



Auditing Theories- Banking-and-Other-Financial-Institution- Module No. 1

Auditing Theories (Cagayan State University)

MODULE 1

Auditing Banking and other Financial Institutions

Overview:

The banking and finance sector performs a critical function in the Philippine economy as it is primarily responsible for the mobilization of domestic savings and the conversion of these funds into directly productive investments. Financing the needs of firms which desire to raise productive capacity by purchasing additional capital equipment, acquiring, or leasing idle property, building, and expanding factories, and increasing inventory are responsible for sustaining economic growth in the long term, alongside the creation of new jobs. It is very important for the banking and finance sector to continue finding ways to encourage households to save their unspent income in various financial assets so that these resources could be used and transformed into loans that will finance the expansion of directly productive business ventures.

The Philippines' banks are classified into three types: universal and commercial banking, rural and cooperative banking, and thrift banking. Of these segments, universal and commercial banks that accepted domestic deposits and offered checking account services had dominated the Philippines' banking industry, with its total deposits valued at approximately 12 trillion Philippine pesos.

Module Objectives:

- Know the nature and background of the particular specialized industry;
- Learn the overview, statistics, and updates of the specialized industry in the Philippine setting;
- Identify the different audit considerations and trends for the industry.

Nature and Background of Specialized Industry

The banking and finance sector is primarily responsible for mobilizing domestic savings and converting these funds into directly productive investments. Financing the needs of firms

which desire to raise productive capacity by purchasing additional capital equipment, acquiring or leasing idle property, building and expanding factories, and increasing inventory are responsible for sustaining economic growth in the long term, alongside the creation of new jobs.

Banks perform the function of safekeeping money and valuables and extending loans, credit and payment services in the form of checking accounts, money orders, cashier's checks as well as the issuance of debit and credit cards. Large banks (particularly the universal and commercial banks) are also allowed to engage in other intermediation activities such as investment banking (underwriting debt instruments and or stocks for other firms) and may offer other forms of portfolio investment instruments and insurance products.

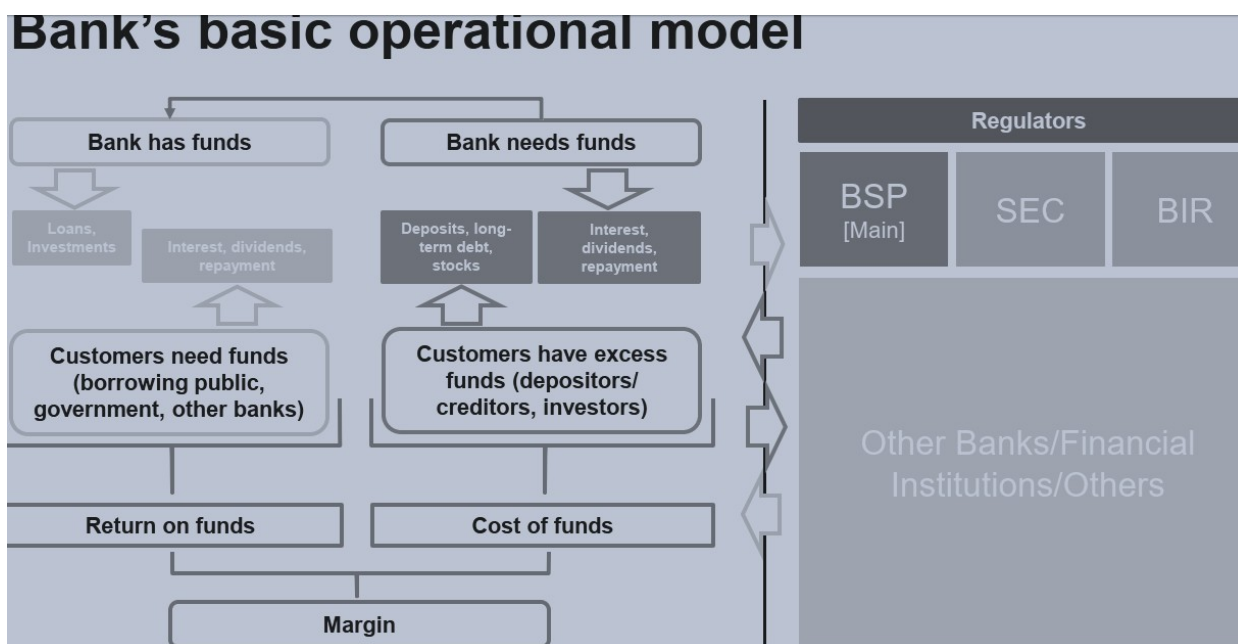
The financial system is composed of two general groups namely: banks and non-bank financial institutions. Banking institutions include: universal banks, commercial banks, thrift or savings banks and the rural and cooperative banks. These institutions are allowed to collect savings and time deposits to fund loans and also perform the function of providing credit and payment services. Large banks, particularly the universal and commercial banks, can engage in other intermediation activities such as investment banking and may offer other forms of portfolio investment instruments and insurance products.

