

# Interaction between financial sector supervisors, auditors, and other supervisory authorities

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*Advancing in Accounting & Auditing Regulation: Improving Compliance through Better Enforcement and Adequate Requirements for Non-Financial Reporting*

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**Centre for Financial  
Reporting Reform**




Strengthening Auditing and Reporting in  
the Countries of the Eastern Partnership



Road to Europe: Program of Accounting Reform  
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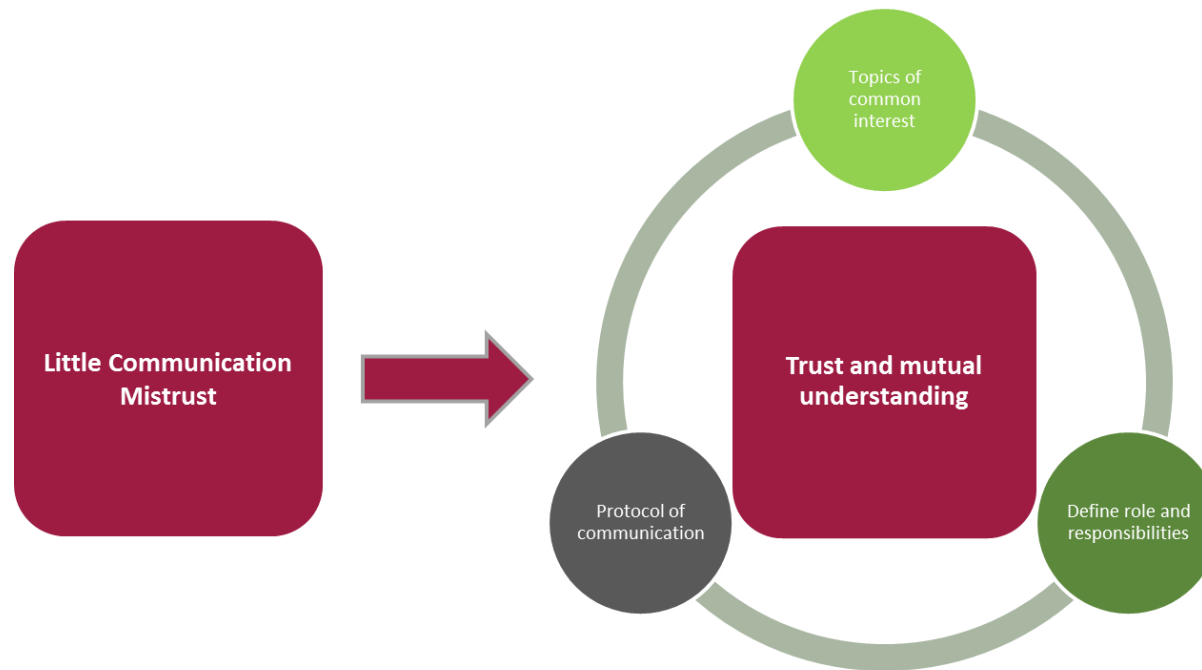
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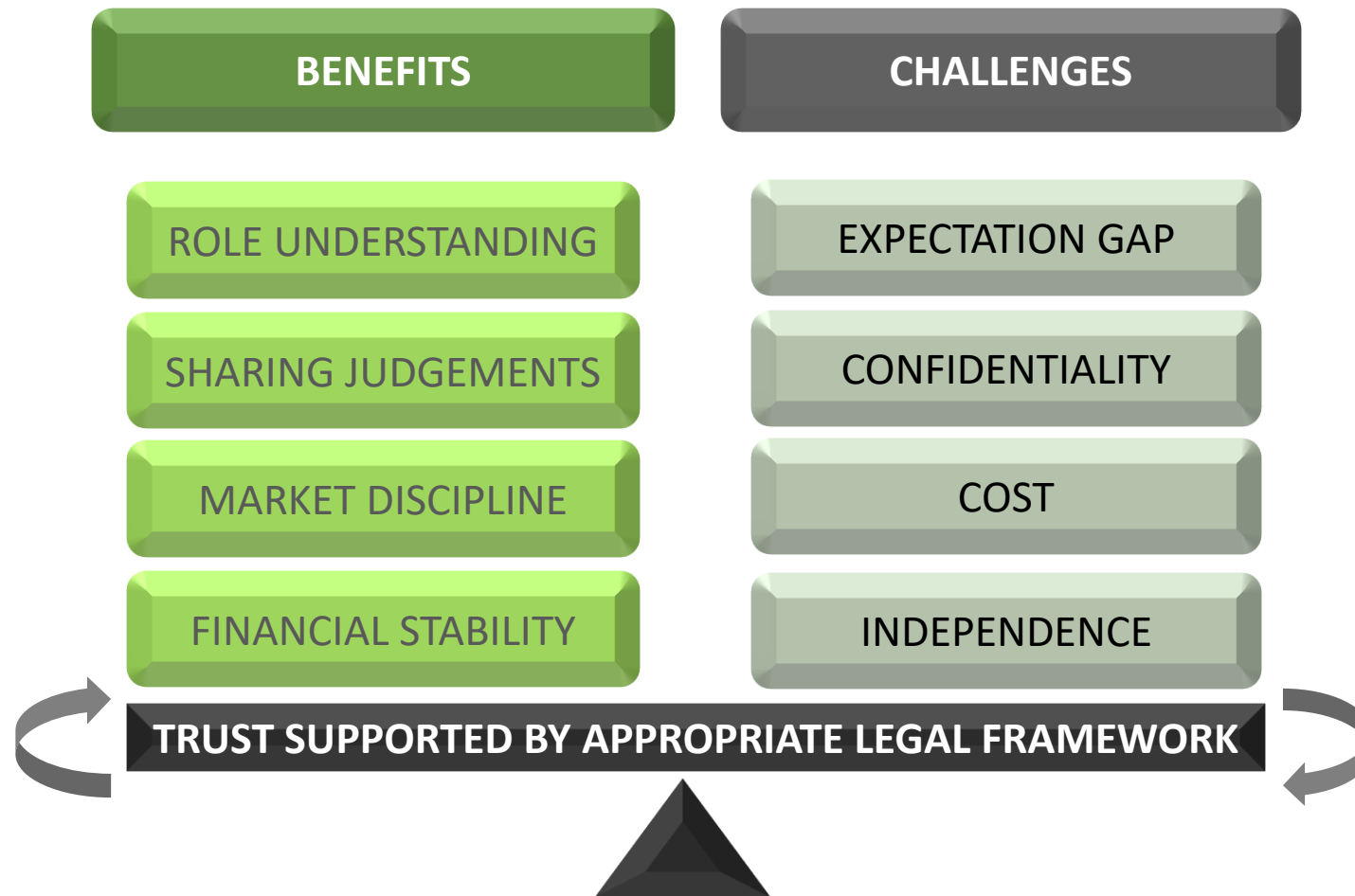
# Introduction: an Effective Engagement

