

Roman Prykhodko

Ukrainian State University of Finance and International Trade, Kyiv, Ukraine

METHODS (PROCEDURES) OF AUDIT OF COMMERCIAL BANK ASSETS

Abstract: Recently, Ukrainian economy has become more and more integrated into the international economy. This matter has also become of a great importance for the financial sector of Ukrainian economy. During the period of 2005-2010 several sound acquisitions in banking sector took place and still banks of Ukraine are very interesting for foreign investors. The issue of transparency becomes more and more important. The problem of correspondence between methods and procedures of audit of commercial bank assets used in Ukraine and worldwide is still urgent and timely. Till now internal auditors of Ukrainian commercial banks and small audit companies in Ukraine mainly use the documentary inspections of the main part of sample. At the same time International Standards of Audit highly encourages auditors to use other methods such as test of controls and analytical procedures.

Keywords: methods, audit, bank, assets.

All over the world the banks constitute significant and powerful segment of business. Most of individuals and legal entities use bank services in the capacity of depositors or borrowers. Banks play an important role in supporting of a confidence in world best bank practice through their close connection to the regulating authority and legislative settings that are instituted for them. Thus, there is a considerable interest in banks' welfare, especially in their financial responsibility and liquidity and also in the appropriate risk level inherent to different types of their activity. Operations and therefore the requirements of the bank accounting differ from the requirements of the commercial enterprise accounting. The quality of bank assets, management and control of liquidity and risks are a big matter for economic stability and people welfare.

Banks are the establishments which function to credit the subjects of economic activity and citizens at the expense of involved assets of enterprises, corporations, organizations, people and other credit resources. Their function also is cash and credit serving of economics, currency exchange and other bank operations. Banks are legal entities thoroughly independent of executive bodies and regulatory authorities of government in decisions concerning their operations. In their work banks follow the Constitution of Ukraine, Ukrainian Laws "About National bank of

Ukraine”, “About banks and bank activity”, Legislation of Ukraine about corporations and other types of economic organizations, other types of legislative acts of Ukraine, normative act of National Bank of Ukraine (NBU) and own statutes.

Bank system of the country in modern models of market economics plays the most important role in functioning of all economic mechanisms. This system is a “circularity system of economics” that provides the regulation of total money supply, controls the motion of financial flow, realizes accumulation and investing of money resources, carries mutual settlements of accounts between economic subjects, credits different sectors of economics and population. Modern commercial banks being financial brokers function to provide intersectoral and interregional redistribution of money funds. Bank mechanisms of spheres and branches distribution and redistribution of capital allow to develop the economics depending on the objective needs of manufacture and encourage its structural rebuilding.

The advance of economic role of commercial banks at the present stage appears in expansion of their activity sphere and development of new types of financial services. Therefore stable and productive functioning of economics in any country is impossible without sensibly built and effectively working bank system. The main goal of commercial banks activity is a profit acquisition, profitability provision, and this is possible provided the ability of bank leadership to find the golden mean between bank assets profitability and their equilibration for the provision of its commitments. The main point in this case is the analysis and control of risks of bank operations: currency, interest, credit and liquidity risks.

In addition to the requirements of other International Financial Reporting Standards, the disclosures in the balance sheet or the notes should include, but are not limited to, the following assets:

- cash and balances with the central bank;
- treasury bills and other bills eligible for rediscounting with the central bank;
- government and other securities held for dealing purposes;
- placements with and loans and advances to other banks;
- other money market placements;
- loans and advances to customers; and
- investment securities.

In Ukraine the main requirements to assets disclosure in balance and notes to financial reports are being governed by instructions and decrees of the NBU, in this case it is the decree of NBU No. 598 of 7.12.2004. According to this decree bank assets should be presented in the form of balance sheet shown in Table 1.

The bank should also disclose assets’ analysis and commitments by grouping them according to the terms of cancellation out off the period of balance that is left till the date of the end of contract.

Examples of the periods that are applied according to the IFRS:

- till 1 month;
- from 1 to 3 months;

- from 3 months to 1 year;
- from 1 to 5 years;
- from 5 years and more.

