sell foreign exchange.

34. The auditor reviews the bank's sources of revenue, and obtains sufficient appropriate audit evidence regarding the following:
- (a) The accuracy and completeness of the accounting records relating to such transactions.
 - (b) The existence of proper controls to limit the banking risks arising from such transactions.
 - (c) The adequacy of any provisions for loss which may be required.
 - (d) The adequacy of any financial statement disclosures which may be required.

Regulatory Considerations

35. The International Auditing Practices Statement 1004 provides information and guidance on the relationship between bank auditors and banking supervisors. The Basel Committee has issued supervisory guidance regarding sound banking practices for managing risks, internal control systems, loan accounting and disclosure, other disclosures and for other areas of bank activities. In addition, the Basel Committee has issued guidance on the assessment of capital adequacy and other important supervision topics. This guidance is available to the auditor and to the public on the internet website of the Bank for International Settlements (BIS).
36. In accordance with ISA 310, "Knowledge of the Business"² the auditor considers whether the assertions in the financial statements are consistent with

² ISA 310, "Knowledge of the Business" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" became effective.

the auditor's knowledge of the business. In many regulatory frameworks, the level and types of business a bank is allowed to undertake depend upon the level of its assets and liabilities and the types and perceived risks attached to those assets and liabilities (a risk-weighted capital framework). In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorizing assets and liabilities or by describing them as being less risky than they actually are, particularly when the bank is operating at, or close to, the minimum required capital levels.

37. There are many procedures that both auditors and bank supervisors perform, including:
- The performance of analytical procedures;
 - Obtaining evidence regarding the operation of the internal control system; and
 - The review of the quality of a bank's assets and the assessment of banking risks.

The auditor therefore finds it advantageous to interact with the supervisors and to have access to communications that the supervisors may have addressed to the bank management on the results of their work. The assessment made by the supervisors in important areas such as the adequacy of risk management practices and provisions for loan losses, and the prudential ratios used by the supervisors can be of assistance to the auditor in performing analytical procedures and in focusing attention on specific areas of supervisory concern.

The Extent of IT and Other Systems

38. The high volume of transactions and the short times in which they must be processed typically result in most banks making extensive use of IT, EFT and other telecommunications systems.

The control concerns arising from the use of IT by a bank are similar to those arising when IT is used by other organizations. However, the matters that are of particular concern to the auditor of a bank include the following:

- The use of IT to calculate and record substantially all of the interest income and interest expense, which are ordinarily two of the most important elements in the determination of a bank's earnings.
- The use of IT and telecommunications systems to determine the foreign exchange security and derivative trading positions, and to calculate and record the gains and losses arising from them.
- The extensive, and in some cases almost total, dependence on the records produced by IT because they represent the only readily

accessible source of detailed up-to-date information on the bank's assets and liability positions, such as customer loan and deposit balances.

- The use of complex valuation models incorporated in the IT systems.
- The models used to value assets and the data used by those models are often kept in spreadsheets prepared by individuals on personal computers not linked to the bank's main IT systems and not subject to the same controls as applications on those systems. IAPS 1001, "IT Environments—Stand-Alone Personal Computers"³ provides guidance to auditors in respect of these applications.
- The use of different IT systems resulting in the risk of loss of audit trail and incompatibility of different systems.

EFT systems are used by banks both internally (for example, for transfers between branches and between automated banking machines and the computerized files that record account activity) and externally between the bank and other financial institutions (for example, through the SWIFT network) and also between the bank and its customers through the internet or other electronic commerce media.

39. The auditor obtains an understanding of the core IT, EFT and telecommunication applications and the links between those applications. The auditor relates this understanding to the major business processes or balance sheet positions in order to identify the risk factors for the organization and therefore for the audit. In addition, it is important to identify the extent of the use of self-developed applications or integrated systems, which will have a direct effect on the audit approach. (Self-developed systems require the auditor to focus more extensively on the program change controls.)
40. When auditing in a distributed IT environment, the auditor obtains an understanding of where the core IT applications are located. If the bank's wide area network (WAN) is dispersed over several countries, specific legislative rules might apply to cross-border data processing. In such an environment, audit work on the access control system, especially on the access violation system, is an important part of the audit.
41. An electronic commerce environment changes significantly the way the bank conducts its business. Electronic commerce presents new aspects of risk and other considerations that the auditor addresses. For example, the auditor considers the following:
- The business risks the bank's e-commerce strategy presents.
 - The risks inherent in the technology the bank has chosen to implement its electronic commerce strategy.

³ IAPS 1001, "IT Environments—Stand-Alone Personal Computers" was withdrawn in December 2004.

- Management's responses to the risks identified, including control considerations regarding:
 - Compliance with legal and regulatory requirements in respect of cross-border transactions;
 - The security and privacy of transmissions across the Internet; and
 - The completion, accuracy, timeliness and authorization of Internet transactions as they are recorded in the bank's accounting system.
- The level of IT and electronic commerce skill and competence the auditor and assistants possess.

42. An organization may outsource IT or EFT related activities to an external service provider. The auditor gains an understanding of the outsourced services and the system of internal controls within the outsourcing bank and the vendor of the services, in order to determine the nature, extent and timing of substantive procedures. ISA 402 gives further guidance on this subject.

Expected Assessment of Inherent and Control Risks

43. The nature of banking operations is such that the auditor may not be able to reduce audit risk to an acceptably low level by the performance of substantive procedures alone. This is because of factors such as the following:
- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the entity's own IT systems.
 - The high volume of transactions entered into by banks, which makes reliance on substantive procedures alone impracticable.
 - The geographic dispersion of banks' operations, which makes obtaining sufficient coverage extremely difficult.
 - The difficulty in devising effective substantive procedures to audit complex trading transactions.

In most situations the auditor will not be able to reduce audit risk to an acceptably low level unless management has instituted an internal control system that allows the auditor to be able to assess the level of inherent and control risks as less than high. The auditor obtains sufficient appropriate audit evidence to support the assessment of inherent and control risks. Paragraphs 56–70 discuss matters relating to internal control in more detail.

The Work of Internal Auditing

44. The scope and objectives of internal auditing may vary widely depending upon the size and structure of the bank and the requirements of management and those charged with governance. However, the role of internal auditing ordinarily includes the review of the accounting system and related internal controls, monitoring their operation and recommending improvements to them. It also generally includes a review of the means used to identify, measure and report financial and operating information and specific inquiry into individual items including detailed testing of transactions, balances and procedures. The factors referred to in paragraph 44 also often lead the auditor to use the work of internal auditing. This is especially relevant in the case of banks that have a large geographic dispersion of branches. Often, as a part of the internal audit department or as a separate component, a bank has a loan review department that reports to management on the quality of loans and the adherence to established procedures in respect thereof. In either case, the auditor often considers making use of the work of the loan review department after an appropriate review of the department and its work. Guidance on the use of the work of internal auditing is provided in ISA 610, “Considering the Work of Internal Auditing.”

Audit Risk

45. The three components of audit risk are:
- (a) Inherent risk (the risk that material misstatements occur);
 - (b) Control risk (the risk that the bank’s system of internal control does not prevent or detect and correct such misstatements on a timely basis); and
 - (c) Detection risk (the risk that the auditor will not detect any remaining material misstatements).

Inherent and control risks exist independently of the audit of financial information and the auditor cannot influence them. The nature of risks associated with banking activities, which are discussed in paragraphs 21–25 indicate that the assessed level of inherent risk in many areas will be high. It is therefore necessary for a bank to have an adequate system of internal control if the levels of inherent and control risks are to be less than high. The auditor assesses these risks and designs substantive procedures so as to reduce audit risk to an acceptably low level.

Materiality

46. In making an assessment of materiality, in addition to the considerations set out in ISA 320, “Audit Materiality,” the auditor considers the following factors:



- Because of high leverage, relatively small misstatements may have a significant effect on the results for the period and on capital, even though they may have an insignificant effect on total assets.
- A bank's earnings are low when compared to its total assets and liabilities and its off-balance sheet commitments. Therefore, misstatements that relate only to assets, liabilities and commitments may be less significant than those that may also relate to the statement of earnings.
- Banks are often subject to regulatory requirements, such as the requirement to maintain minimum levels of capital. A breach of these requirements could call into question the appropriateness of management's use of the going concern assumption. The auditor therefore establishes a materiality level so as to identify misstatements that, if uncorrected, would result in a significant contravention of such regulatory requirements.
- The appropriateness of the going concern assumption often depends upon matters related to the bank's reputation as a sound financial institution and actions by regulators. Because of this, related party transactions and other matters that would not be material to entities other than banks may become material to a bank's financial statements if they might affect the bank's reputation or actions by regulators.

Management's Representations

47. Management's representations are relevant in the context of a bank audit to assist the auditor in determining whether the information and evidence obtained is complete for the purposes of the audit. This is particularly true of the bank's transactions that may not ordinarily be reflected in the financial statements (off-balance sheet items), but which may be evidenced by other records of which the auditor may not be aware. It is often also necessary for the auditor to obtain from management representations regarding significant changes in the bank's business and its risk profile. It may also be necessary for the auditor to identify areas of a bank's operations where audit evidence likely to be obtained may need to be supplemented by management's representations, for example, loan loss provisions and the completeness of correspondence with regulators. ISA 580, "Management Representations" provides guidance as to the use of management representations as audit evidence, the procedures that the auditor applies in evaluating and documenting them, and the circumstances in which representations should be obtained in writing.

Involvement of Other Auditors

48. As a result of the wide geographic dispersion of offices in most banks, it is often necessary for the auditor to use the work of other auditors in many of the

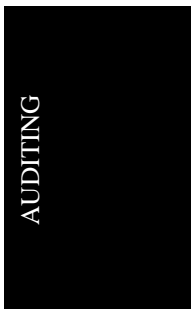
locations in which the bank operates. This may be achieved by using other offices of the auditor's firm or by using other auditing firms in those locations.

49. Before using the work of another auditor, the auditor:
- Considers the independence of those auditors and their competence to undertake the necessary work (including their knowledge of banking and applicable regulatory requirements);
 - Considers whether the terms of the engagement, the accounting principles to be applied and the reporting arrangements are clearly communicated; and
 - Performs procedures to obtain sufficient appropriate audit evidence that the work performed by the other auditor is adequate for this purpose by discussion with the other auditor, by a review of a written summary of the procedures applied and findings, by a review of the working papers of the other auditor, or in any other manner appropriate to the circumstances.

ISA 600, "Using the Work of Another Auditor" provides further guidance on the issues to be addressed and procedures to be performed in such situations.

Coordinating the Work to be Performed

50. Given the size and geographic dispersion of most banks, co-coordinating the work to be performed is important to achieve an efficient and effective audit. The co-ordination required takes into account factors such as the following:
- The work to be performed by:
 - Experts;
 - Assistants;
 - Other offices of the auditor's firm; and
 - Other audit firms.
 - The extent to which it is planned to use the work of internal auditing.
 - Required reporting dates to shareholders and the regulatory authorities.
 - Any special analyses and other documentation to be provided by bank management.
51. The best level of co-ordination between assistants can often be achieved by regular audit-status meetings. However, given the number of assistants and the number of locations at which they will be involved, the auditor ordinarily communicates all or relevant portions of the audit plan in writing. When setting



out the requirements in writing, the auditor considers including commentary on the following matters:

- The financial statements and other information that are to be audited (and if considered necessary, the legal or other mandate for the audit).
- Details of any additional information requested by the auditor, for example, information on certain loans, portfolio composition, narrative commentary on the audit work to be performed (especially on the areas of risk described in paragraphs 21–25 which are important to the bank) and on the results of the audit work, potential points for inclusion in letters to management on internal control, local regulatory concerns, and if relevant, the forms of any required reports.
- That the audit is to be conducted in accordance with ISAs and any local regulatory requirements (and, if considered necessary, information on those requirements).
- The relevant accounting principles to be followed in the preparation of the financial statements and other information (and, if considered necessary, the details of those principles).
- Interim audit status reporting requirements and deadlines.
- Particulars of the entity’s officials to be contacted.
- Fee and billing arrangements.
- Any other concerns of a regulatory, internal control, accounting or audit nature of which those conducting the audit should be aware.

Related Party Transactions

52. The auditor remains alert for related party transactions during the course of the audit, particularly in the lending and investment areas. Procedures performed during the planning phase of the audit, including obtaining an understanding of the bank and the banking industry, may be helpful in identifying related parties. In some jurisdictions, related party transactions may be subject to quantitative or qualitative restrictions. The auditor determines the extent of any such restrictions.

Going Concern Considerations

53. ISA 570, “Going Concern” provides guidance as to the auditor’s consideration of the appropriateness of management’s use of the going concern assumption. In addition to matters identified in that ISA, events or conditions such as the following may also cast significant doubt on the bank’s ability to continue as a going concern:

- Rapid increases in levels of trading in derivatives. This may indicate that the bank is carrying out trading activities without the necessary controls in place.
- Profitability performance or forecasts that suggest a serious decline in profitability, particularly if the bank is at or near its minimum regulatory capital or liquidity levels.
- Rates of interest being paid on money market and depositor liabilities that are higher than normal market rates. This may indicate that the bank is viewed as a higher risk.
- Significant decreases in deposits from other banks or other forms of short term money market funding. This may indicate that other market participants lack confidence in the bank.
- Actions taken or threatened by regulators that may have an adverse effect on the bank's ability to continue as a going concern.
- Increased amounts due to central banks, which may indicate that the bank was unable to obtain liquidity from normal market sources.
- High concentrations of exposures to borrowers or to sources of funding.