“We currently benefit from a long lasting investment in the relation between supervisors and auditors:

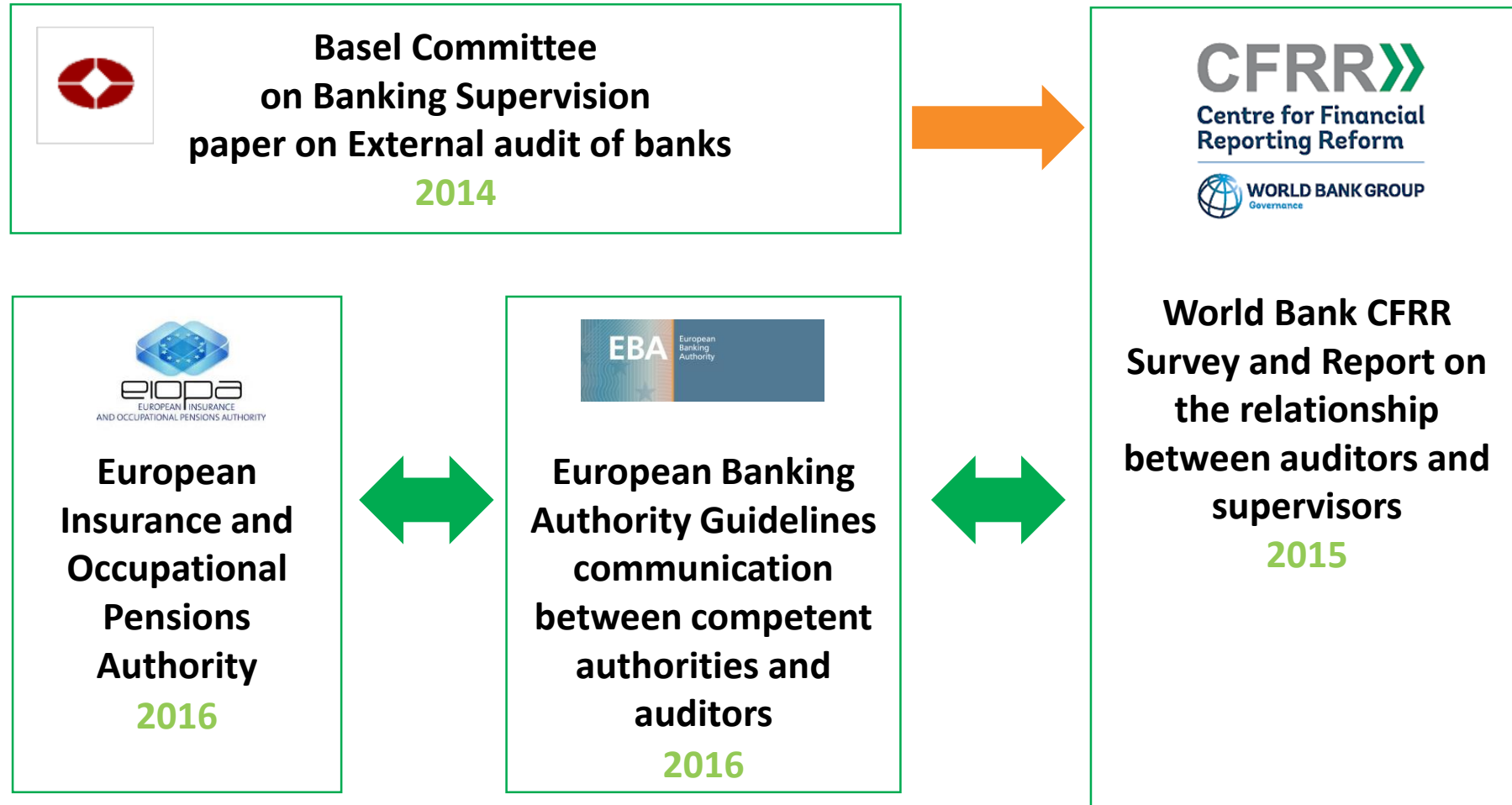


We have invested heavily in this communication structure for over 10 years, and we are sure that we have to keep ‘investing’.” -- Netherland

