

ASSESSMENT OF CREDIT INSTITUTIONS' OPERATIONAL RISKS FROM THE PERSPECTIVE OF EXTERNAL AUDIT

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Credit institution's operational risk should be evaluated by the external auditor cautiously because it is a risk arising from the way in which the bank's global strategy is implemented in practice and how the bank's activity is followed step by step by those charged with governance, internal audit and internal control so to indicate any deviation from the standard rules and procedures and reduce the likelihood of distortions caused by frauds or errors.

International Standards on Auditing require to external auditors to obtain sufficient and appropriate evidences to support the audit opinion, therefore the auditor must first understand the specific banking activities and then identify and properly evaluate the credit institution's operational risks.

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JEL Classification: G21, M42

1. Introduction

ISA 200 "Objectives and General Principles Governing an Audit of Financial Statements" specifies that the objective of an audit is for the auditor to be able "to express an opinion on financial statements, if they are prepared, in all significant material respects, in accordance with the applicable financial reporting framework" (IFAC 2007: 227). An auditor who conducts a conformity audit must obtain a reasonable assurance that the annual financial statements are free of significant material misstatements, whether due to fraud or errors.

Credit institutions are constantly operating in conditions of risk and uncertainty, being exposed to high range of risks, respectively:

- Financial risks;
- Operational risks;
- Business risks;
- Risks of various events' occurrence.

2. Credit Institutions' Operational Risks

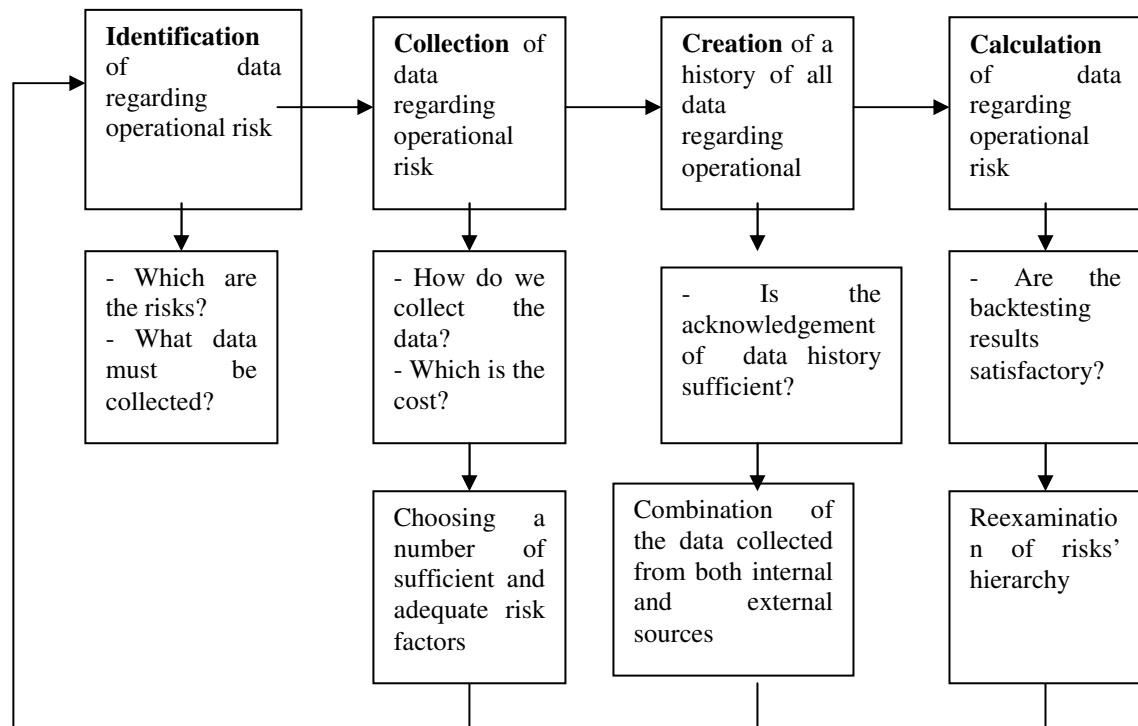
The operational risks are arising for all credit institutions from the practical application of banks' strategic objectives and the functioning of their systems of control and monitoring, including the use of computerized technology.

The main types of operational risks that may occur in banking activity are:

- Internal fraud;
- External fraud;
- trading error;
- malfunction of systems or processes;
- Disturbance or disruption of banking activity;

- Damage to physical assets;
- Violation of information in terms of security, integrity or confidentiality
- Involvement of the bank in money laundering or financing terrorism;
- Forgery of identity, computer piracy or unauthorized transactions.