54. ISA 570 also provides guidance to auditors when an event or condition that may cast significant doubt on the bank's ability to continue as a going concern has been identified. The ISA indicates a number of procedures that may be relevant, and in addition to those, the following procedures may also be relevant:

- Reviewing correspondence with regulators.
- Reviewing reports issued by regulators as a result of regulatory inspections.
- Discussing the results of any inspections currently in process.

55. The regulatory regime under which the bank operates may require the auditor to disclose to the regulator any intention to issue a modified opinion or any concerns that the auditor may have about the bank's ability to continue as a going concern. IAPS 1004 provides further discussion of the relationship between the auditor and the banking supervisor.

Internal Control

Introduction

56. The Basel Committee on Banking Supervision has issued a policy paper, "Framework for Internal Control Systems in Banking Organisations" (September 1998), which provides banking supervisors with a framework for evaluating banks' internal control systems. This framework is used by many banking supervisors, and may be used during supervisory discussions

with individual banking organizations. Auditors of banks' financial statements may find a knowledge of this framework useful in understanding the various elements of a bank's internal control system.

57. Management's responsibilities include the maintenance of an adequate accounting system and internal control system, the selection and application of accounting policies, and the safeguarding of the assets of the entity.

The auditor obtains an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. After obtaining the understanding, the auditor considers the assessment of inherent and control risks so as to determine the appropriate detection risk to accept for the financial statement assertions and to determine the nature, timing and extent of substantive procedures for such assertions.

Where the auditor assesses control risk at less than high, substantive procedures are ordinarily less extensive than are otherwise required and may also differ in their nature and timing.

Identifying, Documenting and Testing Control Procedures

58. ISA 400, "Risk Assessments and Internal Control"⁴ indicates that internal controls relating to the accounting system are concerned with achieving objectives such as the following:

- Transactions are executed in accordance with management's general or specific authorization (paragraphs 59–61).
- All transactions and other events are promptly recorded at the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable financial reporting framework (paragraphs 62 and 63).
- Access to assets is permitted only in accordance with management's authorization (paragraphs 64 and 65).
- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences (paragraphs 66 and 67).

The audit considerations in relation to each of these objectives are discussed in the subsequent paragraphs.

In the case of banks, a further objective of internal controls is to ensure that the bank adequately fulfills its regulatory and fiduciary responsibilities arising out of its trustee activities. The auditor is not directly concerned with these

⁴ ISA 400, "Risk Assessments and Internal Control" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

objectives except to the extent that any failure to comply with such responsibilities might have led to the financial statements being material misstated.

Transactions are Executed in Accordance with Management's General or Specific Authorization

59. The overall responsibility for the system of internal control in a bank rests with those charged with governance, who are responsible for governing the bank's operations. However, since banks' operations are generally large and dispersed, decision-making functions need to be decentralized and the authority to commit the bank to material transactions is ordinarily dispersed and delegated among the various levels of management and staff. Such dispersion and delegation will almost always be found in the lending, treasury and funds transfer functions, where, for example, payment instructions are sent via a secure message. This feature of banking operations creates the need for a structured system of delegation of authority, resulting in the formal identification and documentation of:
- (a) Those who may authorize specific transactions;
 - (b) Procedures to be followed in granting that authorization; and
 - (c) Limits on the amounts that can be authorized, by individual employee or by staff level, as well as any requirements that may exist for concurring authorization.

Those charged with governance also need to ensure that appropriate procedures exist for monitoring the level of exposures. This will ordinarily involve the aggregation of exposures, not only within, but also across, the different activities, departments and branches of the bank.

60. An examination of the authorization controls will be important to the auditor in considering whether transactions have been entered into in accordance with the bank's policies and, for example, in the case of the lending function, that they have been subject to appropriate credit assessment procedures prior to the disbursement of funds. The auditor will typically find that limits for levels of exposures exist in respect of various transaction types. When performing tests of controls, the auditor considers whether these limits are being adhered to and whether positions in excess of these limits are reported to the appropriate level of management on a timely basis.
61. From an audit perspective, the proper functioning of a bank's authorization controls is particularly important in respect of transactions entered into at or near the date of the financial statements. This is because aspects of the transaction have yet to be fulfilled, or there may be a lack of evidence with which to assess the value of the asset acquired or liability incurred. Examples of such transactions are commitments to purchase or sell specific



securities after the period-end and loans, where principal and interest payments from the borrower have yet to be made.

All Transactions and Other Events are Promptly Recorded at the Correct Amount, in the Appropriate Accounts and in the Proper Accounting Period so as to Permit Preparation of Financial Statements in Accordance with the Applicable Financial Reporting Framework

62. In considering the internal controls that management use to ensure that all transactions and other events are properly recorded, the auditor takes into account a number of factors that are especially important in a banking environment. These include the following:
- Banks deal in large volumes of transactions that can individually or cumulatively involve large sums of money. Accordingly, the bank needs to have balancing and reconciliation procedures that are carried out within a time-frame that allows the detection of errors and discrepancies so that they can be investigated and corrected with minimal loss to the bank. Such procedures may be carried out hourly, daily, weekly, or monthly, depending on the volume and nature of the transaction, level of risk, and transactions settlement time-frame. The purpose of these reconciliations is often to ensure the completeness of transaction processing across highly complex integrated IT systems and the reconciliations themselves are normally automatically generated by these systems.
 - Many of the transactions entered into by banks are subject to specialized accounting rules. Banks should have control procedures in place to ensure those rules are applied in the preparation of appropriate financial information for management and external reporting. Examples of such control procedures are those that result in the market revaluation of foreign exchange and security purchase and sale commitments so as to ensure that all unrealized profits and losses are recorded.
 - Some of the transactions entered into by banks may not be required to be disclosed in the financial statements (for example, transactions that the accounting framework allows to be regarded as off balance sheet items). Accordingly, control procedures must be in place to ensure that such transactions are recorded and monitored in a manner that provides management with the required degree of control over them and that allows for the prompt determination of any change in their status that needs to result in the recording of a profit or loss.
 - Banks are constantly developing new financial products and services. The auditor considers whether the necessary revisions are made in accounting procedures and related internal controls.

- End of day balances may reflect the volume of transactions processed through the systems or of the maximum exposure to loss during the course of a business day. This is particularly relevant in executing and processing foreign exchange and securities transactions. The assessment of controls in these areas takes into account the ability to maintain control during the period of maximum volumes or maximum financial exposure.
- The majority of banking transactions must be recorded in a manner that is capable of being verified both internally and by the bank's customers and counterparties. The level of detail to be recorded and maintained on individual transactions must allow the bank's management, transaction counterparties, and customers to verify the accuracy of the amounts and terms. An example of such a control is the continuous verification of foreign exchange trade tickets by having an employee not involved in the transaction match the tickets to incoming confirmations from counterparties.

63. The extensive use of IT and EFT systems has a significant effect on how the auditor evaluates a bank's accounting system and related internal controls. ISA 400, ISA 401, "Auditing in a Computer Information Systems Environment," and IAPS 1008, "Risk Assessments and Internal Control—CIS Characteristics and Considerations,"⁵ provide guidance on the IT aspects of such an evaluation, as do other IAPSs dealing with information technology. The audit procedures include an assessment of those controls that affect system development and modifications, system access and data entry, the security of communications networks, and contingency planning. Similar considerations apply to EFT operations within the bank. To the extent that EFT and other transaction systems are external to the bank, the auditor gives additional emphasis to the assessment of the integrity of pre-transaction supervisory controls and post-transaction confirmation and reconciliation procedures. Reports from the auditors of service organizations may be of use here, and ISA 402 gives guidance on the auditor's consideration of such reports.

Access to Assets is Permitted Only in Accordance with Management's Authorization

64. A bank's assets are often readily transferable, of high value and in a form that cannot be safeguarded solely by physical procedures. In order to ensure that access to assets is permitted only in accordance with management's authorization, a bank generally uses controls such as the following:

⁵ ISA 400, "Risk Assessments and Internal Control," ISA 401, "Auditing in a Computer Information Systems Environment," and IAPS 1008, "Risk Assessments and Internal Control—CIS Characteristics and Considerations" were withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

- Passwords and joint access arrangements to limit IT and EFT system access to authorized employees.
- Segregation of the record-keeping and custody functions (including the use of computer generated transaction confirmation reports available immediately and only to the employee in charge of the record-keeping functions).
- Frequent third-party confirmation and reconciliation of asset positions by an independent employee.

65. The auditor considers whether each of these controls is operating effectively. However, given the materiality and transferability of the amounts involved, the auditor also ordinarily reviews the confirmation and reconciliation procedures that occur in connection with the preparation of the year-end financial statements and may carry out confirmation procedures himself.

Recorded Assets are Compared with the Existing Assets at Reasonable Intervals and Appropriate Action is Taken Regarding Any Differences

66. The large amounts of assets handled by banks, the volumes of transactions undertaken, the potential for changes in the value of those assets due to fluctuations in market prices and the importance of confirming the continued operation of access and authorization controls necessitates the frequent operation of reconciliation controls. This is particularly important for:

- (a) Assets in negotiable form, such as cash, bearer securities and assets in the form of deposit and security positions with other institutions where failure to detect errors and discrepancies quickly (which may mean daily where money market transactions are involved) could lead to an irrecoverable loss: reconciliation procedures used to achieve this control objective will ordinarily be based on physical counting and third party confirmation;
- (b) Assets whose value is determined with reference to valuation models or external market prices, such as securities and foreign exchange contracts; and
- (c) Assets held on behalf of clients.

67. In designing an audit plan to assess the effectiveness of a bank's reconciliation controls, the auditor considers factors such as the following.

- Because of the number of accounts requiring reconciliation and the frequency with which these reconciliations need to be performed:
 - Much of the audit effort is directed to the documentation, testing and evaluation of the reconciliation controls; and

- The work of the internal auditor will also be similarly directed. The auditor therefore can ordinarily use the work of internal auditing.
- Since reconciliations are cumulative in their effect, most reconciliations can be satisfactorily audited at the year-end date, assuming that they are prepared as of that date, soon enough for the auditor to use and that the auditor is satisfied that the reconciliation control procedures are effective.
- In examining a reconciliation, the auditor considers whether items have not been improperly transferred to other accounts that are not subject to reconciliation and investigation at the same time.

Examples of Controls

68. Appendix 2 to this Statement contains examples of controls over authorization, recording, access and reconciliation ordinarily found in the treasury and trading and lending operations of a bank.

Inherent Limitations of Internal Control

69. ISA 400⁶ describes the procedures to be followed by the auditor in identifying, documenting and testing internal controls. In doing so, the auditor is aware of the inherent limitations of internal control. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Irrespective of the assessed levels of inherent and control risks, the auditor performs some substantive procedures for material account balances and classes of transactions.

Considering the Influence of Environmental Factors

70. In assessing the effectiveness of specific control procedures, the auditor considers the environment in which internal control operates. Some of the factors that may be considered include the following:
- The organizational structure of the bank and the manner in which it provides for the delegation of authority and responsibilities.
 - The quality of management supervision.
 - The extent and effectiveness of internal auditing.
 - The extent and effectiveness of the risk management and compliance systems
 - The skills, competence and integrity of key personnel.
 - The nature and extent of inspection by supervisory authorities.

⁶ See footnote 4.

Performing Substantive Procedures

Introduction

71. As a result of the assessment of the level of inherent and control risks, the auditor determines the nature, timing and extent of the substantive tests to be performed on individual account balances and classes of transactions. In designing these substantive tests, the auditor considers the risks and factors that served to shape the bank's systems of internal control. In addition, there are a number of audit considerations significant to these risk areas to which the auditor directs attention. These are discussed in subsequent paragraphs.
72. ISA 500, "Audit Evidence"⁷ lists the assertions embodied in the financial statements as: existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure.

Tests of the completeness assertion are particularly important in the audit of bank's financial statements particularly in respect of liabilities. Much of the audit work on liabilities of other commercial entities can be carried out by substantive procedures on a reciprocal population. Banking transactions do not have the same type of regular trading cycle, and reciprocal populations are not always immediately in evidence. Large assets and liabilities can be created and realized very quickly and, if not captured by the systems, may be overlooked. Third party confirmations and the reliability of controls become important in these circumstances.

Audit Procedures

73. To address the assertions discussed above, the auditor may perform the following procedures:
 - (a) Inspection.
 - (b) Observation.
 - (c) Inquiry and confirmation.
 - (d) Computation.
 - (e) Analytical procedures.

In the context of the audit of a bank's financial statements, inspection, inquiry and confirmation, computation and analytical procedures require particular attention and are discussed in the following paragraphs.

⁷ ISA 500, "Audit Evidence" was withdrawn in December 2004 when the revised ISA 500, "Audit Evidence" became effective.

Inspection

74. Inspection consists of examining records, documents, or tangible assets. The auditor inspects in order to:
- Be satisfied as to the physical existence of material negotiable assets that the bank holds; and
 - Obtain the necessary understanding of the terms and conditions of agreements (including master agreements) that are significant individually or in the aggregate in order to:
 - Consider their enforceability; and
 - Assess the appropriateness of the accounting treatment they have been given.
75. Examples of areas where inspection is used as an audit procedure are:
- Securities;
 - Loan agreements;
 - Collateral; and
 - Commitment agreements, such as:
 - Asset sales and repurchases; and
 - Guarantees.
76. In carrying out inspection procedures, the auditor remains alert to the possibility that some of the assets the bank holds may be held on behalf of third parties rather than for the bank's own benefit. The auditor considers whether adequate internal controls exist for the proper segregation of such assets from those that are the property of the bank and, where such assets are held, considers the implications for the financial statements. As noted in paragraph 58 the auditor is concerned with the existence of third party assets only to the extent that the bank's failure to comply with its obligations may lead to the financial statements being materially misstated.