Table 1. Structure of balance sheet according to Ukrainian regulations

	Balance sheet line	As of the reporting date	As of the prior financial year end date
1	Cash balances with National Bank of Ukraine		
2	Securities that are refinanced by NBU		
3	Due from other banks		
4	Securities in trading portfolio		
5	Securities available for sale		
6	Loans and advances to customers		
7	Securities held to maturity		
8	Investments in associates		
9	Fixed assets		
10	Intangible assets		
11	Accrued income		
12	Deferred tax asset		
13	Other assets		
14	Long-term assets available for sale		
15	Total assets		

Source: own elaboration.

According to the Ukrainian requirements we have the same liquidity presentation. The IFRS pays attention also to the fact that bank should disclose any fundamental concentrations of its assets, commitments and off-balance lines. Such disclosure should be made according to geographical regions, groups of customers or branches or by other risk concentrations. The bank should also disclose the sum of fundamental risks in foreign currency on the net basis.

If we analyze in detail the requirements of the NBU for concentration presentation in the annual report, we can say that they are mainly aimed at the macroeconomic statistical information collection for further analysis of the Ukrainian banking system as a whole. Geographic concentration has only break down table of: Ukraine, CIS countries and other countries. Taking into account that Ukrainian banks are still relatively small, this information is not very useful for analysis of the commercial bank itself. Economic groups also according to the NBU requirements are in line with Ministry of Economy of Ukraine classification, not with each bank peculiarities. According to the IFRS requirements each significant concentration should be presented in notes to financial statements.

In Table 2 we show the structure of the banking assets portfolio for top ten banks of Ukraine and the share of loans and securities in it.

Table 2. The structure of the banking assets portfolio for top ten banks of Ukraine as of 1/01/2010 (mln Ukrainian hryvnas)

Row	Bank	Bank assets portfolio	Share of loans and securities in the portfolio, %	As of 1/01/2010			
				Interbank loans	Corporate loans	Loans to individuals	Securities
1	Privatbank	67,431.6	10.612	8,145.18	39,767.9	18,988.82	529.69
2	Oschadbank	51,005.5	8.027	1,259.48	35,146.75	5,688.23	8,911.04
3	Ukreximbank	46,028.6	7.244	1,320.16	41,108.43	1,291.27	2,308.69
4	Raiffeisen Bank Aval	41,120.3	6.471	436.60	14,823.12	22,539.94	3,320.62
5	Ukrsibbank (BNP)	37,970.5	5.976	848.94	9,806.08	26,770.53	544.98
6	Ukrsocbank	34,572.5	5.441	166.43	13,148.48	20,708.51	549.11
7	OTP Bank	25,182.8	3.963	207.55	9,416.68	15,107.40	451.20
8	VTB Bank	22,989.6	3.618	238.68	19,419.82	2,998.74	332.33
9	Alfa-Bank	21,462.6	3.378	1,830.11	13,978.59	5,245.12	408.78
10	Nadra	19,824.4	3.120	404.60	4,632.60	14,359.73	427.43
	Whole banking system of Ukraine	635,422	100	37,566.28	347,806.77	214,850.36	35,198.61

Source: own elaboration.

For the purpose of the audit of the above-mentioned cases of bank assets auditors use the following instruments (techniques):

- procedures for understanding the client's control environment,
- test of controls,
- substantive procedures.

Procedures for understanding the client's control environment. The system of internal control includes the client's management policy of decision-making and procedures which take place during the operations of audited client in order to ensure correctness and completeness of accounting data, timeliness and reliability of financial reporting preparation, stable and efficient company work.

Audit of client's system of internal control is based on the understanding of two main components: control environment and control procedures.

The main factors of control environment:

- organizational chart,
- information and documentation flows,
- security hardware devices,
- personnel,
- internal control systems.

For the present situation in general for the Ukrainian banks all the above-mentioned factors are quite well documented, it is almost the rule and instruction of NBU. There are set of instructions, orders and rules issued by NBU related to this topic. Each bank has developed internal written manuals, policies and procedures for the control of bank operations. The main aim for the auditors in this case is to

understand them correctly, and to ensure that the practical performance of procedures corresponds with the written documents.