Credit institutions are obliged to take into account all the possibilities to prevent operational risks by collection and processing of data concerning operational risk, according to the schedule set out in Figure No. 1:



Source: Own adaptation after Eric Lamarque, *Management de la Banque*, Ed. Pearson Education France, Paris, 2011, page 41

Figure no.1 Collection and processing of data regarding operational risk

Credit institutions find themselves facing a variety of operational risks, so that we can only agree with Eric Lamarque when he states that "the real challenge is to integrate these different components of operational risk in a coherent and effective assembly" (Lamarque 2011: 50), which consists of the following:

- a self-assessment instrument, by a careful examination of all aspects regarding operational risks that may occur in the activity of credit institution;
- a consistent database meant to collect information on operational risks;
- a section of key and risk measurement indicators, including scenarios of situations more or less predictable;
- a reporting instrument, for both internal management and supervisory and regulatory authorities;
- a workflow system able to provide sufficient opportunities for reducing losses associated to operational risk.

It is obvious that the top management of credit institution must have a rapid response rate to any occurrence of symptoms indicating a manifestation of a form of operational risk, but a primarily

proactive attitude based on internal rules and reliable procedures, focused on operational risk prevention, is more desirable.

3. Assessment of the Operational Risk from the perspective of International Standards on Auditing

According to ISA 315, „the auditor understands the entity's objectives and strategies and any business risks related that could result in material misstatements of financial statements” (IFAC 2007: 315). The auditor should observe how the leadership was able to identify risks relevant to financial reporting, to assess the significance of those risks and evaluate the possibility of their recurrence but to examine as well how the top management was able to manage risks. When he finds a material misstatement in the risk assessment process of the entity, he will communicate it to those charged with governance. For this, he must previously make a series of tests on internal control and auditing procedures in terms of the effectiveness of these procedures applied by entity.

By analyzing the potential operational risks of credit institutions, it seems fairly normal for auditors to focus on the risk of fraud. ISA 240 "The Auditor's Responsibility to consider fraud in an audit of financial statements" makes a distinction between fraud and error, so "the term of *error* refers to an unintentional distortion occurring in the financial statements, including the omission of an amount or a presentation such as:

- an omission during the collection and processing of data based on which the financial statements are done;

- an incorrect accounting estimation due to overlooking or misinterpreting the facts;

- an error occurring while the accounting policies on assessment, recognition, classification, presentation and description of any information are applied” (IFAC 2007: 288)

Fraud, as defined in ISA 240, is seen as a deliberate action done for obtaining an unjust or illegal advantage. The auditor is interested in fraud only in the measure it can affect the quality of accounting information by generating significant material misstatements. A distinction is usually made between internal and external fraud, meaning that external fraud is caused by third parties, while internal fraud can be caused either by involvement of one or more members of the top management or those charged with governance, in which case we can talk about a "management fraud" or by common employees and then it is called a "staff association fraud".

In conformity with the International Statement on Auditing Practice 1006, "Audit of the Banks' Financial Statements", the factors that contribute significantly to operational risk include:

- the need to carry out a large volume of transactions in a predetermined period of time;

- the need for electronic transfer of funds or other telecommunications systems for fast transfer of funds;

- the performance of banking operations in a large geographical area;

- the need to monitor and manage significant exposures that can occur over short periods of time;

- taking in large amounts of cash;

- the volatility and the inherent complexity of the financial-banking environment;

- numerous operating restrictions stipulated by law and prudential supervision norms.

4. Risks and other aspects regarding frauds and illegal acts

The risk of fraudulent or illegal acts arises at banks both from the inside and outside of the credit institution. Among the many fraudulent and illegal acts that banks may face with are: fraud related to the issuance of checks, fraudulent crediting and trading, money laundering and misappropriation of bank assets. These fraudulent activities may involve collusion by management of banks and their customers. Those perpetrating fraudulent activities may prepare false and misleading documents to justify inappropriate transactions and hide illegal activities. Fraudulent financial reporting is another serious concern.

In addition, banks are permanently confronted with the threat of computer fraud. Hackers and others who may gain unauthorized access to banks' computer systems and their databases can allocate intentionally funds to their personal accounts and steal private information about the institution and its customers. In the case of all companies for profit, fraud and criminal activity perpetrated by authorized users within the bank are also of particular concern. Fraud is more likely to occur at banks that have serious deficiencies in corporate governance and internal control.

Significant losses from fraud can occur in case of the following categories of deficiencies in corporate governance and internal control:

- Lack of a proper oversight and accountability on behalf of the top management and the absence of a "culture" on strong control manifested in the bank;
- Inadequate recognition and assessment of risk of certain banking activities, either regarding balance sheet or off-balance sheet ones;
- Absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations and reviews of operating performances;
- Inadequate communication of information between different levels of management within the bank, especially in communicating problems at a higher hierarchical level;
- Inadequate and ineffective internal audit programs and monitoring activities.