Inquiry and Confirmation

77. Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. The auditor inquires and confirms in order to:
- Obtain evidence of the operation of internal controls;
 - Obtain evidence of the recognition by the bank's customers and counterparties of amounts, terms and conditions of certain transactions; and

- Obtain information not directly available from the bank's accounting records.

A bank has significant amounts of monetary assets and liabilities, and of off-balance-sheet commitments. External confirmation may be an effective method of determining the existence and completeness of the amounts of assets and liabilities disclosed in the financial statements. In deciding the nature and extent of external confirmation procedures that the auditor will perform, the auditor considers any external confirmation procedures undertaken by internal auditing. ISA 505, "External Confirmations" provides guidance on the external confirmation process.

78. Examples of areas for which the auditor may use confirmation including the following:

- Collateral.
- Verifying or obtaining independent confirmation of, the value of assets and liabilities that are not traded or are traded only on over-the-counter markets.
- Asset, liability and forward purchase and sale positions with customers and counterparties such as:
 - Outstanding derivative transactions;
 - Nostro and vostro account holders;
 - Securities held by third parties;
 - Loan accounts;
 - Deposit accounts;
 - Guarantees; and
 - Letters of credit.
- Legal opinions on the validity of a bank's claims.

Computation

79. Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations. In the context of the audit of a bank's financial statements, computation is a useful procedure for checking the consistent application of valuation models.

Analytical Procedures

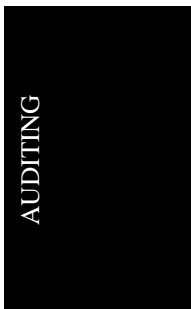
80. Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predicted

amounts. ISA 520, “Analytical Procedures” provides guidance on the auditor’s use of this technique.

81. A bank invariably has individual assets (for example, loans and, possibly, investments) that are of such a size that the auditor considers them individually. However, for most items, analytical procedures may be effective for the following reasons:

- Ordinarily two of the most important elements in the determination of a bank’s earnings are interest income and interest expense. These have direct relationships to interest bearing assets and interest bearing liabilities, respectively. To establish the reasonableness of these relationships, the auditor can examine the degree to which the reported income and expense vary from the amounts calculated on the basis of average balances outstanding and the bank’s stated rates during the year. This examination is ordinarily made in respect of the categories of assets and liabilities used by the bank in the management of its business. Such an examination could, for example, highlight the existence of significant amounts of non-performing loans or unrecorded deposits. In addition, the auditor may also consider the reasonableness of the bank’s stated rates to those prevailing in the market during the year for similar classes of loans and deposits. In the case of loan assets, evidence of rates charged or allowed above market rates may indicate the existence of excessive risk. In the case of deposit liabilities, such evidence may indicate liquidity or funding difficulties. Similarly, fee income, which is also a large component of a bank’s earnings, often bears a direct relationship to the volume of obligations on which the fees have been earned.
- The accurate processing of the high volume of transactions entered into by a bank, and the auditor’s assessment of the bank’s internal controls, may benefit from the review of ratios and trends and of the extent to which they vary from previous periods, budgets and the results of other similar entities.
- By using analytical procedures, the auditor may detect circumstances that call into question the appropriateness of the going concern assumption, such as undue concentration of risk in particular industries or geographic areas and potential exposure to interest rate, currency and maturity mismatches.
- In most countries there is a wide range of statistical and financial information available from regulatory and other sources that the auditor can use to conduct an in-depth analytical review of trends and peer group analyses.

A useful starting point in considering appropriate analytical procedures is to consider what information and performance or risk indicators management



use in monitoring the bank's activities. Appendix 3 to this Statement contains examples of the most frequently used ratios in the banking industry.

Specific Procedures in Respect of Particular Items in the Financial Statements

82. Paragraphs 83–100 identify the assertions that are ordinarily of particular importance in relation to the typical items in a bank's financial statements. They also describe some of the audit considerations that help the auditor to plan substantive procedures and suggest some of the techniques that could be used in relation to the items selected by the auditor for testing. The procedures do not represent an exhaustive list of procedures that it is possible to perform, nor do they represent a minimum requirement that should always be performed.

Financial Statement Item	Financial Statement Assertions of Particular Importance
83.	<p>BALANCES WITH OTHER BANKS</p> <p>Existence</p> <p>The auditor considers third party confirmations of the balance. Where the balances held with other banks are the result of large volumes of transactions, the receipt of confirmations from those other banks is likely to provide more cogent evidence as to the existence of the transactions and of the resultant inter-bank balances than is the testing of the related internal controls. Guidance on inter-bank confirmation procedures, including terminology and the content of confirmation requests, can be found in the IAPS 1000, "Inter-Bank Confirmation Procedures."</p> <p>Valuation</p> <p>The auditor considers whether to assess the collectability of the deposit in light of the credit-worthiness of the depository bank. The procedures required in such an assessment are similar to those used in the audit of loan valuation, discussed later.</p> <p>Presentation and Disclosure</p> <p>The auditor considers whether the balances with other banks as at the date of the financial statements represent bona fide commercial transactions or whether any significant variation</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
84.	<p>from normal or expected levels reflects transactions entered into primarily to give a misleading impression of the financial position of the bank or to improve liquidity and asset ratios (often known as “window-dressing”).</p> <p>Where window-dressing occurs in a magnitude which may distort the true and fair view of the financial statements, the auditor requests management to adjust the balances shown in the financial statements, or make additional disclosure in the notes. If management fails to do so, the auditor considers whether to modify the audit report.</p> <p>MONEY MARKET INSTRUMENTS</p> <p>Existence</p> <p>The auditor considers the need for physical inspection or confirmation with external custodians and the reconciliation of the related amounts with the accounting records.</p> <p>Rights and Obligations</p> <p>The auditor considers the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor pays particular attention to establishing the ownership of instruments held in bearer form. The auditor also considers whether there are any encumbrances on the title to the instruments.</p> <p>The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.</p> <p>Valuation</p> <p>The auditor considers the appropriateness of the valuation techniques employed in light of the creditworthiness of the issuer.</p> <p>Measurement</p> <p>The auditor considers whether there is a need to test for the proper accrual of income earned on</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
85.	<p data-bbox="727 237 1235 327">money market instruments, which in some cases is through the amortization of a purchase discount.</p> <p data-bbox="727 342 1089 365">The auditor also considers whether:</p> <ul data-bbox="727 380 1235 667" style="list-style-type: none"> <li data-bbox="727 380 1235 470">• The relationship between the types of securities owned and the related income is reasonable; and <li data-bbox="727 485 1235 667">• All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities). <p data-bbox="727 699 1122 758">SECURITIES HELD FOR TRADING PURPOSES</p> <p data-bbox="727 772 1235 863">Appendix 2 gives further examples of internal control considerations and audit procedures in respect of trading operations.</p> <p data-bbox="727 884 834 907">Existence</p> <p data-bbox="727 921 1235 1045">The auditor considers physical inspection of securities or confirmation with external custodians and the reconciliation of the amounts with the accounting records.</p> <p data-bbox="727 1066 964 1089">Rights and Obligations</p> <p data-bbox="727 1104 1235 1320">The auditor considers the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor pays particular attention to establishing the ownership of securities held in bearer form. The auditor also considers whether there are any encumbrances on the title to the securities.</p> <p data-bbox="727 1335 1235 1425">The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.</p> <p data-bbox="727 1446 834 1470">Valuation</p> <p data-bbox="727 1484 1235 1543">Financial reporting frameworks often prescribe different valuation bases for securities depending</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>on whether they are held for trading purposes, held as portfolio investments, or held for hedging purposes. For example, a financial reporting framework might require trading securities to be carried at market value, portfolio investments at historic cost subject to impairment reviews, and hedging securities on the same basis as the underlying assets they hedge. Management's intentions determine whether any particular security is held for a given purpose, and hence the valuation basis to be used. If management's intentions change, the valuation basis changes too. Accordingly, when securities have been transferred from one category to another, the auditor obtains sufficient appropriate audit evidence to support management's assertions as to their revised intentions. The possibility of changing an asset's categorization provides management with an opportunity for fraudulent financial reporting, as it would be possible to recognize a profit or avoid recognizing a loss by changing the categorization of particular securities.</p> <p>When securities held for trading purposes are carried at market value, the auditor considers whether securities whose market value has increased have been arbitrarily transferred from Portfolio Investments (see paragraph 87) primarily so that an unrealized gain can be taken into income.</p> <p>The auditor also considers whether to reperform the valuation calculations and the extent of tests of the controls over the bank's valuation procedures.</p> <p>Measurement</p> <p>The auditor also considers whether:</p> <ul style="list-style-type: none"> • The relationship between the types of securities owned and the related income is reasonable; and

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<ul style="list-style-type: none"> All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).
86. (Those involving current investment of funds, for example, blocks of loans purchased for resale, purchases of securitized assets)	<p>OTHER FINANCIAL ASSETS</p> <p>Rights and Obligations</p> <p>The auditor examines the underlying documentation supporting the purchase of such assets in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for.</p> <p>Valuation</p> <p>The auditor considers the appropriateness of the valuation techniques employed. Since there may not be established markets for such assets, it may be difficult to obtain independent evidence of value. Additionally, even where such evidence exists, there may be a question as to whether there is sufficient depth to existing markets to rely on quoted values for the asset in question and for any related offsetting hedge transactions that the bank has entered into in those markets. The auditor also considers the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.</p>
87.	<p>Portfolio Investments</p> <p>In many cases the audit of a bank's portfolio investments does not differ from the audit of portfolio investments held by any other entity. However, there are some special aspects that pose particular problems in respect of banking operations.</p>

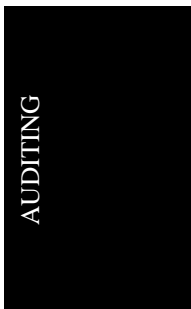
Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="776 247 883 275">Valuation</p> <p data-bbox="776 285 1289 506">The auditor considers the value of the assets supporting the security value, particularly in respect of securities that are not readily marketable. The auditor also considers the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.</p> <p data-bbox="776 527 922 554">Measurement</p> <p data-bbox="776 564 1289 940">As discussed in paragraph 85, financial reporting frameworks frequently allow different valuation bases for securities held for different purposes. Where securities have been transferred from the Trading Account, the auditor determines whether any unrealized losses in market value are recorded if so required by relevant financial reporting framework. When the financial reporting framework does not require the recording of unrealized losses, the auditor considers whether the transfer was made to avoid the need to recognize reductions in the securities' market value.</p> <p data-bbox="776 951 1127 978">The auditor also considers whether:</p> <ul data-bbox="776 989 1289 1281" style="list-style-type: none"> <li data-bbox="776 989 1289 1087">• The relationship between the types of securities owned and the related income is reasonable; and <li data-bbox="776 1098 1289 1281">• All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).
88.	<p data-bbox="776 1302 1247 1365">INVESTMENTS IN SUBSIDIARIES AND ASSOCIATED ENTITIES</p> <p data-bbox="776 1375 1289 1560">In many cases the audit of a bank's investments in subsidiaries and associated entities does not differ from the audit of such investments held by any other entity. However, there are some special aspects that pose particular problems in respect of banking operations.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>Valuation</p> <p>The auditor considers the implications of any legal or practical requirement for the bank to provide future financial support to ensure the maintenance of operations (and hence the value of the investment) of subsidiaries and associated companies. The auditor considers whether the related financial obligations are recorded as liabilities of the bank.</p> <p>The auditor determines whether appropriate adjustments are made when the accounting policies of companies accounted for on an equity basis or consolidated do not conform to those of the bank.</p>
89. (Comprising advances, bills of exchange, letters of credit, acceptances, guarantees, and all other lines of credit extended to customers, including those in connection with foreign exchange and money market activities)	<p>LOANS</p> <p>Existence</p> <p>The auditor considers the need for external confirmation of the existence of loans.</p> <p>Valuation</p> <p>The auditor considers the appropriateness of the provision for loan losses. The auditor understands the laws and regulations that may influence the amounts determined by management. The Basel Committee has published a set of Sound Practices for Loan Accounting and Disclosure, which provides guidance to banks and banking supervisors on recognition and measurement of loans, establishment of loan loss provisions, credit risk disclosure and related matters. It sets out banking supervisors' views on sound loan accounting and disclosure practices for banks and so may influence the financial reporting framework within which a bank prepares its financial statements. However, the bank's financial statements are prepared in accordance with a specified financial reporting framework, and the loan loss provision must be made in accordance with that framework.</p>
<ul style="list-style-type: none"> • Personal • Commercial • Government • Domestic • Foreign 	

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>Appendix 2 gives further information on the auditor's consideration of loans.</p> <p>The major audit concern is the adequacy of the recorded provision for loan losses.</p> <p>In establishing the nature, extent and timing of the work to be performed, the auditor considers the following factors:</p> <ul style="list-style-type: none"> • The degree of reliance it is reasonable to place on the bank's system of loan quality classification, on its procedures for ensuring that all documentation is properly completed, on its internal loan review procedures and on the work of internal auditing. • Given the relative importance of foreign lending, the auditor ordinarily examines: <ul style="list-style-type: none"> ○ The information on the basis of which the bank assesses and monitors the country risk and the criteria (for example, specific classifications and valuation ratios) it uses for this purpose; and ○ Whether and, if so, by whom credit limits are set for the individual countries, what the limits are and the extent to which they have been reached. • The composition of the loan portfolio, with particular attention to: <p>The concentration of loans to specific:</p> <ul style="list-style-type: none"> ○ Borrowers and parties connected to them (including the procedures in place to identify such connections); ○ Commercial and industrial sectors; ○ Geographic regions; and ○ Countries; ○ The size of individual credit exposures (few large loans versus numerous small loans);