# A Key Challenge: Finding the Right Balance



# Overview of Key Publications





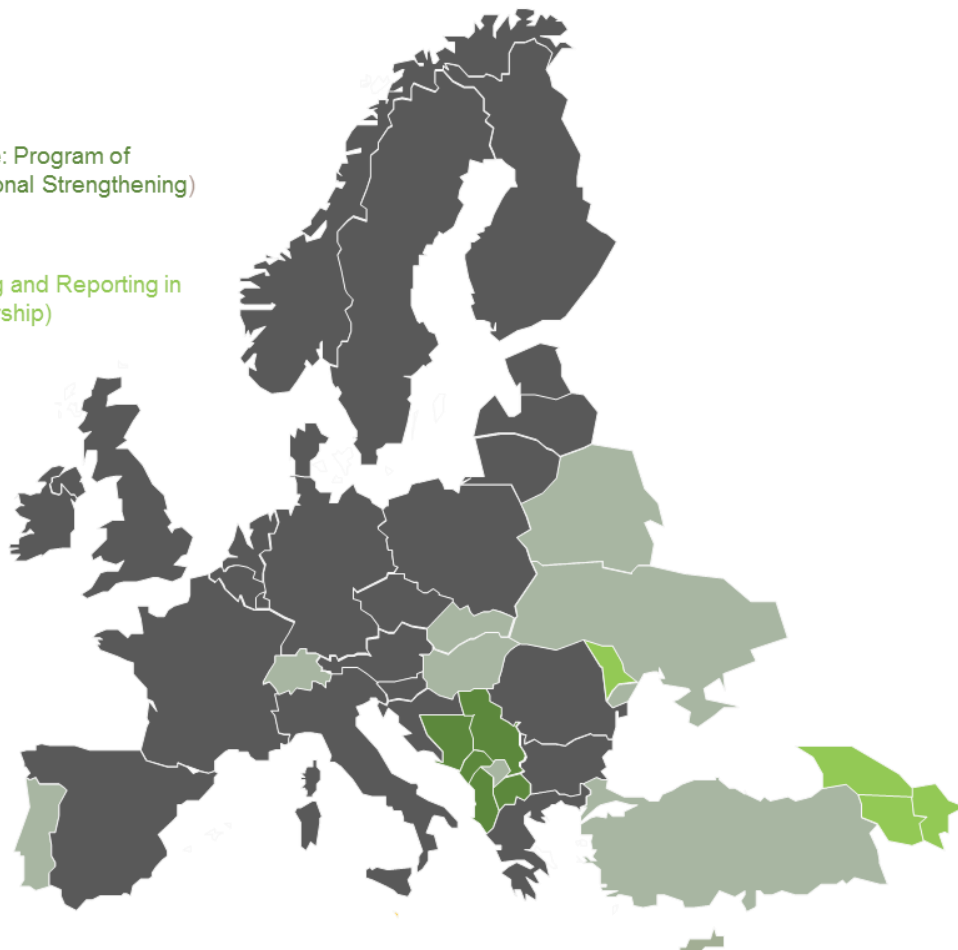
# Disclaimer

1. Actions are suggestions/reported good practices and are not exhaustive
2. Supervisors and external auditors should also take into account that:
  - a) The actions **do not change the respective roles and responsibilities** of the supervisor, the external auditor or the bank's management.
  - b) The actions **do not supersede** ISA, IFRS, international best practices on corporate governance or internationally recognized principles (IOSCO, Basel, EIOPA, IAASB, etc.) especially in the areas of independence and accountability of external auditors and bank's management.
  - c) The key objectives of the actions are to:
    - i. **Build or strengthen communication and interaction** between supervisors and auditors;
    - ii. **Ensure** that the interaction between supervisors and external auditors are **on- going and conducted in a systematic and structured manner**;
    - iii. **Maintain** a supervisors - auditors relationship that is both **critical and constructive**;
    - iv. **Provide a basis** for a better and more detailed mutual understanding of the underlying issues and risks in the supervised sectors; and
    - v. **Reinforce the supervisory as well as the audit processes.**

# Source of Information

## PARTICIPATION OF 35 COUNTRIES ACROSS EUROPE AND CENTRAL ASIA

- EU + Norway
- REPARIS (The Road to Europe: Program of Accounting Reform and Institutional Strengthening)
- STAREP (Strengthening Auditing and Reporting in Countries of the Eastern Partnership)



44  
questions to  
supervisors

35  
countries  
in ECA

85%  
responses  
rate

# Guide: Insights

## External audit



Auditors' work does contribute to effective supervision

## Channels of Communication



Supervisors could engage more effectively with external auditors

## Topics of Mutual Interest



External auditors could contribute more on specific areas of interest to supervisors

## Supervisors' Input to Audits



Supervisors do contribute to enhanced audit quality

## Other Communication



Effective communication between audit / entity supervisors / Audit Committees does improve audit quality

# Brief Country Diagnostic: KNF Poland

## External audit

- International Auditing Standards (ISAs) translated by the Oversight Authority (KIBR) applied
- Supervisors have access to the audit reports
- External auditors required by law to disclose material fraud and other significant findings (error, weakness of internal control)
- Supervisors can not ask auditors to perform additional tasks outside the scope of the audit in order to contribute to regulatory work

