

Supervisors and External Auditors: Building a Constructive Relationship

Insight 1:

Auditors' work does contribute to the effective supervision of banks

Insight 2:

Supervisors could engage more effectively with external auditors

Insight 3:

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

Insight 4:

Supervisors do contribute to enhanced audit quality

Insight 5:

Effective communication between audit and banking supervisors and audit committees does improve audit quality

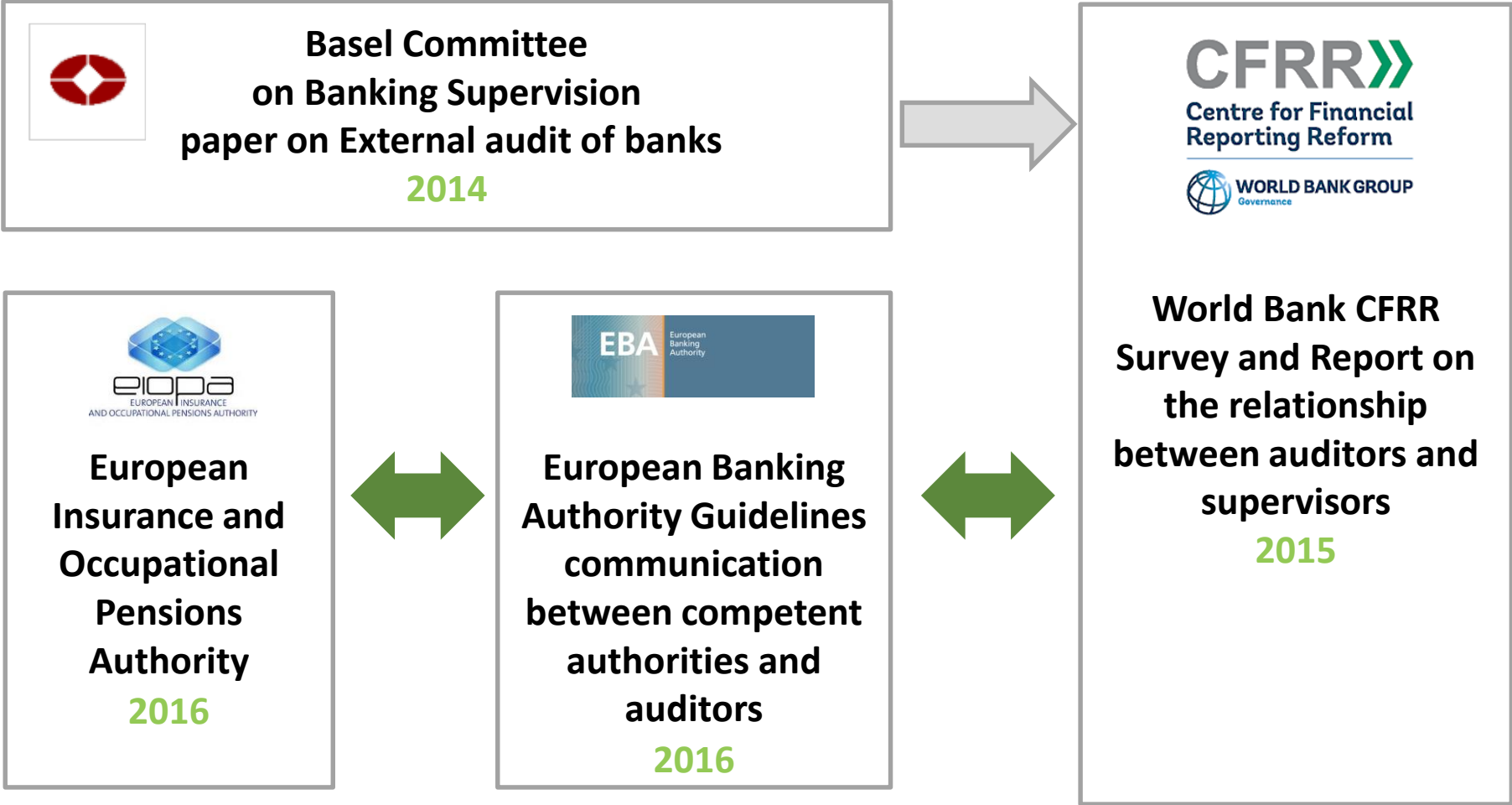
Objectives of the Session

1. Introduce the Guide

2. Review:

- i. the insights drawn from the World Bank CFRR report;
- ii. Examples of possible actions, good practices and regulation.