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<ul style="list-style-type: none"> ○ The trends in loan volume by major categories, especially categories having exhibited rapid growth, and in delinquencies, non-accrual and restructured loans; and ○ Related party lending. <p>Identified potential non-performing loans, with particular attention to:</p> <ul style="list-style-type: none"> ○ The previous loss and recovery experience, including the adequacy and timeliness of provisions and charge-offs; and ○ Results of regulatory examinations. <p>Local, national and international economic and environmental conditions, including restrictions on the transfer of foreign currency that may affect the repayment of loans by borrowers.</p> <p>In addition to those non-performing loans identified by management and, where applicable, by bank regulators, the auditor considers additional sources of information to determine those loans that may not have been so identified. These include:</p> <ul style="list-style-type: none"> ● Various internally generated listings, such as “watchlist” loans, past due loans, loans on non-accrual status, loans by risk classification, loans to insiders (including directors and officers), and loans in excess of approved limits; ● Historical loss experience by type of loan; and ● Those loan files lacking current information on borrowers, guarantors or collateral. <p>Presentation and Disclosure</p> <p>Banks are often subject to particular disclosure requirements concerning their loans and provisions for loan losses. The auditor considers whether the information disclosed is in accordance with the applicable financial or regulatory reporting framework.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
90.	ACCOUNTS WITH DEPOSITORS
(a) General deposits	<p data-bbox="776 296 927 321">Completeness</p> <p data-bbox="776 348 1289 562">The auditor assesses the system of internal control over accounts with depositors. The auditor also considers performing confirmation and analytical procedures on average balances and on interest expense to assess the reasonableness of the recorded deposit balances.</p> <p data-bbox="776 590 1073 615">Presentation and Disclosure</p> <p data-bbox="776 632 1289 716">The auditor determines whether deposit liabilities are classified in accordance with regulations and relevant accounting principles.</p> <p data-bbox="776 737 1289 821">Where deposit liabilities have been secured by specific assets, the auditor considers the need for appropriate disclosure.</p> <p data-bbox="776 842 1289 989">The auditor also considers the need for disclosure where the bank has a risk due to economic dependence on a few large depositors or where there is an excessive concentration of deposits due within a specific time.</p>
(b) Items in transit	<p data-bbox="776 1010 878 1035">Existence</p> <p data-bbox="776 1062 1289 1241">The auditor determines whether items in transit between branches, between the bank and its consolidated subsidiaries, and between the bank and counterparties, are eliminated and that reconciling items have been appropriately addressed and accounted for.</p> <p data-bbox="776 1262 1289 1470">Additionally, the auditor examines individual items comprising the balance that have not been cleared within a reasonable time period and also considers whether the related internal control procedures are adequate to ensure that such items have not been temporarily transferred to other accounts in order to avoid their detection.</p>



Financial Statement Item	Financial Statement Assertions of Particular Importance
91.	<p data-bbox="727 254 1036 279">CAPITAL AND RESERVES</p> <p data-bbox="727 296 1240 667">Banking regulators pay close attention to a bank's capital and reserves in monitoring the level of a bank's activities and in determining the extent of a bank's operations. Small changes in capital or reserves may have a large effect on a bank's ability to continue operating, particularly if it is near to its permitted minimum capital ratios. In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorizing assets and liabilities or by describing them as being less risky than they actually are.</p> <p data-bbox="727 688 1027 714">Presentation and Disclosure</p> <p data-bbox="727 730 1240 1136">The auditor considers whether capital and reserves are adequate for regulatory purposes (for example, to meet capital adequacy requirements), the disclosures have been appropriately calculated and that the disclosures are both appropriate and in accordance with the applicable financial reporting framework. In many jurisdictions auditors are required to report on a wide range of disclosures about the bank's capital and its capital ratios, either because that information is included in the financial statements or because there is requirement to make a separate report to banking supervisors.</p> <p data-bbox="727 1157 1240 1276">In addition, where applicable regulations provide for restrictions on the distribution of retained earnings, the auditor considers whether the restrictions are adequately disclosed.</p> <p data-bbox="727 1297 1240 1440">The auditor also determines whether the requirements of the applicable financial reporting framework with respect to the disclosure of hidden reserves have been complied with (see also paragraph 103).</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
92. (For example, commitments to lend funds and to guarantee repayment of funds by customers to third parties)	<p data-bbox="776 254 1279 407">PROVISIONS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (OTHER THAN DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS)</p> <p data-bbox="776 428 927 457">Completeness</p> <p data-bbox="776 470 1289 590">Many contingent assets and liabilities are recorded without there being a corresponding liability or asset (memorandum items). The auditor therefore:</p> <ul data-bbox="786 604 1289 1549" style="list-style-type: none"> <li data-bbox="786 604 1289 695">• Identifies those activities that have the potential to generate contingent assets or liabilities (for example, securitizations); <li data-bbox="786 709 1289 926">• Considers whether the bank's system of internal control is adequate to ensure that contingent assets or liabilities arising out of such activities are properly identified and recorded and that evidence is retained of the customer's agreement to the related terms and conditions; <li data-bbox="786 940 1289 1220">• Performs substantive procedures to test the completeness of the recorded assets and liabilities. Such procedures may include confirmation procedures as well as examination of related fee income in respect of such activities and are determined having regard to the degree of risk attached to the particular type of contingency being considered; <li data-bbox="786 1234 1289 1388">• Reviews the reasonableness of the period-end contingent asset and liability figures in the light of the auditor's experience and knowledge of the current year's activities; and <li data-bbox="786 1402 1289 1549">• Obtains representation from management that all contingent assets and liabilities have been recorded and disclosed as required by the financial reporting framework.

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="727 247 836 273">Valuation</p> <p data-bbox="727 285 1240 567">Many of these transactions are either credit substitutes or depend for their completion on the credit-worthiness of the counterparty. The risks associated with such transactions are in principle no different from those associated with “Loans.” The audit objectives and considerations of particular importance discussed in paragraph 89 is equally relevant in respect of these transactions.</p>
	<p data-bbox="727 592 1026 617">Presentation and Disclosure</p> <p data-bbox="727 630 1240 1066">Where assets or liabilities have been securitized or otherwise qualify for an accounting treatment that removes them from the bank’s balance sheet, the auditor considers the appropriateness of the accounting treatment and whether appropriate provisions have been made. Similarly, where the bank is a counterparty to a transaction that allows a client entity to remove an asset or liability from the client’s balance sheet, the auditor considers whether there is any asset or liability that the financial reporting framework requires to be shown in the balance sheet or in the notes to the financial statements.</p>
	<p data-bbox="727 1092 1240 1396">Although the relevant financial reporting framework ordinarily requires disclosure of such obligations in the notes to the financial statements rather than in the balance sheet, the auditor nevertheless considers the potential financial impact on the bank’s capital, funding and profitability of the need to honor such obligations and whether this needs to be specifically disclosed in the financial statements.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
93. (For example, foreign exchange contracts, interest rate and currency swaps, futures, options, and forward rate agreements)	<p data-bbox="776 254 1273 310">DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS</p> <p data-bbox="776 323 1289 543">Many of these instruments are dealt with as part of the bank's treasury and trading activities. Appendix 2 gives more information on the auditor's consideration of treasury and trading activities. For transactions involving derivatives that the bank enters into as an end user, IAPS 1012 provides further guidance.</p> <p data-bbox="776 569 1024 600">Rights and Obligations</p> <p data-bbox="776 611 1289 768">The auditor examines the underlying documentation supporting such transactions in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for.</p> <p data-bbox="776 785 883 816">Existence</p> <p data-bbox="776 827 1289 1110">The auditor considers the need for third party confirmations of outstanding balances, which are selected from back office records of open transactions and from lists of approved counterparties, brokers and exchanges. It may be necessary to perform confirmation tests separately on the various products as the systems may not facilitate a combined selection of all transactions with any given counterparty.</p> <p data-bbox="776 1136 927 1167">Completeness</p> <p data-bbox="776 1178 1289 1356">Due to the continuing development of new financial instruments, there may be a lack of established procedures between participants and within the bank. The auditor therefore assesses the adequacy of the system of internal control, particularly with respect to:</p> <ul data-bbox="776 1373 1289 1528" style="list-style-type: none"> <li data-bbox="776 1373 1289 1528">• The adequacy of the procedures and the division of duties regarding the matching of documentation received from counterparties and reconciliation of accounts with counterparties; and

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<ul style="list-style-type: none"> <li data-bbox="727 237 1166 268">• The adequacy of internal audit review. <p data-bbox="727 279 1240 562">The auditor considers assessing the adequacy of the related system of internal control, including regular profit and loss account reconciliations at appropriate intervals and period-end reconciliation procedures, particularly in respect of the completeness and accuracy of the recording of outstanding positions as at the period end. (This requires the auditor to be familiar with standard inter-bank transaction confirmation procedures);</p> <p data-bbox="727 573 1240 793">The auditor may also find it useful to examine post period-end transactions for evidence of items that should have been recorded in the year-end financial statements. ISA 560, “Subsequent Events” provides further guidance on the auditor’s consideration of events occurring after the period end.</p> <p data-bbox="727 804 841 835">Valuation</p> <p data-bbox="727 846 1240 940">Similar considerations arise here as arise for Other Financial Assets above. However, the following further considerations also arise.</p> <p data-bbox="727 951 1240 1329">Derivatives and off-balance sheet financial instruments are ordinarily valued at market or fair value, except that, in some financial reporting frameworks, hedging instruments are valued on the same basis as the underlying item being hedged. The applicable financial reporting framework may not require financial instruments to be shown on the balance sheet, or may require them to be to be valued at cost. In such instances, there may be an obligation to disclose the market or fair values of derivatives or off-balance sheet instruments in the notes to the financial statements.</p> <p data-bbox="727 1339 1240 1497">If the instrument is traded on an investment exchange, the value may be determined through independent sources. If the transaction is not traded, independent experts may be required to assess the value.</p> <p data-bbox="727 1507 1240 1568">Additionally, the auditor considers the need for and adequacy of fair value adjustments to</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="776 237 1289 359">financial instruments, such as a liquidity risk provision, a modeling risk provision and a provision for operational risk. The auditor considers matters such as the following:</p> <ul data-bbox="776 373 1289 926" style="list-style-type: none"> <li data-bbox="776 373 1289 495">• The appropriateness of the exchange rates, interest rates or other underlying market rates used at the financial statement date to calculate unrealized gains and losses. <li data-bbox="776 510 1289 758">• The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the financial statement date. In addition, the auditor considers whether details of individual contracts, valuation rates and assumptions used are appropriately entered into the models. <li data-bbox="776 772 1289 926">• The appropriateness of the accounting policies used having regard to relevant accounting principles particularly with regard to the distinction between realized and unrealized profits and losses. <p data-bbox="776 940 1289 1094">When market values need to be considered, but are not available, the auditor considers whether appropriate alternative valuation techniques have been employed, based, where appropriate, on current interest or foreign exchange rates.</p> <p data-bbox="776 1108 1289 1230">As some of these instruments have been developed only recently, the auditor examines their valuation with a special degree of caution, and in doing so bears in mind the following factors:</p> <ul data-bbox="776 1245 1289 1562" style="list-style-type: none"> <li data-bbox="776 1245 1289 1367">• There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms. <li data-bbox="776 1381 1289 1562">• There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a greater difficulty in establishing controls that would prevent

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="776 239 1240 296">misstatements or detect and correct them on a timely basis.</p> <ul style="list-style-type: none"> <li data-bbox="727 310 1240 653">• Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the bank to hedge its positions. <li data-bbox="727 667 1240 758">• The models used for valuing such instruments may not operate properly in abnormal market conditions. <p data-bbox="727 779 873 804">Measurement</p> <p data-bbox="727 821 1240 1129">The auditor considers the purpose for which the transaction resulting in the instrument was entered into, in particular whether the transaction was a trading transaction or a hedging one. The bank may have been dealing as principal to create a dealing position or to hedge another asset, or it may have been dealing as an intermediary or broker. The purpose may determine the appropriate accounting treatment.</p> <p data-bbox="727 1146 1240 1297">Since settlement of such transactions is at a future date, the auditor considers whether a profit or loss has arisen by the period end that is required to be recorded in the financial statements.</p> <p data-bbox="727 1314 1240 1495">The auditor considers whether there has been a reclassification of hedging and trading transactions/positions that may have been made primarily with a view to taking advantage of differences in the timing of profit and loss recognition.</p>