Non-bank financial institutions on the other hand, are composed of insurance companies, pension fund institutions, investment banks, financing companies, pawnshops and mutual fund institutions. These institutions are not allowed to collect deposits but may encourage the general public to invest household savings in various financial instruments. Premium payments for term insurance policies, regular contributions to pension funds, investment into mutual funds or purchases of shares of stock in financing companies and pawnshops are some of the ways by which non-bank financial institutions can source funds to finance lending and or investment operations.

Universal and commercial banks have the largest resources and offer the widest variety of banking services outside of collecting deposits and providing loans. These other services include underwriting and other functions of investment houses, investing in equities and non-allied undertakings. Thrift banks include savings and mortgage banks, private development banks, stock savings and loan associations and microfinance thrift banks. They accumulate the savings of depositors and provide housing loans and financing for short-term working capital as well as medium- and long-term financing to small and medium scale enterprises engaged in agriculture, services, and industry. Rural and cooperative banks promote and expand the rural community by

mobilizing savings and extending loans and other financial services to farmers to help with the purchase of seeds, livestock, fertilizers, and other farm inputs and the marketing of their produce.

Non-bank financial institutions, on the other hand, are composed of insurance companies, pension fund institutions, investment banks, financing companies, pawnshops, and mutual fund institutions. There are several types of non-bank financial institutions offering a wide variety of services such as investment houses, financing companies, investment companies, securities dealers/brokers, lending investors, government non-bank financial institutions, venture capital corporations, non-stock savings and loans associations, pawnshops and credit card companies.



Overview, Updates, Statistics of the Specialized Industry in the Philippines

The Bangko Sentral ng Pilipinas (BSP) is the independent central monetary authority of the Philippines that has regulatory and supervisory power over banks and non-bank financial institutions. The BSP supervises the nation's banking system. Non-bank financial institutions such as insurance companies and investment houses are overseen by the Insurance Commission and Securities and Exchange Commission, respectively. The role of financial intermediation in the Philippine economy continues to expand and is expected to create greater prospects for employment over the next several years. The share of financial intermediation output to total service sector output as well as to gross domestic product has continually increased over the recent past.

The main services of commercial banks in the Philippines are accepting deposits and offer checking account services, universal banking on the other hand provides all kinds of services of commercial banking and exercise the powers of an investment house and invest in non-allied enterprises. In the Philippines, these kinds of banks are the largest group of financial institutions and the most popular among customers with different financial needs because of its wide array of financial services.

As of October 2020, the value of loans granted by universal and commercial banks in the Philippines amounted to nearly 9.7 trillion Philippine pesos. Of these loans, approximately 364 billion Philippine pesos have been granted for motor vehicle loans for household consumption and approximately 1.6 trillion Philippine pesos worth of loans granted for production of real estate businesses in the country.

While granting loans for customers seeking financial help for a business venture or providing loans for household consumption have been increasing, a sound and healthy banking sector is essential to sustain this growing pattern. Bank loans that have nonperforming loans are generally considered bad debts and can affect a bank's cash flows. A low ratio of nonperforming loans to total gross loans meant a healthy banking sector. As of 2019, the ratio of bank nonperforming loans to total gross loans in the Philippines was almost two percent and has significantly decreased over the past years.

The Philippine banking industry is not spared from the adverse impact of this pandemic. The Bangko Sentral ng Pilipinas (BSP) issued the implementing rules and regulation for the Bayanihan Act RA No. 11469. The law requires all lenders under BSP supervision to grant a 30-day grace period or extension for the payment of loans due within the enhanced community quarantine (ECQ) period, without imposing additional interest, penalties or charges on their borrowers. Further, the BSP also relaxed the know-your-customer (KYC) requirements for both over the counter and electronic or online transactions. This is to make sure that Filipinos continue to have access to basic government and financial services amid the COVID-19 situation.

Ranking as to Total Assets

Universal and Commercial Bank Group

As of 30 September 2020

(Amounts in Million Pesos)

RANK	NAME OF BANK	TOTAL ASSETS
1	BDO UNIBANK INC	3,185,977.27
2	LAND BANK OF THE PHILIPPINES	2,257,545.02
3	METROPOLITAN BANK & TCO	2,088,307.51
4	BANK OF THE PHIL ISLANDS	1,884,542.40
5	PHIL NATIONAL BANK	1,025,161.82
6	DEVELOPMENT BANK OF THE PHIL	944,711.93
7	CHINA BANKING CORP	926,024.26
8	RIZAL COMM'L BANKING CORP	724,017.03
9	UNION BANK OF THE PHILS	674,155.33
10	SECURITY BANK CORP	648,112.62

Ranking as to Total Deposit Liabilities

Universal and Commercial Bank Group

As of 30 September 2020

(Amounts in Million Pesos)