## Channels of communication

- No proportionate approach in the communication with auditors
- Conduct both trilateral and bilateral meetings, plus meetings that include the audit committee, always after the issuance of the audit opinion (meet normally once per year but systemically important issues are discussed on an ad-hoc basis.) There is a mix of both formal and informal channels of communication
- No feedback system

## Topics of mutual interest

- No discussion with auditors about their audit strategy & plan. The audit strategy is not transmitted to the supervisor
- Loan valuation and provisioning, bank's asset valuation, risk management, annual financial statements, effectiveness of internal controls and bank-assurance are typically discussed. (Not typical to discuss the audit committee and management letter)
- Auditors audit some prudential returns (i.e. solvency ratio) but not the reconciliation of audit FS with prudential capital elements

## Supervisors input to audit

- There is no legal restriction regarding information that supervisors can share with the external auditors
- No role of supervisory authority in the initial appointment of external auditors (there is also no specific criteria for the appointment of external auditors of banks)
- No mandatory rotation or retendering of audit firm (i.e. rotation after 5 years is required for the key audit partner only)

## Other Communication

- There is a system of Audit Oversight Body (KIBR and KKN) and a member of UKNF is in the structure of one KIBR. There is also a system of Quality Assurance. Typically they meet more than once per year the supervisor
- Audit committee required for commercial banks only. Meet once per year minimum, otherwise ad-hoc basis



# External Audit



**Auditors' work  
does  
contribute  
to effective  
supervision**

- » Supervisors and external auditors: complementary skills and knowledge
- » Financial statements: an important input to supervision (i.e. greater confidence in prudential returns through the reconciliation with audited FS)
- » External auditors may participate in the supervisory process by providing reasonable or limited assurance on a range of areas at the request of supervisors:
  - » Internal controls
  - » IT systems
  - » Risk management
  - » Prudential returns

**External auditor's reporting help strengthen supervisory process**



**Auditors' work  
does  
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to effective  
supervision**

## Capacity of Supervisors

### Common Issues

Supervisors face capacity constraints in terms of staffing and accounting and auditing training.