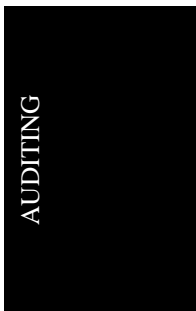
Financial Statement Item	Financial Statement Assertions of Particular Importance
94.	<p data-bbox="776 247 1073 268">Presentation and Disclosure</p> <p data-bbox="776 289 1289 632">In some financial reporting frameworks, the relevant accounting principles require the recording of accrued gains and losses on open positions, whether or not these positions are recorded on the balance sheet. In other financial reporting frameworks there is only an obligation to disclose the commitment. Where the latter is the case, the auditor considers whether the unrecorded amounts are of such significance as to require a disclosure in the financial statements or qualification in the audit report.</p> <p data-bbox="776 646 1279 667">The following additional considerations may arise:</p> <ul data-bbox="776 688 1289 1136" style="list-style-type: none"> <li data-bbox="776 688 1289 961">• The auditor considers the appropriate accounting treatment and presentation of such transactions in accordance with relevant financial reporting requirements. Where those requirements have different treatments for transactions that are entered into for hedging purposes, the auditor considers whether transactions have been appropriately identified and treated. <li data-bbox="776 982 1289 1136">• Some financial reporting frameworks require the disclosure of the potential risk arising from open positions, as for example, the credit risk equivalent and replacement value of outstanding off-balance sheet instruments. <p data-bbox="776 1161 1211 1224">INTEREST INCOME AND INTEREST EXPENSE</p> <p data-bbox="776 1245 922 1266">Measurement</p> <p data-bbox="776 1287 1289 1371">Interest income and expense ordinarily comprise two of the main items in a bank's income statement. The auditor considers:</p> <ul data-bbox="776 1392 1289 1545" style="list-style-type: none"> <li data-bbox="776 1392 1289 1476">• Whether satisfactory procedures exist for the proper accounting of accrued income and expenditure at the year-end; <li data-bbox="776 1497 1289 1545">• Assessing the adequacy of the related system of internal control; and

Financial Statement Item	Financial Statement Assertions of Particular Importance
95.	<ul style="list-style-type: none"> • Using analytical procedures in assessing the reasonableness of the reported amounts. Such techniques include comparison of reported interest yields in percentage terms: <ul style="list-style-type: none"> ○ To market rates; ○ To central bank rates; ○ To advertised rates (by type of loan or deposit); and ○ Between portfolios. <p>In making such comparisons, average rates in effect (for example, by month) are used in order to avoid distortions caused by changes in interest rates.</p> <p>The auditor considers the reasonableness of the policy applied to income recognition on non-performing loans, especially where such income is not being received on a current basis. The auditor also considers whether income recognition on non-performing loans complies with the policy of the bank, as well as the requirements of the applicable financial reporting framework.</p> <p>PROVISIONS FOR LOAN LOSSES</p> <p>Measurement</p> <p>The major audit concerns in this area are discussed above under “Loans.” Usually, provisions take two forms, namely specific provisions in respect of identified losses on individual loans and general provisions to cover losses that are thought to exist but have not been specifically identified. The auditor assesses the adequacy of such provisions based on such factors as past experience and other relevant information and considers whether the specific and general provisions are adequate to absorb estimated credit losses associated with the loan portfolio. Appendix 2 to this Statement contains examples of substantive procedures for the evaluation of loan loss provisions. In some</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
96.	<p data-bbox="776 237 1289 520">countries the levels of general provisions are prescribed by local regulations. In those countries, the auditor determines whether the reported provision expense is calculated in accordance with such regulations. The auditor also considers the adequacy of the disclosures in the financial statements and, when the provisions are not adequate, the implications for the audit report.</p> <p data-bbox="776 548 1159 573">FEE AND COMMISSION INCOME</p> <p data-bbox="776 596 919 621">Completeness</p> <p data-bbox="776 636 1289 789">The auditor considers whether the amount recorded is complete (that is, all individual items have been recorded). In this respect, the auditor considers using analytical procedures in assessing the reasonableness of the reported amounts.</p> <p data-bbox="776 812 915 837">Measurement</p> <p data-bbox="776 852 1289 909">The auditor considers matters such as the following:</p> <ul data-bbox="776 924 1289 1283" style="list-style-type: none"> <li data-bbox="776 924 1289 1043">• Whether the income relates to the period covered by the financial statements and that those amounts relating to future periods have been deferred. <li data-bbox="776 1058 1289 1178">• Whether the income is collectible (this is considered as part of the loan review audit procedures where the fee has been added to a loan balance outstanding). <li data-bbox="776 1192 1289 1283">• Whether the income is accounted for in accordance with the applicable financial reporting framework.
97.	<p data-bbox="776 1314 1203 1339">PROVISION FOR TAXES ON INCOME</p> <p data-bbox="776 1362 915 1388">Measurement</p> <p data-bbox="776 1411 1289 1560">The auditor becomes familiar with the special taxation rules applicable to banks in the jurisdiction in which the bank being reported on is located. The auditor also considers whether any auditors on whose work it is intended to rely in respect of the</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
98.	<p data-bbox="727 237 1240 363">bank's foreign operations are similarly familiar with the rules in their jurisdiction. The auditor is aware of the taxation treaties between the various jurisdictions in which the bank operates.</p> <p data-bbox="727 390 1138 453">RELATED PARTY TRANSACTIONS Presentation and Disclosure</p> <p data-bbox="727 478 1240 1045">Financial reporting frameworks often require the disclosure of the existence of related parties and of transactions with them. Related party transactions may occur in the ordinary course of a bank's business. For example, a bank may extend credit to its officers or directors or to entities that are owned or controlled by officers or directors. The auditor remains aware of the risk that where such lending transactions with related parties exist, normal measures of banking prudence, such as credit assessment and collateral requirements, may not be exercised properly. The auditor becomes familiar with the applicable regulatory requirements for lending to related parties and performs procedures to identify the bank's controls over related party lending, including approval of related party credit extensions and monitoring of performance of related party loans.</p> <p data-bbox="727 1056 1240 1556">Other related party transactions that may occur in the ordinary course of a bank's business include deposit and other transactions with directors, officers, or affiliated entities. A bank may also guarantee loans to, or the financial performance of, an affiliated entity. The guarantee may be formalized in a written agreement or the guarantee may be informal. Informal guarantees may be oral agreements, "understood" agreements based on the affiliate's historical performance, or the result of the business culture in which the bank operates. Such agreements, whether formal or informal, are of particular concern when the guarantee relates to an unconsolidated affiliate, as the guarantee is not disclosed in the bank's consolidated financial</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>statements. The auditor makes inquiries of management and reviews the minutes of the board of directors to determine if such guarantees exist and whether there is appropriate disclosure of the guarantees in the bank's financial statements.</p> <p>Valuation</p> <p>Related party transactions may also result from management's attempts to avoid adverse circumstances. For example, a bank's management may transfer problem assets to an unconsolidated affiliated entity at or near the period end, or prior to a regulatory examination, to avoid a deficiency in the provision for loan losses or to avoid criticism about asset quality. The auditor considers reviewing transactions involving related parties that have been accounted for as sales transactions to determine whether there are unrecorded recourse obligations involved.</p> <p>Representations from management or others are often required to understand the business purpose of a particular transaction. Such representations are evaluated in the light of apparent motives and other audit evidence. In order to obtain a complete understanding of a transaction, certain circumstances may warrant a discussion with the related party, their auditor, or other parties such as legal counsel, who are familiar with the transaction. ISA 580, "Management Representations" gives further guidance on the use of management representations.</p>
99.	<p>FIDUCIARY ACTIVITIES</p> <p>Completeness</p> <p>The auditor considers whether all the bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also considers whether the bank has incurred any material undisclosed</p>



Financial Statement Item	Financial Statement Assertions of Particular Importance
100. (Including, where applicable, a Statement of Accounting Policies)	<p>liability from a breach of its fiduciary duties, including the safekeeping of assets.</p> <p>Presentation and Disclosure</p> <p>The auditor considers whether the financial reporting framework requires disclosure of the nature and extent of its fiduciary activities in the notes to its financial statements, and whether the required disclosures have been made.</p> <p>NOTES TO THE FINANCIAL STATEMENTS</p> <p>Presentation and Disclosure</p> <p>The auditor determines whether the notes to the bank's financial statements are in accordance with the applicable financial reporting framework.</p>

Reporting on the Financial Statements

101. In expressing an opinion on the bank's financial statements, the auditor:
- Adheres to any specific formats and terminology specified by the law, the regulatory authorities, professional bodies and industry practice; and
 - Determines whether adjustments have been made to the accounts of foreign branches and subsidiaries that are included in the consolidated financial statements of the bank to bring them into conformity with the financial reporting framework under which the bank is reporting. This is particularly relevant in the case of banks because of the large number of countries in which such branches and subsidiaries may be located and the fact that in most countries local regulations prescribe specialized accounting principles applicable primarily to banks. This may lead to a greater divergence in the accounting principles followed by branches and subsidiaries, than is the case in respect of other commercial entities.
102. The financial statements of banks are prepared in the context of the legal and regulatory requirements prevailing in different countries, and accounting policies are influenced by such regulations. In some countries the financial reporting framework for banks (the banking framework) differs materially from the financial reporting framework for other entities (the general framework). When the bank is required to prepare a single set of financial statements that comply with both frameworks, the auditor may express a totally unqualified opinion only if the financial statements have been prepared in accordance with both frameworks. If the financial statements are in accordance with only one of the frameworks, the auditor expresses an unqualified opinion in respect of compliance with that framework and a qualified or adverse opinion in respect of compliance with the other framework. When the bank is required to comply with the banking framework instead of the general framework, the auditor considers the need to refer to this fact in an emphasis of matter paragraph.
103. Banks often present additional information in annual reports that also contain audited financial statements. This information frequently contains details of the bank's risk adjusted capital, and other information relating to the bank's stability, in addition to any disclosures in the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements" provides guidance on the procedures to be undertaken in respect of such additional information.

Appendix 1

Risks and Issues in Respect of Fraud and Illegal Acts

Paragraph 26 of this Statement indicates some of the general considerations in respect of fraud. These are also discussed in more detail in ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements.”⁸ ISA 240 requires the auditor to consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets. Appendix 1 to the ISA gives an indication of general fraud risk factors: this appendix gives examples of fraud risk factors applicable to banks.

The risk of fraudulent activities or illegal acts arises at banks both from within the institution and from outsiders. Among the many fraudulent activities and illegal acts that banks may face are check-writing fraud, fraudulent lending and trading arrangements, money laundering and misappropriation of banking assets. Fraudulent activities may involve collusion by management of banks and their clients. Those perpetrating fraudulent activities may prepare false and misleading records to justify inappropriate transactions and hide illegal activities. Fraudulent financial reporting is another serious concern.

In addition, banks face an ongoing threat of computer fraud. Computer hackers, and others who may gain unauthorized access to banks computer systems and information databases, can misapply funds to personal accounts and steal private information about the institution and its customers. Also, as is the case for all businesses, fraud and criminal activity perpetrated by authorized users inside banks is a particular concern.

Fraud is more likely to be perpetrated at banks that have serious deficiencies in corporate governance and internal control. Significant losses from fraud may arise from the following categories of breakdowns in corporate governance and internal control:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank. Major losses due to fraud often arise as a consequence of management's lack of attention to, and laxity in, the control culture of the bank, insufficient guidance and oversight by those charged with governance and management, and a lack of clear management accountability through the assignment of roles and responsibilities. These situations also may involve a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control consciousness within business areas.
- Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet. When the risks of new products and activities are not adequately assessed and when control systems that function well for

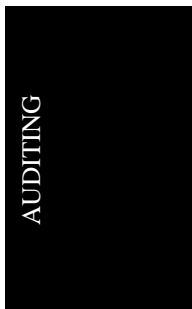
⁸ See footnote 1.

simpler traditional products are not updated to address newer complex products, a bank may be exposed to a greater risk of loss from fraud.

- The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance. In particular, the lack of a segregation of duties has played a major role in fraudulent activities that resulted in significant losses at banks.
- Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems. When policies and procedures are not appropriately communicated to all personnel involved in an activity, an environment is created that may foster fraudulent activities. In addition, fraud may go undetected when information about inappropriate activities that should be brought to the attention of higher level management is not communicated to the appropriate level until the problems become severe.
- Inadequate or ineffective internal audit programs and monitoring activities. When internal auditing or other monitoring activities are not sufficiently rigorous to identify and report control weaknesses, fraud may go undetected at banks. When adequate mechanisms are not in place to ensure that management corrects deficiencies reported by auditors, fraud may continue unabated.

The following table and discussion in this appendix provide examples of fraud risk factors.

	Deposit Taking	Dealing	Lending
Management & Employee Fraud	Depositors' camouflage Unrecorded deposits Theft of customer deposits or investments, particularly from dormant accounts	Off-market rings Related party deals Broker kickbacks False deals Unrecorded deals Delayed deal allocations Misuse of discretionary accounts Exploiting weaknesses in matching procedures	Loans to fictitious borrowers Use of nominee companies Deposit transformation Transactions with connected companies Kickbacks and inducements Use of parallel organizations Funds transformation Selling recovered



	Deposit Taking	Dealing	Lending
		<p>Mismarking of book</p> <p>Collusion in providing valuations (Valuation rings)</p> <p>Theft or misuse of collateral held as security</p>	<p>collateral at below market prices</p> <p>Bribes to obtain the release of security or to reduce the amount claimed</p> <p>Theft or misuse of collateral held as security</p>
External Fraud	<p>Money laundering</p> <p>Fraudulent instructions</p> <p>Counterfeit currency or drafts</p> <p>Fraudulent use of Check float periods (Check kiting)</p>	<p>Fraudulent custodial sales</p> <p>False information or documents regarding counterparties</p>	<p>Impersonation and false information on loan applications and subsequently provided documents</p> <p>Double-pledging of collateral</p> <p>Fraudulent valuations (Land flips)</p> <p>Forged or valueless collateral</p> <p>Misappropriation of loan funds by agents/ customers</p> <p>Unauthorized sale of collateral</p>

Fraud Risk Factors in Respect of the Deposit Taking Cycle*Depositors' Camouflage*

(Hiding the identity of a depositor, possibly in connection with funds transformation or money laundering.)