Table no.1 *Examples of Fraud Risk Factors*

	Acceptance of Deposits	Trading	Crediting
Frauds committed by top management and other personnel	Depositors' camouflage Unrecorded deposits Theft from customers' deposits or investments, especially in the case of inactive accounts	Off-market rings Transactions with affiliated third parties Fees of brokers for bringing in clients False transaction Unrecorded transactions Delayed allocation of transactions Intentional wrong use of discretionary accounts Exploiting the weaknesses of correlation procedures Marking intentionally erroneous the registry Association to commit fraud during an evaluation (assessment rings) Theft or intentional wrong use of guarantees	Loans to fictitious borrowers Use of Nominee Companies Deposits transformation Transactions with affiliates Fees for bringing in clients Use of parallel organizations Funds transformation Selling recovered collaterals at a price below the market price Bribes to obtain the release of collateral or to reduce the amount claimed Theft or intentional use of misleading guarantees
External Frauds	Money laundering Fraudulent instructions Counterfeiting money or assets Fraudulent use of cashing periods (checks uncovered)	Fraudulent custodial sales False information or documents on partners	Impersonation and false information on loan applications and other documents submitted latter Double guarantee with the same good Forged evaluations or Fraudulent or worthless guarantees fraudulent Wrongful use of credit funds

			by representatives / customers Unauthorized sale of securities
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Source: Audit financiar. Standarde. Codul etic / Financial Audit. Standards. Code of Ethics – 2006, Ed. Irecson, București, 2007, pg. 807-808

5. Case Study – Société Generale 2008

Jerome Kerviel, a trader at Société Generale in a subdivision specialized in financial market operations, managed to avoid internal control and to defraud the bank of 4.9 billion Euros. It is obviously an internal fraud, which can be circumscribed to the issues related to operational risk. Kerviel was selling and buying futures contracts "taking advantage of exchange rate differences recorded by the indexes DAX (Germany), CAC 40 (France) and Footsie (United Kingdom). In principle, the internal procedures imposed covering with the same type of security in order to generate no operational risk (when he sold he had to buy in return, when he bought he had to sell in return).

Before working in the banking sector, Kerviel have worked in internal control and knew how to avoid the organizational procedures, so he managed to remain undetected by creating fictional counterparts with Deutsche Bank. After he closed his position at Société Generale he lost 6.3 billion Euros, which compensated by the 1.4 billion" gains" made by Kerviel in 2007, led to a total fraud of 4.9 billion euro.

Kerviel was found guilty and was sentenced to only three counts:

- Embezzlement;
- Fraudulent introduction of data in an automated system
- Fake and forgery.

Can we consider that Jerome Kerviel was the only guilty part? So how was it possible that:

- No one has answered the request for information made by Eurex Compensation Chamber in November 2007 and has not studied its request?
- No one noticed the disparity between fictitious investments and bank's treasury?
- No one noticed that Jerome Kerviel was always present in the bank, not taking holidays and days off in the last two years?
- Gains of 1.4 billion a year have not drawn attention to potential risks?

6. Conclusions

Credit institutions have some responsibilities in terms of assets they hold but which belong to other persons and entities. Public trust is for bank a capital as important as the equity, therefore they must establish operating procedures and internal controls designed to ensure the public that those assets are treated strictly in conformity with the terms and conditions under which they were transferred to the bank.

A very old banking axiom, which states "when trust is gone, the crisis occurs", requires credit institutions to better manage the risks and to apply consistently the principle of prudential banking. For an external auditor, the challenges of his mission are related to:

- the special nature of the risks associated with the transactions conducted by banks;
- the scale of banking operations, the large exposures and the operations' speed;
- the excessive dependence on IT (with advantages and disadvantages);
- the occurrence of regulations from different jurisdictions (especially when the controlling company has status of a non-resident);
- the occurrence of "financial innovation" and emergence of new banking products and practices more or less compatible with the ability of resilience of internal control and audit.

Determinants of bank fraud may occur in the form of:

- Pressure (inciting a person to commit fraud);

-Opportunities (offered by the knowledge of the bank's internal environment, in case of an internal fraud, or specific technical or relational knowledge, where external fraud occurs)
 -Attitudes (generated by the ethical values that guide the person who commits fraud).
 Audit evidences should be adequate and sufficient thus the risk of non-detection will decrease when the quality and quantity of proving evidences shall increase which will determine correct conclusion based on which an audit opinion will be issued accordingly.

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