Supervisors do not always have a good understanding of what an external audit consists of and how they can rely on auditors' work.

### Possible Actions

- Providing on-going training on ISA and IFRS to staff at the supervisory authority.



### Examples of best practices

The UK Prudential Regulation Authority (PRA) tries to provide more regular training for supervisors on auditor-supervisor engagement, with a focus on how they might better understand the work of auditors as well as encouraging a more open and in-depth dialogue.



**Auditors' work  
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contribute  
to effective  
supervision**

## Extent of use of external auditors

### Common Issues

The majority of European supervisors can ask external auditors to perform additional tasks outside the scope of the audit. However, practices vary across ECA in terms of the scope of auditors' work, the extent of auditors' contributions to the supervisory process, and the type of assurance they provide.

### Possible Actions

► Exchanging information with the external auditors on a continuous basis and before planning the statutory audit.



### Examples of best practices

In Ireland, the Central Bank Act 2013 introduced a provision for the Central Bank requesting external auditors to provide assurance over areas concerning: 1) Administrative or accounting procedures; 2) Internal control mechanisms; 3) Risk management; 4) Organizational structure; and 5) Governance of regulated financial service providers.



**Auditors' work  
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## Long-Form Audit Report

### Common Issues

Currently, very few supervisors request a Long-Form Audit Report (LFAR) from external auditors.

### Possible Actions

- ▶ Requesting an annual LFAR for SIBs
- ▶ LFAR scope and content: flexible, established jointly, including audit methodology/limitations, findings on going concern/risks and recommended remedial actions
- ▶ Discussing LFAR with external auditor, bank's management, audit & risk committee



### Examples of best practices

In Austria, according to the Austrian Banking Act, external auditors of banks are obliged to audit an additional appendix (prudential report) together with the external audit of financial statements.



Auditors' work  
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## Duty and right to report

### Common Issues

External auditors do not always have the **statutory duty to report** significant findings and fraud encountered during the course of their audit. Also, not all the jurisdictions provide “safe haven” rules for auditors when exercising of his/her **right to report** other findings.

### Possible Actions

- ▶ Updating regulations : creating safe haven rules
- ▶ Requesting access to any type of audit information relevant to supervision



### Examples of best practices

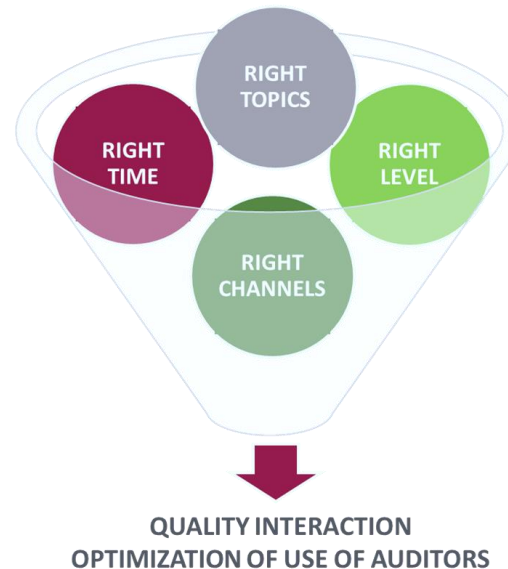
In the FYR of Macedonia, the audit firm shall immediately notify the Governor in writing if, during the audit, it finds out that a bank's solvency or liquidity is compromised and the bank operates, and/or has operated, contrary to the regulations. This requirement applies also to legal entities with which the bank has close links.

# Channels of Communication



Supervisors  
could engage  
more  
effectively  
with external  
auditors

- » Regular exchanges of information enable both parties to perform their duties more efficiently
- » A strong and fruitful relationship depends on the “quality” of interaction



*“the right discussions  
at the right level and  
at the right time”  
using the most  
appropriate channels  
of communication*

# Channels of Communication



Supervisors  
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## Proportionate risk-based approach

### Common Issues

Not all supervisors use a proportionate risk-based approach when communicating with external auditors.