- Similar or like-sounding names across various accounts.
- Offshore company depositors with no clearly defined business or about which there are few details.

Unrecorded Deposits

- Any evidence of deposit-taking by any other company of which there are details on the premises, whether part of the bank or not.
- Documentation held in management offices that it is claimed has no connection with the business of the bank or evasive replies regarding such documents.

Theft of Customer Deposits/Investments

- Customers with hold-mail arrangements who only have very occasional contact with the bank.
- No independent resolution of customer complaints or review of hold-mail accounts.

Fraud Risk Factors in Respect of the Dealing Cycle*Off-market Rings/Related Party Deals*

- No spot checks on the prices at which deals are transacted.
- Unusual levels of activity with particular counterparties.

Broker Kickbacks

- High levels of business with a particular broker.
- Unusual trends in broker commissions.

False Deals

- A significant number of cancelled deals.
- Unusually high value of unsettled transactions.

Unrecorded Deals

- High levels of profit by particular dealers in relation to stated dealing strategy.
- Significant number of unmatched counterparty confirmations.

Delayed Deal Allocations

- No time stamping of deal tickets or a review of the time of booking.
- Alterations to or overwriting of details on deal sheets.

Misuse of Discretionary Accounts

- Unusual trends on particular discretionary accounts.
- Special arrangements for preparation and issue of statements.

Mismarking of the Book

- No detailed valuation policies and guidelines.
- Unusual trends in the value of particular books.

Fraud Risk Factors in Respect of the Lending Cycle*Loans to Fictitious Borrowers/Transactions with Connected Companies*

- “Thin” loan files with sketchy, incomplete financial information, poor documentation or management claim the borrower is wealthy and undoubtedly creditworthy.
- Valuations which seem high, valuers used from outside the usually permitted area or the same valuer used on numerous applications.
- Generous extensions or revised terms when the borrower defaults.

Deposit Transformation or Back-to-back Lending

A bank deposit is made by another bank, which is then used to secure a loan to a beneficiary nominated by the fraudulent staff member of the first bank, who hides the fact that the deposit is pledged.

- Pledges over deposits (disclosed by confirmations which have specifically requested such pledges to be disclosed).
- Documentation of files held in directors’ or senior managers’ offices outside the usual filing areas; deposits continually rolled over or made even when liquidity is tight.

Use of Nominee Companies/Transactions with Connected Companies

- Complex structures which are shrouded in secrecy.
- Several customers with sole contact, that is, handled exclusively by one member of staff.
- Limited liability partnerships without full disclosure of ownership or with complex common ownership structures.

Kickbacks and Inducements

- Excessive amounts of business generated by particular loan officers.
- Strong recommendation by director or lending officer but missing data or documentation on credit file.
- Indications of weak documentation controls, for example providing funding before documentation is complete.

Use of Parallel Organizations

(Companies under the common control of directors/shareholders)

- Unexpected settlement of problem loans shortly before the period end or prior to an audit visit or unexpected new lending close to the period end.
- Changes in the pattern of business with related organizations.

Funds Transformation

(Methods used to conceal the use of bank funds to make apparent loan repayments)

- Loans which suddenly become performing shortly before the period end or prior to an audit visit.
- Transactions with companies within a group or with its associated companies where the business purpose is unclear.
- Lack of cash flow analysis that supports the income generation and repayment ability of the borrower.

Impersonation and False Information on Loan Applications/Double-pledging of Collateral/Fraudulent Valuations/Forged or Valueless Collateral

- No on-site appraisal of or visit by the borrower.
- Difficulty in obtaining corroboration of the individual's credentials, inconsistent or missing documentation and inconsistencies in personal details.
- Valuer from outside the area in which the property is situated.
- Valuation is ordered and received by the borrower rather than the lender.
- Lack of verification of liens to substantiate lien positions and priorities
- Lack of physical control of collateral that requires physical possession to secure a loan (for example, jewelry, bearer bonds and art work).

Appendix 2**Examples of Internal Control Considerations and Substantive Procedures for Two Areas of a Bank's Operations**

1. The internal controls and substantive procedures listed below represent neither an exhaustive list of controls and procedures that should be undertaken, nor do they represent any minimum requirement that should be satisfied. Rather, they provide guidance on the controls and procedures that the auditor may consider in dealing with the following areas:
 - (a) Treasury and trading operations; and
 - (b) Loans and advances.

Treasury and Trading Operations*Introduction*

2. Treasury operations, in this context, represent all activities relating to the purchase, sale, borrowing and lending of financial instruments. Financial instruments may be securities, money market instruments or derivative instruments. Banks usually enter into such transactions for their own use (for example, for the purpose of hedging risk exposures) or for meeting customers' needs. They also carry out, to a larger or smaller extent, trading activities. Trading may be defined as the purchase and sale (or origination and closing) of financial instruments (including derivatives) with the intention of deriving a gain from the change in market price parameters (for example, foreign exchange rates, interest rates, equity prices) over time. Banks manage and control their treasury activities on the basis of the various risks involved rather than on the basis of the particular type of financial instrument dealt with. The auditor ordinarily adopts the same approach when obtaining audit evidence. IAPS 1012 gives guidance on the audit implications of derivatives acquired by the bank as an end user.

Internal Control Considerations

3. Generally, treasury operations involve transactions that are recorded by IT systems. The risk of processing error in such transactions is ordinarily low provided they are processed by reliable systems. Consequently, the auditor tests whether key processing controls and procedures are operating effectively before assessing the level of inherent and control risks as low. Typical controls in a treasury environment are listed below. These include controls that address business risks of banks and do not necessarily represent controls that address audit risks and that are tested by the auditor in order to assess the levels of inherent and control risks.

Typical Control Questions*Strategic Controls*

4. Have those charged with governance established a formal policy for the bank's treasury business that sets out:
 - The authorized activities and products the bank can trade on its own or a third party's behalf, ideally broken down by product or risk group;
 - The markets in which trading activities take place: these could be regional markets, or Over-the-Counter (OTC) versus Exchange markets;
 - The procedures for measuring, analyzing, supervising and controlling risks;
 - The extent of risk positions permissible, after taking into account the risk they regard as acceptable;
 - The appropriate limits and procedures covering excesses over defined limits;
 - The procedures, including documentation, that must be complied with before new products or activities are introduced;
 - The type and frequency of reports to those charged with governance; and
 - The schedule and frequency with which the policy is reviewed, updated and approved?

Operational Controls

5. Is there appropriate segregation of duties between the front office and back office?
6. Are the following activities conducted independently of the front office/business unit:
 - Confirmation of trades;
 - Recording and reconciliation of positions and results;
 - Valuation of trades or independent verification of market prices; and
 - Settlement of trades?
7. Are trade tickets pre-numbered (if not automatically generated)?
8. Does the bank have a code of conduct for its dealers that addresses the following:
 - Prohibiting dealers from trading on their own account;
 - Restricting acceptance of gifts and entertainment activities;

- Confidentiality of customer information;
 - Identification of approved counterparties; and
 - Procedures for the review of dealers' activities by management?
9. Are remuneration policies structured to avoid encouraging excessive risk taking?
 10. Are new products introduced only after appropriate approvals are obtained and adequate procedures and risk control systems are in place?

Limits and Trading Activity

11. Does the bank have a comprehensive set of limits in place to control the market, credit and liquidity risks for the whole institution, business units and individual dealers? Some commonly used limits are notional or volume limits (by currency or counterparty), stop loss limits, gap or maturity limits, settlement limits and value-at-risk limits (for both market and credit risks).
12. Are limits allocated to risks in line with the overall limits of the bank?
13. Do all dealers know their limits and the use thereof? Does every new transaction reduce the available limit immediately?
14. Are procedures in place that cover excesses over limits?

Risk Measurement and Management

15. Is there an independent risk management function (sometimes referred to as Middle Office) for measuring, monitoring and controlling risk? Does it report directly to those charged with governance and senior management?
16. Which method is employed to measure the risk arising from trading activities (for example, position limits, sensitivity limits, value at risk limits, etc.)?
17. Are the risk control and management systems adequately equipped to handle the volume, complexity and risk of treasury activities?
18. Does the risk measurement system cover all portfolios, all products and all risks?
19. Is appropriate documentation in place for all elements of the risk system (methodology, calculations, parameters)?
20. Are all trading portfolios revalued and risk exposures calculated regularly, at least daily for active dealing operations?
21. Are risk management models, methodologies and assumptions used to measure risk and to limit exposures regularly assessed, documented and updated continuously to take account of altered parameters, etc?

22. Are stress situations analyzed and “worst case” scenarios (which take into account adverse market events such as unusual changes in prices or volatilities, market illiquidity or default of a major counterparty) conducted and tested?
23. Does management receive timely and meaningful reports?

Confirmations

24. Does the bank have written procedures in use:
 - For the independent dispatch of pre-numbered outward confirmations to counterparties for all trades entered into by the dealers;
 - For the independent receipt of all incoming confirmations and their matching to pre-numbered copies of internal trade tickets;
 - For independent comparison of signatures on incoming confirmations to specimen signatures;
 - For the independent confirmation of all deals for which no inward confirmation has been received; and
 - For the independent follow-up of discrepancies on confirmations received?

Settlement of Transactions

25. Are settlement instructions exchanged in writing with counterparties by the use of inward and outward confirmations?
26. Are settlement instructions compared to the contracts?
27. Are settlements made only by appropriate authorized employees independent of the initiation and recording of transactions and only on the basis of authorized, written instructions?
28. Are all scheduled settlements (receipts and payments) notified daily in writing to the settlement department so that duplicate requests and failures to receive payments can be promptly detected and followed-up?
29. Are accounting entries either prepared from or checked to supporting documentation by operational employees, other than those who maintain records of uncompleted contracts or perform cash functions?

Recording

30. Are exception reports generated for excesses in limits; sudden increases in trading volume by any one trader, customer or counterparty; transactions at unusual contract rates, etc? Are these monitored promptly and independently of the dealers?



31. Does the bank have written procedures that require:
- The accounting for all used and unused trade tickets;
 - The prompt recording into the accounting records by an independent party of all transactions, including procedures to identify and correct rejected transactions;
 - The daily reconciliation of dealer's positions and profits with the accounting records and the prompt investigation of all differences; and
 - Regular reports to management in appropriate detail to allow the monitoring of the limits referred to above?
32. Are all *nostro* and *vostro* account reconciliations performed frequently and by employees independent of the settlement function?
33. Are suspense accounts regularly reviewed?
34. Does the bank have an accounting system that allows it to prepare reports that show its spot, forward, net open and overall positions for the different types of products, for example:
- By purchase and sale, by currency;
 - By maturity dates, by currency; and
 - By counterparty, by currency?
35. Are open positions revalued periodically (for example, daily) to current values based on quoted rates or rates obtained directly from independent sources?

General Audit Procedures

36. Certain audit procedures apply to the environment in which treasury activities are carried out. To understand this environment, the auditor initially obtains an understanding of the:
- Scale, volume, complexity and risk of treasury activities;
 - Importance of treasury activities relative to other business of the bank;
 - Framework within which treasury activities take place; and
 - Organizational integration of the treasury activities.
37. Once the auditor has obtained this understanding and has performed tests of controls with satisfactory results, the auditor ordinarily assesses:
- The accuracy of the recording of transactions entered into during the period and related profits and losses, by reference to deal tickets and confirmation slips;

- The completeness of transactions and proper reconciliation between the front office and accounting systems of open positions at the period end;
 - The existence of outstanding positions by means of third party confirmations at an interim date or at the period end;
 - The appropriateness of the exchange rates, interest rates or other underlying market rates used at the year end date to calculate unrealized gains and losses;
 - The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the period end; and
 - The appropriateness of the accounting policies used particularly around income recognition and the distinction between hedged and trading instruments.
38. Relevant aspects of treasury operations that generally pose increased audit risks are addressed below:

Changes in Products or Activities

39. Particular risks often arise where new products or activities are introduced. To address such risks the auditor initially seeks to confirm that predefined procedures are in place for these cases. Generally, the bank should commence such activities only when the smooth flow of the new transactions through the controls system is ensured, the relevant IT systems are fully in place (or where adequate interim system support is in place) and the relevant procedures are properly documented. Newly traded instruments are ordinarily subject to careful review by the auditor, who initially obtains a list of all new products introduced during the period (or a full list of all instruments transacted). Based on this information, the auditor establishes the associated risk profile and seeks to confirm the reliability of the internal control and accounting systems.

Reliance on Computer Experts

40. Due to the volume of transactions, virtually all banks support the treasury transactions cycle using IT systems. Due to the complexity of systems in use and the procedures involved, the auditor ordinarily seeks the assistance of IT experts to supply appropriate skills and knowledge in the testing of systems and relevant account balances.

Purpose for which Transactions are Undertaken

41. The auditor considers whether the bank holds speculative positions in financial instruments or hedges them against other transactions. The purpose for entering such transactions, whether hedging or trading, should be

identified at the dealing stage in order for the correct accounting treatment to be applied. Where transactions are entered for hedging purposes, the auditor considers the appropriate accounting treatment and presentation of such transactions and the matched assets/liabilities, in accordance with relevant accounting requirements.