Examples of control procedures:

- reconciliation, check and analysis of account balances,
- checking of arithmetic entry correctness,
- checking of IT environment, SW and HW security,
- documentation chart flow,
- budgeting process, etc.

For the control procedures auditor also has to understand and document them correctly. Usually auditors do it as narrative with flow chart diagram, and then do one transaction re-performance in order to ensure that everything corresponds to the reality.

The description of control environment is done for the client-bank as a whole organization. The control procedures are identified and described for each general transaction process of the bank such as: loans, client account, securities, interest income and expenses, commissions, interbank operations, financial instruments, etc.

Test of controls. They are tests which are done in order to get the evidence for the correspondence of the internal control and accounting system effectiveness.

Types of test of controls:

- client personnel interviews,
- check of entries and documents,
- observation and re-performance of client control procedures,
- analysis of actual results with the budget, etc.

The main aim is to ensure the client procedures are not only designed correctly but also work.

Substantive procedures. Tests which are done in order to get audit evidence and identify material misstatements or errors in financial statements. There are two types of substantive procedures:

- detailed checks of transactions and balance of accounts,
- analytical procedures.

Examples of detailed checks of transactions and balance of accounts: loan review, review of contracts for deposits and interbank operations, requests of letter confirmation from correspondent banks, etc.

Due to the fact that in Ukraine still the main part of bank's income is interest income, the main part of assets is concentrated in loans. The approaches for loan review depend on the bank but the most common is sampling.

Therefore in a modern practice of bank's audit the sampling method is widely used for audit of the financial statements lines which are connected with accounting and valuation of big files of bank operations, such as audit of deposits attracted, credits issued, interest incomes and expenses, commission incomes and expenses, audit of the fixed assets and others.

Sampling cannot be opposed to continuous test of operations, as something forced and defective. Besides sometimes sampling has advantages in comparison with continuous tests of operations. Among these advantages are the following.

1. Higher efficiency. Selective observation is more effective than continuous one, which essentially shortens the period of examination. That is very important during the “busy season” audit. For example, you have to make an audit after the balance sheet, but before the deadline stated by stakeholders (meeting of stockholders, terms of reporting set by regulatory authorities or creditors, etc.).

2. Sampling could be used under circumstances which do not give an opportunity of continuous supervision. For example, auditors’ test of hundreds departments and other divisions of Oschadbank (or other developed companies) is practically impossible without sampling because of too big amount of work. But it is not a powerful argument for the benefit of sampling. For example if we have to define accuracy rating for mortgage loan borrower, we need to test only their random sample, because full testing would take a lot of time and money.

3. Opportunity of significant audit program extension. Economy of time on each site of the account of economic operations enables to check up a plenty of such sites. Samples can be included into continuous checks but only in some especially important spheres while for the control of routine transactions sampling is enough.

4. Growth in quality of audit evidence. Sampling observation at its correct organization and performance provides higher quality of auditor evidence (proofs) as it is possible to pick up and well train assistants of the auditor who perform this work.

5. Possibility of random control for total inspections. In a number of cases random sampling gives us more accurate results than total scanning of documents by the assistant in order to find any discrepancies in accounting, “stumble on the fault”. Sometimes services of internal audit of audited bank are used, which reduces the price of external audit. Therefore with the help of sample the auditor or senior can quickly check up quality of the involved expert’s/assistant’s work.

6. Audit cost reduction. Reduction of time, increase of quality and better results of carrying out inspections based on sampling ensure the reduction of the bank’s costs of technical aspects of audit.

While executing the order auditors widely use sampling observation – based on statistical methods and estimation. The problem of sufficiency, timeliness and reliability of audit evidence is directly connected with the volume of sample. At its planning the purpose of measurements is taken into account.

Having made the decision what procedures to choose and when they should be carried out, the auditor defines not only the quantity of items of the sample and its volume but what to be the target population.

Using estimating sample (sometimes – traditional sample) the auditor defines the volume of sample, relying on his own intuition and on theories of sample. He also uses it for making decision on total population from which the sample was selected.