### Possible Actions

- ▶ Developing appropriate criteria to define systemically important entities
- ▶ Arranging for more and earlier discussions with external auditors of these entities
- ▶ Conducting meetings with chairs of the audit committees of these entities



### Examples of best practices and regulation

The National Bank of Belgium (NBB) uses a proportionate approach when interacting with external auditors based on the risk profile of the bank, its size, and whether it is headquartered in Belgium. A set of criteria determines Systemically Important Banks (SIB). SIB meetings are conducted every quarter (1x/year for non-SIB), with more senior NBB staff. The NBB sends a copy of most of the communication between the NBB and the bank to the external auditor.



# Channels of Communication



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## Timing and frequency of communication

### Common Issues

While most supervisors mentioned the ability to have ad-hoc meetings with external auditors, they tend to communicate with external auditors only after the audit opinion has been issued.

### Possible Actions

- ▶ Jointly define term&scope of relation
- ▶ Meeting + exchanging information earlier & more regularly within the audit process. Meetings at the planning stage & before the issuance of the audit opinion
- ▶ Establishing ad-hoc meetings/contacts
- ▶ Keeping flexibility and avoiding routine



### Examples of best practices

The National Bank of the Netherlands (NBB) introduced trilateral meetings 2x/year for large banks and 1x/year for other banks (except for small banks). NBB also meet 3x/year with the financial sector committees of the Dutch Association of Accountants (NBA), and with senior management of audit firms (big 4) on a subsector basis (banks, insurers and pension funds). They also meet with the board of the NBA 1x/year to discuss matters of strategic nature.



# Channels of Communication



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## Channels of communication

### Common Issues

Generally, supervisors either use formal channels or an equal mix of both formal and informal channels when communicating with external auditors.

### Possible Actions

- Using as applicable: Formal/informal Oral/written channels; Ad-hoc/structured meetings
- Primary relationship holders, colleagues and staff of their respective teams and/or experts



### Examples of best practices

In Denmark, the Financial Supervisory Authority (FSA) receives a Long Form Audit Report from external auditors every year, while external auditors receive a copy of most of the communication between the bank and the Danish FSA.

# Channels of Communication



Supervisors  
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## Feedback Process

### Common Issues

The majority of supervisors do not have a feedback system for assessing the quality of the relationship with external auditors. When a feedback process exists, it tends to be informal.

### Possible Actions

- Setting up a regular feedback process and using it to monitor the quality of dialogue and assess existing practices



### Examples of best practices

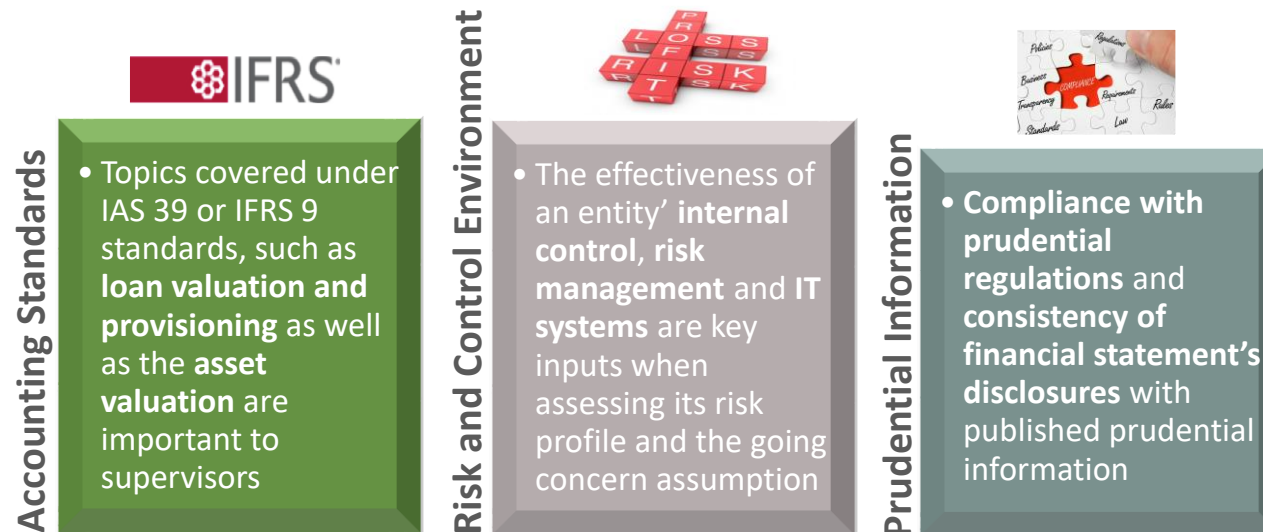
In the UK, the Prudential Regulation Authority (PRA) Board conducted an electronic survey of supervisors of the largest firms on: 1) The frequency and timing of scheduled or formal auditor-supervisor meetings; 2) The quality of those meetings; and 3) Whether the broader relationship was such that supervisors believe that auditors would contact them proactively, informally, outside scheduled meetings, to disclose emerging concerns.