Valuation Procedures

42. Off-balance sheet financial instruments are ordinarily valued at market or fair value, except for instruments used for hedging purposes, which, under many financial reporting frameworks, are valued on the same basis as the underlying item being hedged. Where market prices are not readily available for an instrument, financial models that are widely used by the banking industry may be used to determine the fair value. In addition to disclosure of the notional amounts of open positions, several countries require the disclosure of the potential risk arising, as for example, the credit risk equivalent and replacement value of such outstanding instruments.
43. The auditor ordinarily tests the valuation models used, including the controls surrounding their operation, and considers whether details of individual contracts, valuation rates and assumptions are appropriately entered into such models. As many of these instruments have been developed only recently, the auditor pays particular attention to their valuation, and in doing so bears in mind the following factors:
 - There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms.
 - There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a greater difficulty in establishing controls that would prevent misstatements or detect and correct them on a timely basis.
 - Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the bank to hedge its positions.
 - The models used for valuing such instruments may not operate properly in abnormal market conditions.
44. In addition, the auditor considers the need for, and adequacy of, provisions against financial instruments, such as liquidity risk provision, modeling risk

provision and reserve for operational risk. The complexity of certain instruments requires specialist knowledge. If the auditor does not have the professional competence to perform the necessary audit procedures, advice is sought from appropriate experts.

45. A further issue of particular interest to the auditor is transactions entered into at rates outside the prevailing market rates; these often involve the risk of hidden losses or fraudulent activity. As a result, the bank ordinarily provides mechanisms that are capable of detecting transactions out of line with market conditions. The auditor obtains sufficient appropriate audit evidence concerning the reliability of the function performing this task. The auditor also considers reviewing a sample of the identified transactions.

Loans and Advances

Introduction

46. According to a consultative paper, “Principles for the Management of Credit Risk,” issued by the Basel Committee on Banking Supervision, credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.
47. Loans and advances are the primary source of credit risk for most banks, because they usually are a bank’s most significant assets and generate the largest portion of revenues. The overriding factor in making a loan is the amount of credit risk associated with the lending process. For individual loans, credit risk pertains to the borrower’s ability and willingness to pay. Aside from loans, other sources of credit risk include acceptances, inter-bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.
48. Credit risk represents a major cause of serious banking problems, and is directly related to lax credit standards for borrowers and counterparties, lack of qualified lending expertise, poor portfolio risk management, and a lack of attention to changes in economic or other circumstances that may lead to a deterioration in the credit standing of a bank’s counterparties. Effective credit risk management is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization. In managing credit risk, banks should consider the level of risk inherent in both individual credits or transactions and in the entire asset portfolio. Banks also need to analyze the risk between credit risk and other risks.

Typical Control Questions

49. Credit risks arise from characteristics of the borrower and from the nature of the exposure. The creditworthiness, country of operation and nature of

borrower's business affect the degree of credit risk. Similarly, the credit risk is influenced by the purpose and security for the exposure.

50. The credit function may conveniently be divided into the following categories:
 - (c) Origination and disbursement.
 - (d) Monitoring.
 - (e) Collection.
 - (f) Periodic review and evaluation.

Origination and Disbursement

51. Does the bank obtain complete and informative loan applications, including financial statements of the borrower, the source of the loan repayment and the intended use of proceeds?
52. Does the bank have written guidelines as to the criteria to be used in assessing loan applications (for example, interest coverage, margin requirements, debt-to-equity ratios)?
53. Does the bank obtain credit reports or have independent investigations conducted on prospective borrowers?
54. Does the bank have procedures in use to ensure that related party lending has been identified?
55. Is there an appropriate analysis of customer credit information, including projected sources of loan servicing and repayments?
56. Are loan approval limits based on the lending officer's expertise?
57. Is appropriate lending committee or board of director approval required for loans exceeding prescribed limits?
58. Is there appropriate segregation of duties between the loan approval function and the loan disbursement monitoring, collection and review functions?
59. Is the ownership of loan collateral and priority of the security interest verified?
60. Does the bank ensure that the borrower signs a legally enforceable document as evidence of an obligation to repay the loan?
61. Are guarantees examined to ensure that they are legally enforceable?
62. Is the documentation supporting the loan application reviewed and approved by an employee independent of the lending officer?
63. Is there a control to ensure the appropriate registration of security (for example, recording of liens with governmental authorities)?

64. Is there adequate physical protection of notes, collateral and supporting documents?
65. Is there a control to ensure that loan disbursements are recorded immediately?
66. Is there a control to ensure that to the extent possible, loan proceeds are used by the borrower for the intended purpose?

Monitoring

67. Are trial balances prepared and reconciled with control accounts by employees who do not process or record loan transactions?
68. Are reports prepared on a timely basis of loans on which principal or interest payments are in arrears?
69. Are these reports reviewed by employees independent of the lending function?
70. Are there procedures in use to monitor the borrower's compliance with any loan restrictions (for example, covenants) and requirements to supply information to the bank?
71. Are there procedures in place that require the periodic reassessment of collateral values?
72. Are there procedures in place to ensure that the borrower's financial position and results of operations are reviewed on a regular basis?
73. Are there procedures in place to ensure that key administrative dates, such as the renewal of security registrations, are accurately recorded and acted upon as they arise?

Collection

74. Are the records of principal and interest collections and the updating of loan account balances maintained by employees independent of the credit granting function?
75. Is there a control to ensure that loans in arrears are followed up for payment on a timely basis?
76. Are there written procedures in place to define the bank's policy for recovering outstanding principal and interest through legal proceedings, such as foreclosure or repossession?
77. Are there procedures in place to provide for the regular confirmation of loan balances by direct written communication with the borrower by employees independent of the credit granting and loan recording functions, as well as the independent investigation of reported differences?

Periodic Review and Evaluation

78. Are there procedures in place for the independent review of all loans on a regular basis, including:
- The review of the results of the monitoring procedures referred to above; and
 - The review of current issues affecting borrowers in relevant geographic and industrial sectors?
79. Are there appropriate written policies in effect to establish the criteria for:
- The establishment of loan loss provisions;
 - The cessation of interest accruals (or the establishment of offsetting provisions);
 - The valuation of collateral security for loss provisioning purposes;
 - The reversals of previously established provisions;
 - The resumption of interest accruals; and
 - The writing off of loans?
80. Are there procedures in place to ensure that all required provisions are entered into the accounting records on a timely basis?

General Audit Procedures

81. The following audit procedures are intended to allow the auditor to discover the operating standards and processes that the bank has established and to consider whether controls regarding credit risk management are adequate.

Planning

82. The auditor obtains a knowledge and understanding of the bank's method of controlling credit risk. This includes matters such as the following:
- The bank's exposure monitoring process, and its system for ensuring that all connected party lending has been identified and aggregated.
 - The bank's method for appraising the value of exposure collateral and for identifying potential and definite losses.
 - The bank's lending practices and customer base.
83. The auditor considers whether the exposure review program ensures independence from the lending functions including whether the frequency is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions and whether the frequency is increased for identified problem credits.

84. The auditor considers the qualifications of the personnel involved in the credit review function. The industry is changing rapidly and fundamentally creating a lack of qualified lending expertise. The auditor considers whether credit review personnel possess the knowledge and skills necessary to manage and evaluate lending activities.
85. The auditor considers, through information previously generated, the causes of existing problems or weaknesses within the system. The auditor considers whether these problems or weaknesses present the potential for future problems.
86. The auditor reviews management reports and considers whether they are sufficiently detailed to evaluate risk factors.
87. Note that defining and auditing related party lending transactions are difficult because the transactions with related parties are not easily identifiable. Reliance is primarily upon management to identify all related parties and related-party transactions and such transactions may not be easily detected by the bank's internal control systems.

Tests of Control

88. The auditor obtains a knowledge and understanding of the bank's method of controlling credit risk. This includes matters such as:
 - The exposure portfolio and the various features and characteristics of the exposures;
 - The exposure documentation used by the bank;
 - What constitutes appropriate exposure documentation for different types of exposures; and
 - The bank's procedures and authority levels for granting an exposure.
89. The auditor reviews the lending policies and considers:
 - Whether the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions and new business lines of the bank; and
 - Whether those charged with governance have approved the policies and whether the bank is in compliance.
90. The auditor examines the exposure review reporting system, including credit file memoranda and an annual schedule or exposure review plan, and considers whether it is thorough, accurate and timely and whether it will provide sufficient information to allow management to both identify and control risk. Do the reports include:
 - Identification of problem credits;

- Current information regarding portfolio risk; and
 - Information concerning emerging trends in the portfolio and lending areas?
91. The auditor considers the nature and extent of the scope of the exposure review, including the following:
- Method of exposure selection.
 - Manner in which exposures are reviewed including:
 - An analysis of the current financial condition of the borrower which addresses repayment ability; and
 - Tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations.
92. The auditor considers the effectiveness of the credit administration and portfolio management by examining the following:
- Management's general lending philosophy in such a manner as to elicit management responses.
 - The effect of credits not supported by current and complete financial information and analysis of repayment ability.
 - The effect of credits for which exposure and collateral documentation are deficient.
 - The volume of exposures improperly structured, for example, where the repayment schedule does not match exposure purpose.
 - The volume and nature of concentrations of credit, including concentrations of classified and criticized credits.
 - The appropriateness of transfers of low quality credits to or from another affiliated office.
 - The accuracy and completeness of reports.
 - Competency of senior management, exposure officers and credit administration personnel.

Substantive Procedures

93. The auditor considers the extent of management's knowledge of the bank's own credit exposure problems through selective exposure file reviews. Selection criteria include the following:
- Accounts with an outstanding balance equal to or greater than a specified amount.

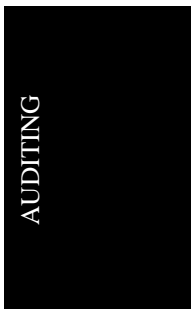
- Accounts on a “Watch List” with an outstanding balance in excess of a specified amount.
- Accounts with a provision in excess of a specified amount.
- Accounts that are handled by the department that manages the bank’s problem or higher risk accounts.
- Accounts where principal or interest of more than a specified amount is in arrears for more than a specified period.
- Accounts where the amount outstanding is in excess of the authorized credit line.
- Accounts with entities operating in industries or countries that the auditor’s own general economic knowledge indicates could be at risk.
- Problem accounts identified by the bank regulatory authorities and problem accounts selected in the prior year.
- The extent of exposure to other financial institutions on inter-bank lines.

94. In addition, where the bank’s personnel have been requested to summarize characteristics of all exposures over a specified size grouped on a connection basis, the auditor reviews the summaries. Exposures with the following characteristics may indicate a need for a more detailed review:

- Large operating loss in the most recent fiscal year.
- Sustained operating losses (for example, 2 or more years).
- A high debt/equity ratio (for example, in excess of 2:1—the ratio will vary by industry).
- Failure to comply with terms of agreement on covenants.
- Modified auditor’s report.
- Information provided not current or complete.
- Advances significantly unsecured or secured substantially by a guarantee.
- Accounts where reviews not performed by bank management on a timely basis.

95. The auditor selects the exposures for detailed review from the exposure listings above using the sample selection criteria determined above and obtains the documents necessary to consider the collectability of the exposures. These may include the following:

- The exposure and security documentation files.
- Arrears listings or reports.



- Activity summaries.
 - Previous doubtful accounts listings.
 - The non-current exposure report.
 - Financial statements of the borrower.
 - Security valuation reports.
96. Using the exposure documentation file, the auditor:
- Ascertains the exposure type, interest rate, maturity date, repayment terms, security and stated purpose of the exposure;
 - Considers whether security documents bear evidence of registration as appropriate, and that the bank has received appropriate legal advice about the security's legal enforceability;
 - Considers whether the fair value of the security appears adequate (particularly for those exposures where a provision may be required) to secure the exposure and that where applicable, the security has been properly insured. Critically evaluates the collateral appraisals, including the appraiser's methods and assumptions;
 - Evaluates the collectability of the exposure and considers the need for a provision against the account;
 - Determines whether the appropriate authority levels within the bank have approved the exposure application or renewal;
 - Reviews periodic financial statements of the borrower and notes significant amounts and operating ratios (that is, working capital, earnings, shareholders' equity and debt-to-equity ratios); and
 - Reviews any notes and correspondence contained in the exposure review file. Notes the frequency of review performed by the bank's staff and considers whether it is within bank guidelines.
97. The auditor considers whether policies and procedures exist for problem and workout exposures, including the following:
- A periodic review of individual problem credits.
 - Guidelines for collecting or strengthening the exposure, including requirements for updating collateral values and lien positions, documentation review, officer call reports.
 - Volume and trend of past due and non-accrual credits.
 - Qualified officers handling problem exposures.
 - Guidelines on proper accounting for problem exposures, for example, non-accrual policy, specific reserve policy.

98. In addition to assessing the adequacy of the provisions against individual exposures, the auditor considers whether any additional provisions need to be established against particular categories or classes of exposures (for example, credit card exposures and country risk exposures) and assesses the adequacy of any provisions that the bank may have established through discussions with management.

Appendix 3

Examples of Financial Information, Ratios and Indicators Commonly Used in the Analysis of a Bank's Financial Condition and Performance

There are a large number of financial ratios that are used to analyze a bank's financial condition and performance. While these ratios vary somewhat between countries and between banks, their basic purpose tends to remain the same, that is, to provide measures of performance in relation to prior years, to budget and to other banks. The auditor considers the ratios obtained by one bank in the context of similar ratios achieved by other banks for which the auditor has, or may obtain, sufficient information.

These ratios generally fall into the following categories:

- Asset quality.
- Liquidity.
- Earnings.
- Capital adequacy.
- Market risk.
- Funding risk.

Set out below are those overall ratios that the auditor is likely to encounter. Many other, more detailed ratios are ordinarily prepared by management to assist in the analysis of the condition and performance of the bank and its various categories of assets and liabilities, departments and market segments.