Statistical sampling observation, based on the theory of probability, gives the auditor a chance to use the developed method of calculation of volume of sample and quality valuation of its results.

In practice of sampling observation different ways of formation of samples are used, such as: simple random, mechanical, fragmentary and serial selection.

Simple random selection is executed by draw or with the help of random numbers tables. It is a classical way of formation of samples, and exactly on this the theory of a sampling method is based. This method is used for the audit of bank transactions which are performed with the use of IT software, routine and performed on the daily basis (cash-settlements transaction, related income and expenses).

Mechanical selection executed through equal intervals from previously ranked by certain principal general population.

Thus we can see that sampling plays very big role in the process of conducting audit and especially for making detailed checks of transactions and balance of accounts.

Analytical procedures comprise the process of analysis, estimation and comparison of the main financial and economic indexes of the company, industry and country. It could be the study of different variations and correlations between linked indices in the financial statements, in comparison of budget versus actual, common practice in the industry.

During the process of conducting analytical procedures the financial information of the bank is checked:

- in comparison with the information on prior periods,
- with the forecasted results of bank performance,
- the same information presented by companies of the same industry.

The correlations which should be checked by the auditor during the analytical procedures for the bank assets:

- Between elements of financial statements. For example in the case the auditor identifies the increase in the amount of loans to individuals, the corresponding increase of interest income for such operations also should be noticed.
- Between non-financial and financial information. For example the bank has increased its branch network thus the increase in capital, maintenance and labour expenses should be identified.

According to the requirements of ISA 520 “Analytical procedures” the auditor should use them:

- in the process of planning, determining the nature, timing and volume of audit procedures,
- as a part of substantive procedures in case the analytical procedures are more efficient from the perspective of time and result,
- at the stage of finishing the audit during the financial statements review.

Thus the proper use of all the described in the article methods (procedures) of audit of commercial bank assets is essential.

References

- [1] Киреев О., Формування фінансової звітності комерційних банків на основі МСБО, *Бухгалтерський облік і аудит*, №1-2. 1998 Постанова Правління НБУ від 07.12.2004 р. № 598.
- [2] *Аудит*, Монтгомери / Ф.Л. Дефлиз, Г.Р. Дженик, В.М. О'Рейли, М.Б. Хирш: Пер. С англ. С.М. Бычковой / Под ред. проф. Я.В. Соколова. – М.: Аудит, ЮНИТИ, 1997. – 542 с.
- [3] Кіндрацька Л.М., *Бухгалтерський облік у банках України. Навчальний посібник*. – К.: КНЕУ, 2001. – 636 с.
- [4] Сінки Дж. мл., *Управление финансами в коммерческих банках* / Пер. с англ. 4-го переработанного изд. / Под ред. Ф. Я. Левиты, Б. С. Пинскера. – М: Финансы и статистика, 1999. – 820 с.

METODY (PROCEDURY) AUDYTU AKTYWÓW BANKÓW KOMERCYJNYCH

Streszczenie: Ostatnio obserwuje się integrację ukraińskiej gospodarki z gospodarką międzynarodową. Ta tendencja ma również duże znaczenie dla sektora finansowego ukraińskiej gospodarki. W okresie 2005-2010 przeprowadzono kilka nabyć w sektorze bankowym i nadal banki Ukrainy są bardzo interesujące dla inwestorów zagranicznych. W tych warunkach problem przejrzystości działalności staje się coraz ważniejszy. Ważna jest harmonizacja procedur kontroli aktywów banków komercyjnych wykorzystywanych na Ukrainie z procedurami stosowanymi na całym świecie. Obecnie audytorzy ukraińskich banków komercyjnych przeprowadzają inspekcję dokumentacji na podstawie próbek. W tym samym czasie międzynarodowe standardy kontroli zachęcają biegłych rewidentów do stosowania innych metod badania i kontroli oraz procedur analitycznych. Głównym celem tego artykułu jest prezentacja dodatkowych metod kontroli aktywów banków komercyjnych oraz wskazanie, jakie procedury, kiedy i w jakich sytuacjach mogą być stosowane.