# Topics of Mutual Interest



External auditors could contribute more on specific areas of interest to supervisors

- » There are numerous topics of mutual interest to supervisors and auditors, mainly due to their complexity, materiality or subjectivity
- » Supervisors have little information on audit committees' activities



# Topics of Mutual Interest



External auditors could contribute more on specific areas of interest to supervisors

## Audit Planning and Progress

### Common Issues

Few supervisors discuss the audit strategy and plan with external auditors. Changes in those plans are not systematically communicated to supervisors.

### Possible Actions

- ▶ Discuss with external auditor areas that may impact the audit strategy
- ▶ Using the audit strategy and plan as an input to the supervisory work plan
- ▶ Request and discuss the audit plan and strategy for systemically important entities



### Examples of best practices and regulation

In Croatia, an audit firm is required to deliver an annual audit plan for each credit institution to the Croatian National Bank, indicating the areas of focus, the audit methodology, as well as the envisaged duration of audit.

# Topics of Mutual Interest



External auditors could contribute more on specific areas of interest to supervisors

## Accounting Policies

### Common Issues

Loan valuation and loan loss provisioning, and more generally the bank's asset valuation, and the effectiveness of financial controls were topics of particular interest for supervisors to discuss with external auditors.

### Possible Actions

► Discuss with external auditors the processes to obtain a detailed understanding of internal controls and assumptions used in the valuation process to ensure that supervisors can critically assess whether they are relevant, reliable and are being used consistently



### Examples of best practices

The French regulator provides a list of potential discussion topics: **Accounting topics** (ex: implementation of new accounting standards, review of significant accounting estimates); **Non-recurring items** (ex: likelihood of the issuance of a qualified opinion.); **Audit committee** (ex: key points that will be communicated to the audit committee); **Other possible topics of discussion** (ex: evidence of a failure of the control environment)

# Topics of Mutual Interest



External auditors could contribute more on specific areas of interest to supervisors

## Prudential Returns

### Common Issues

Reconciliation between prudential capital elements and audited financial statements is often not subject to an audit. Prudential returns are often not reviewed by auditors.

### Possible Actions

- ▶ Requesting external auditors to review the reconciliation of prudential own funds with accounting capital;
- ▶ Requesting external auditors to review and assess the entity's internal controls for preparing the prudential returns in the regulatory reporting system;



### Examples of best practices and regulation

In Spain, external auditors might be asked to check the consistency of accounting figures contained in certain prudential returns with accounting registers reviewed within the scope of the audit, and in some cases include it in the Long-Form Audit Report.

# Supervisors' Input to Audits



**Supervisors  
do contribute  
to enhanced  
audit quality**

- » Supervisors can help improve the quality of financial information in different ways:
  - » They can provide an environment which supports the independence, objectivity and integrity of audit work
  - » They can regulate certain conditions regarding the appointment and rotation of external auditors, and the audit retendering as well as monitoring and sanctioning auditors and their work
  - » They can enhance audit quality by sharing relevant information with external auditors



# Supervisors' Input to Audits



Supervisors  
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## Information sharing: supervisors to auditors

### Common Issues

Confidentiality rules can prevent supervisors from sharing information with external auditors, which can have negative impacts on supervision.

### Possible Actions

► Creating “gateway” rules to allow the sharing of information with external auditors. This information can be entity specific, industry specific and related to current and emerging risks. The objective is to help auditors conduct a better quality audit and which, in turn, could contribute to the supervisory process.



### Examples of best practices

In the Netherlands, supervisors have, by law, the choice to share information with external auditors, but are not required to do so. Sometimes sharing sensitive information with auditors can endanger “solutions”. In such cases supervisors do not share this sensitive information with auditors. However, if the information has or could have a direct influence on the auditors’ opinion, the supervisor will share this information with external auditors.



# Supervisors' Input to Audits



Supervisors  
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## Appointments of external auditors

### Common Issues

Most European supervisors have some form of oversight responsibility over the appointment of external auditors (i.e. the right to pre-select, approve/remove or to commission an independent audit). However, supervisors' responsibilities vary on a country-by-country basis.