RANK	NAME OF BANK	TOTAL DEPOSITS
1	BDO UNIBANK INC	2,517,958.33
2	LAND BANK OF THE PHILIPPINES	1,977,248.34
3	METROPOLITAN BANK & TCO	1,532,588.73
4	BANK OF THE PHIL ISLANDS	1,417,019.30
5	DEVELOPMENT BANK OF THE PHIL	754,948.80
6	CHINA BANKING CORP	746,544.44
7	PHIL NATIONAL BANK	741,607.48
8	RIZAL COMM'L BANKING CORP	498,689.59
9	UNION BANK OF THE PHILS	481,798.23
10	SECURITY BANK CORP	439,439.44

Recent Issuances

A

BSP Circulars

- No. 1072
- No. 1073
- No. 1074
- No. 1075
- No. 1076
- No. 1077
- No. 1079
- No. 1080
- No. 1082
- No. 1083
- No. 1084
- No. 1086
- No. 1088
- No. 1091
- No. 1092
- No. 1093
- No. 1094

B

BSP Memorandum

BSP Memorandum No. M-2020-008,
Regulatory Relief for BSFIs Affected by Corona Virus Disease 2019 (COVID-19), as amended by BSP
Memorandum No. M-2020-032,
Amendments to the Regulatory Relief for BSFIs Affected by Corona Virus Disease 2019 (COVID-19)

BSP Memorandum No. M-2020-022,
Reclassification of Debt Securities Measured at Fair Value to the Amortized Cost

C

SEC Memorandum Circular

SEC Memorandum Circular No. 32,
 Series of 2020



Audit Considerations

Banking Laws (Presidential Decrees, Republic Acts and Implementing Rules and Regulations)

Law	Date	Title
PD 114	Jan. 29, 1973	Governing the establishment, operation and regulation of Investment Houses
PD 1034	Feb. 15, 1973	Authorizing the establishment of an offshore banking system in the Philippines
RA 7653	Jun. 10, 1993	The New Central Bank Act
RA 8791	Apr. 12, 2000	General Banking Law of 2000
RA 9160	Sep. 29, 2001	Anti-Money Laundering Act of 2001
RA 10574	May 24, 2013	An Act Allowing the Infusion of Foreign Equity in the Capital of Rural Banks
RA 10641	July 15, 2015	An Act allowing the full entry of foreign banks in the Philippines, amending for the purpose Republic Act No. 7721

Key audit considerations

- Why is the audit of banks considered different or more difficult than usual?

01

Acceptance

1. Experience
2. Resources
3. Use of experts/specialist

02

Highly regulated

1. Various reporting requirements
2. Accreditation requirements

03

Peculiar transactions

1. Complex FIs
2. Complex estimates
3. Assets could rapidly change in value

04

Extensive use of PFRS 9

1. Debt modification due to BARO
2. ECL – COVID-19 overlay

05

Fraud consideration

1. Inherent risk of fraud especially in a highly digitized environment
2. Compliance pressure

06

Remote auditing and COVID-19 limitations

1. Authenticity of documents
2. Inherent limitations

Key Risks Considerations (PFRS 9)



Reporting on the Financial Statements (see Philippine Auditing Practice Statement 1006 AUDITS OF THE FINANCIAL STATEMENTS OF BANKS for more details)

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 generally accepted accounting principles in the Philippines. This is particularly relevant in the case of banks with foreign branches and subsidiaries because 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.

The financial statements of banks are prepared in the context of the legal and regulatory requirements and accounting policies are influenced by such regulations. The BSP regulatory accounting principles for banks (RAP) may differ materially from generally accepted accounting principles (GAAP). When the bank is required to prepare a single set of financial statements that comply with both frameworks (i.e., RAP and GAAP), 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 RAP instead of GAAP, the auditor considers the need to refer to this fact in an emphasis of matter paragraph.

By assessing key risks, it is evident that there are challenges on all sides. Banks are under attack, being subject to enforcement actions, fines, penalties, and expensive remediation action.

Regulators and politicians are under pressure from the public, and sometimes each other, to deal more firmly with the banking sector, the banks, and bankers involved in breaches of regulations, criminal law, public trust, and confidence. Auditors have perhaps been too accommodating in allowing bank management and directors to somehow “manage” the audit relationship to their advantage, and in order to mitigate their reputation and regulatory risk. Throughout history, in moments of crisis and challenge, there are great opportunities. As stated in the new Basel Committee “Corporate Governance Principles for Banks”, internal audit provides independent assurancein promoting an effective governance process and the long-term soundness of the bank. The audit profession must rise to the challenge, embrace the key audit trends for 2015, and raise the standard of auditing to meet the higher level of Banking Governance now required.

Assessments:

1. Look for at least 2-3 audited financial statements of companies under the specialized industry in the Philippines and list down your observations from audit report to the financial statements
2. State the nature and background of the specialized industry.
3. What are the relevant statistics, and updates of the specialized industry in the Philippine setting?
4. Identify the different audit and accounting considerations and trends for the industry.