(a) Asset quality ratios:

- Loan losses to total loans
- Non-performing loans to total loans
- Loan loss provisions to non-performing loans
- Earnings coverage to loan losses
- Increase in loan loss provisions to gross income
- Size, credit risk concentration, provisioning

(b) Liquidity ratios:

- Cash and liquid securities (for example, those due within 30 days) to total assets
- Cash, liquid securities and highly marketable securities to total assets

- Inter-bank and money market deposit liabilities to total assets
- (c) Earnings ratios:
- Return on average total assets
 - Return on average total equity
 - Net interest margin as a percentage of average total assets and average earning assets
 - Interest income as a percentage of average interest bearing assets
 - Interest expense as a percentage of average interest bearing liabilities
 - Non-interest income as a percentage of average commitments
 - Non-interest income as a percentage of average total assets
 - Non-interest expense as a percentage of average total assets
 - Non-interest expense as a percentage of operating income
- (d) Capital adequacy ratios:
- Equity as a percentage of total assets
 - Tier 1 capital as a percentage of risk-weighted assets
 - Total capital as a percentage of risk-weighted assets
- (e) Market risk:
- Concentration of risk of particular industries or geographic areas
 - Value at risk
 - Gap and duration analysis (basically a maturity analysis and the effect of changes in interest rates on the bank's earnings or own funds)
 - Relative size of engagements and liabilities
 - Effect of changes in interest rates on the bank's earnings or own funds
- (f) Funding risk:
- Clients' funding to total funding (clients' plus interbank)
 - Maturities
 - Average borrowing rate

Appendix 4**Risks and Issues in Securities Underwriting and Securities Brokerage****Securities Underwriting**

Many banks provide such financial services as underwriting publicly offered securities or assisting in the private placement of securities. Banks engaging in these activities may be exposed to substantial risks that have audit implications. These activities and the risks associated with them are quite complex, and consideration is given to consulting with experts in such matters.

The type of security being underwritten, as well as the structure of the offering, influence the risks present in securities underwriting activities. Depending upon how a security offering is structured, an underwriter may be required to buy a portion of the positions offered. This creates the need to finance the unsold portions, and exposes the entity to the market risk of ownership.

There is also a significant element of legal and regulatory risk that is driven by the jurisdiction in which the security offering is taking place. Examples of legal and regulatory risk areas include an underwriter's exposure for material misstatements included in a securities registration or offering statement and local regulations governing the distribution and trading in public offerings. Also included are risks arising from insider trading and market manipulation by management or the bank's staff. Private placements are ordinarily conducted on an agency basis and therefore result in less risk than that associated with a public offering of securities. However, the auditor considers local regulations covering private placements.

Securities Brokerage

Many banks also are involved in securities brokerage activities that include facilitating customers' securities transactions. As with securities underwriting, banks engaging in these activities (as a broker, dealer, or both) may be exposed to substantial risks that have audit implications. These activities and the risks associated with them are quite complex, and consideration is given to consulting with experts in such matters.

The types of services offered to customers and the methods used to deliver them determine the type and extent of risks present in securities brokerage activities. The number of securities exchanges on which the bank conducts business and executes trades for its customers also influences the risk profile. One service often offered is the extension of credit to customers who have bought securities on margin, resulting in credit risk to the bank. Another common service is acting as a depository for securities owned by customers. Entities are also exposed to liquidity risks associated with funding securities brokerage operations. The related audit risk factors are similar to those set out in Appendix 5, "Risks and Issues in Asset Management."

There is also a significant element of legal and regulatory risk that is driven by the jurisdiction in which the security brokerage activities are taking place. This may be a consideration for regulatory reporting by the bank, reports directly by the auditor to regulators and also from the point of view of reputation and financial risk that may occur in the event of regulatory breaches by the bank.



Appendix 5

Risks and Issues in Private Banking and Asset Management

Private Banking

Provision of superior levels of banking services to individuals, typically people with high net worth, is commonly known as private banking. Such individuals may often be domiciled in a country different from that of the bank. Before auditing private banking activities, the auditor understands the basic controls over these activities. The auditor considers the extent of the entity's ability to recognize and manage the potential reputational and legal risks that may be associated with inadequate knowledge and understanding of its clients' personal and business backgrounds, sources of wealth, and uses of private banking accounts. The auditor considers the following:

- Whether management oversight over private banking activities includes the creation of an appropriate corporate culture. Additionally, high levels of management should set goals and objectives and senior management must actively seek compliance with corporate policies and procedures.
- Policies and procedures over private banking activities should be in writing and should include sufficient guidance to ensure there is adequate knowledge of the entity's customers. For example, the policies and procedures should require that the entity obtain identification and basic background information on their clients, describe the clients' source of wealth and lines of business, request references, handle referrals, and identify suspicious transactions. The entity should also have adequate written credit policies and procedures that address, among other things, money laundering related issues, such as lending secured by cash collateral.
- Risk management practices and monitoring systems should stress the importance of the acquisition and retention of documentation relating to clients, and the importance of due diligence in obtaining follow-up information where needed to verify or corroborate information provided by a customer or his or her representative. Inherent in sound private banking operations is the need to comply with any customer identification requirements. The information systems should be capable of monitoring all aspects of an entity's private banking activities. These include systems that provide management with timely information necessary to analyze and effectively manage the private banking business, and systems that enable management to monitor accounts for suspicious transactions and to report any such instances to law enforcement authorities and banking supervisors as required by regulations or laws.

The auditor considers the assessed levels of inherent and control risk related to private banking activities when determining the nature, timing and extent of substantive procedures. The following list identifies many of the common audit risk factors to

consider when determining the nature, timing and extent of procedures to be performed. Since private banking frequently involves asset management activities the audit risk factors associated with asset management activities are also included below.

- *Compliance with regulatory requirements.* Private banking is highly regulated in many countries. This may be a consideration for regulatory reporting by the client, reports directly by the auditor to regulators and also from the point of view of the reputation and financial risk that may occur in the event of regulatory breaches by the bank. Also, the nature of private banking activities may increase the bank's susceptibility to money laundering, and thus may have increased operational, regulatory, and reputational risks, which may have audit implications.
- *Confidentiality.* This is generally a feature of private banking. In addition to the normal secrecy which most countries accord bank/client relationships, many jurisdictions where private banking is common have additional banking secrecy legislation which may reduce the ability of regulators, taxing authorities or police, from their own or other jurisdictions, to access client information. A bank may seek to impose restrictions on an auditor's access to the names of the bank's private clients, affecting the auditor's ability to identify related party transactions. A related issue is that the bank may be requested by a client not to send correspondence, including account statements (hold mail accounts). This may reduce the auditor's ability to gain evidence as to completeness and accuracy and, in the absence of adequate alternative procedures, the auditor considers the implications of this for the auditor's report.
- *Management fraud.* The tight confidentiality and personal nature of private banking relationships may reduce the effectiveness of internal controls that provide supervision and oversight over staff who deal with private clients' affairs. The high degree of personal trust that may exist between a client and their private banker may add to the risk in that many private bankers are given some degree of autonomy over the management of their clients' affairs. This risk is exacerbated to the extent private clients may not be in a position to verify their affairs on a regular basis as explained above.
- *Services designed to legally transfer some degree of ownership/control of assets to third parties, including trusts and other similar legal arrangements.* Such arrangements are not confined to private banking relationships, however, they are commonly present in them. For the bank, the risk is that the terms of the trust or other legal arrangement are not complied with or do not comply with the applicable law. This exposes the bank to possible liability to the beneficiaries. Controls in this area are particularly important, given that errors are often identified only when the trust or other arrangement is wound up, possibly decades after its creation. Private bankers often are also involved in preparing wills or other testamentary documents, and act as executors. Improper drafting of a will may carry financial consequences to the bank. Controls should exist in this area and in the area of monitoring executor activity. The auditor considers

whether there are any undisclosed liabilities in respect of such services. Confidentiality requirements may affect the auditor's ability to obtain sufficient appropriate audit evidence, and if so, the auditor considers the implications for the auditor's report. Finally, trust and similar arrangements provided by private banks are often outsourced to third parties. The auditor considers what audit risk factors remain for outsourced services, the procedures needed to understand the risks and relationships and assess the controls over and within the outsourced service provider.

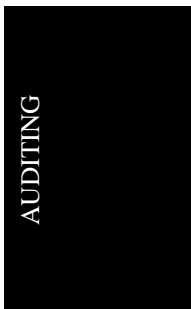
- *Credit risk.* Credit risk is often more complex when private banking services are provided because of the nature of their customers' borrowing requirements. The following services often make credit risk difficult to judge: structured facilities (credit transactions with multiple objectives which address client requirements in areas such as tax, regulation, hedging, etc.); unusual assets pledged as security (for example, art collections, not readily saleable properties, intangible assets whose value is reliant on future cash flows); and reliance placed on personal guarantees (name lending).
- *Custody.* Private banks may offer custodial services to clients for physical investment assets or valuables. The related audit risk factors are similar to those set out below under Asset Management.

Asset Management

The following risk factors are provided as considerations in planning the strategy and execution of the audit of a bank's asset management activities. Included in this area are fund management, pension management, vehicles designed to legally transfer some degree of ownership/control of assets to third parties such as trusts or other similar arrangements etc. This list is not exhaustive as the financial services industry is a rapidly changing industry.

- *When both the asset manager and the assets themselves are not both audited by the same audit firm.* The performance of an asset manager and the assets themselves generally are closely linked. It is easier to identify and understand the implications of an issue arising in one entity on the financial statements of the other if both are audited by the same firm, or if arrangements have been made to permit an appropriate exchange of information between two audit firms. Where there is no requirement for both the assets and the asset manager to be audited, or where appropriate access to the other audit firm is not possible, the auditor considers whether he is in a position to form a complete view.
- *Fiduciary responsibility to third parties.* Mismanagement of third party funds may have a financial or reputational effect on an asset manager. Matters falling into this category may include:
 - Improper record keeping;
 - Inadequate controls over the protection and valuation of assets;

- Inadequate controls to prevent fund manager fraud;
 - Inappropriate physical and/or legal segregation of client funds from the manager's funds or other clients' funds (often a regulated aspect);
 - Inappropriate segregation of client investments from the manager's own investments (either personal or corporate or both) or other clients' investments;
 - Inappropriate segregation of bank staff engaged in asset management duties and those engaged in other operations;
 - Non-compliance with mandates from clients or the investment policy under which funds were supposed to be managed; and
 - Failure to comply with reporting requirements (contractual or regulatory) to clients.
- Consideration is given to the policies and controls over client acceptance; investment decisions; compliance with client instructions; conflicts of interest; compliance with regulations; segregation and safeguarding of funds and proper reporting of client assets and transactions.
 - *Fund manager remuneration.* There is a heightened potential for fund managers to make imprudent or illegal business decisions based upon a desire for personal gain through a bonus or incentive arrangement.
 - *Technology.* Technology is critical to the operation of most asset management companies therefore an examination is made of the security, completeness and accuracy of data and data input where computer controls are being relied on for audit purposes, as well as the overall computer control environment. Consideration is given as to whether appropriate controls exist to ensure transactions on behalf of clients are separately recorded from the bank's own transactions.
 - *Globalization and international diversification.* These are features of many asset managers and this may give rise to additional risks due to the diversity of practice among different countries regarding matters such as pricing and custody rules, regulations, legal systems, market practices, disclosure rules and accounting standards.



Glossary of Terms

Hidden Reserves	Some financial reporting frameworks allow banks to manipulate their reported income by transferring amounts to non-disclosed reserves in years when they make large profits and transferring amounts from those reserves when they make losses or small profits. The reported income is the amount after such transfers. The practice served to make the bank appear more stable by reducing the volatility of its earnings, and would help to prevent a loss of confidence in the bank by reducing the occasions on which it would report low earnings.
Nostros	Accounts held in the bank's name with a correspondent bank.
Provision	An adjustment to the carrying value of an asset to take account of factors that might reduce the asset's worth to the entity. Sometimes called an allowance.
Prudential Ratios	Ratios used by regulators to determine the types and amounts of lending a bank can undertake.
Stress Testing	Testing a valuation model by using assumptions and initial data outside normal market circumstances and assessing whether the model's predictions are still reliable.
Vostros	Accounts held by the bank in the name of a correspondent bank.

Reference Material

The following is a list of material that auditors of banks' financial statements may find helpful.

Basel Committee on Banking Supervision:

Publication 30: Core Principles for Effective Banking Supervision. Basel, 1997.

Publication 33: Framework for Internal Control Systems in Banking Organisations. Basel, 1998.

Publication 55: Sound Practices for Loan Accounting and Disclosure. Basel, 1999.

Publication 56: Enhancing Corporate Governance in Banking Organisations. Basel, 1999.

Publication 72: Internal Audit in Banking Organisations and the Relationship of the Supervisory Authorities with Internal and External Auditors. Basel, 2000

Publication 75: Principles for the Management of Credit Risk. Basel, 2000.

Publication 77: Customer Due Diligence for Banks. Basel, 2001.

Publication 82: Risk Management Principles for Electronic Banking. Basel, 2001.

Publications of the Basel Committee on Banking Supervision can be downloaded from the website of the Bank for International Settlements: <http://www.bis.org>.

International Accounting Standards Board:

IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions. London, 1999.

IAS 32: Financial Instruments: Disclosure and Presentation. London, 2000.

IAS 37: Provisions, Contingent Liabilities and Contingent Assets. London, 1998.

IAS 39: Financial Instruments: Recognition and Measurement. London, 2000.

In addition a number of IFAC member bodies have issued reference and guidance material on banks and the audits of the financial statements of banks.