### Possible Actions

- ▶ Setting up a principles-based framework
- ▶ Ensuring that the process for external auditor appointment is fair, objective, transparent, independent of the entity's management and well documented
- ▶ Reviewing and monitoring regularly the conditions of an external auditor's appointment



### Examples of best practices

In Denmark, external auditors of banks are obliged to be certified by the Danish FSA. They should, **among other criteria**, demonstrate that they have performed at least 1,500 chargeable hours auditing financial institutions within the past 5 years. Of these chargeable hours, 1,000 must include audit services to at least 3 banks. All of these hours should be realized after being authorized as a state public accountant and 50% of them as a signing auditor or audit team manager.

# Supervisors' Input to Audits



Supervisors  
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## Audit firm rotation and retendering

### Common Issues

Results show that mandatory audit firm rotations are scarce while the majority of supervisors currently enforce compulsory key audit partner rotations;

In most jurisdictions, the same external auditor can be reappointed without going through a mandatory tender process.

### Possible Actions

- ▶ Setting up a framework for the rotation of external auditors in line with international best practices to ensure independence and avoid a conflict of interest
- ▶ Requesting that the appropriate criteria have been used to select the key audit partner by the relevant parties



### Examples of regulation

In the EU, since June 2016, Public Interest Entities (PIEs) are required to change their audit firms after a maximum 10-year mandate. The 10-year mandate can be extended up to 10 additional years if tenders are carried out, and by up to 14 additional years in case of a joint audit. There is the possibility to adopt a shorter rotation term. Key audit partners of PIEs are required to rotate at least every 7 years with a cooling off period of 3 years.

## Other Communication



**Effective communication between audit / entity supervisors / Audit Committees does improve audit quality**

- » ACs and AOBs contribute to enhanced audit quality through the effective oversight of external auditors' work and their ability to form an opinion on an entity's financial statements:
  - » ACs advise on the appointment of external auditor and evaluate the effectiveness of their work
  - » AOBs aim to identify failures and weaknesses in an entity' external audits, and to examine the work of external auditors, imposing sanctions and/or remedial actions as necessary
- » Both play a critical role in building an appropriate framework for corporate governance and for high-quality external audits



**Effective communication between audit / entity supervisors / Audit Committees does improve audit quality**

## Relationship between supervisors and AOBs

### Common Issues

Although most of the supervisors have communication lines with AOBs, the frequency of meetings and communication with AOBs varies depending on the jurisdictions.

### Possible Actions

- ▶ Signature of a Memorandum of Understanding (MoU) between the AOB and supervisory authority
- ▶ Meeting the AOB on a regular basis without preventing ad-hoc meetings



### Examples of regulation

According to the EU Directive on statutory audit, the public oversight systems will have the ultimate responsibility for the oversight of: the approval and registration of statutory auditors and audit firms; the adoption of standards on ethics, internal quality control of audit firms and auditing; continuous education, quality assurance; investigative and disciplinary systems.



**Effective communication between audit / entity supervisors / Audit Committees does improve audit quality**

## Audit Oversight Bodies & Quality Assurance

### Common Issues

In many jurisdictions, the professional organization for auditors is responsible for quality assurance .

In the EU, a single competent authority will be designated to bear ultimate responsibility for the audit public oversight system (mandatory from 2016).

### Possible Actions

► Requesting the implementation of the appropriate tools, methodologies and skills for public oversight and quality assurance agencies in the respective jurisdiction. This includes on-going training and knowledge requirements in IFRS and ISA, as applicable.



### Examples of best practices and regulation

In Czech Rep. the audit QA system shall: be independent; be subjected to public oversight; have safe financing; be executed by a natural person who is independent of the controlled auditors and who has sufficient professional education and experience in the area of statutory audits and accounting reporting (i.e. passed specialized training determined by the Chamber); and be performed at least once in three years for the auditors of banks.

# Other Communication



**Effective communication between audit / entity supervisors / Audit Committees does improve audit quality**

## Audit Committees

### Common Issues

The role and responsibilities, as well as the capacity, of audit committees vary in the ECA region. In a few jurisdictions, audit committees are not mandatory for banks.

### Possible Actions

- ▶ Requiring banks to have an audit committee
- ▶ Promoting effective audit committees, with members that are independent and have the appropriate skills
- ▶ Meeting with chairs of audit committees of SIBs



### Examples of best practices

In Slovenia, audit committees monitor the effectiveness of the risk management process, internal audit and internal control functions, and review the bank's accounting procedures.



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**THANK YOU FOR YOUR ATTENTION**