Overview of Key Publications



About this Guide

The Guide lists observations and possible actions for supervisors illustrated by examples of good practices and regulations from supervisory authorities in Europe under three categories:

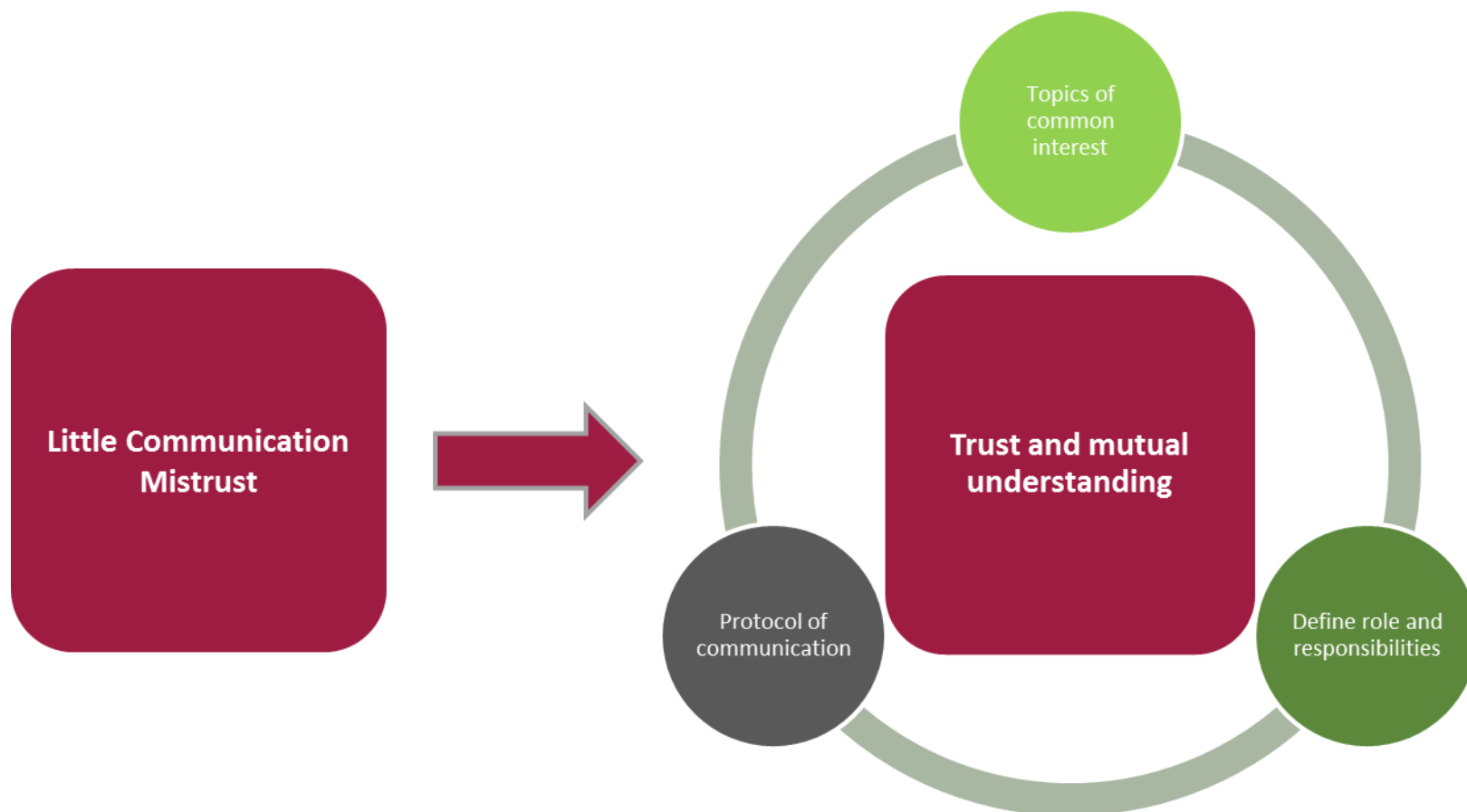
i. Policy Actions

ii. Capacity Building

iii. Working Practices

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'." -- Netherlands

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 & supervisors & AC does improve audit quality

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

External Audit



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

Capacity of Supervisors

Observation

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

Capacity Building:

- ▶ Providing on-going training on ISA and IFRS to staff at the supervisory authority.
- ▶ Hire supervisors with accounting and auditing experience.



Examples of good practices and regulation

Prudential Regulation Authority (PRA) provides 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.

External Audit



**Auditors' work
does
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supervision**

Long-Form Audit Report

Observation

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

Possible Actions

Policy Actions:

- ▶ Requiring 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 and submitted on a timely basis.

Working Practices:

- ▶ Discussing LFAR with external auditor, bank's management, audit & risk committee.



Examples of good practices and regulation

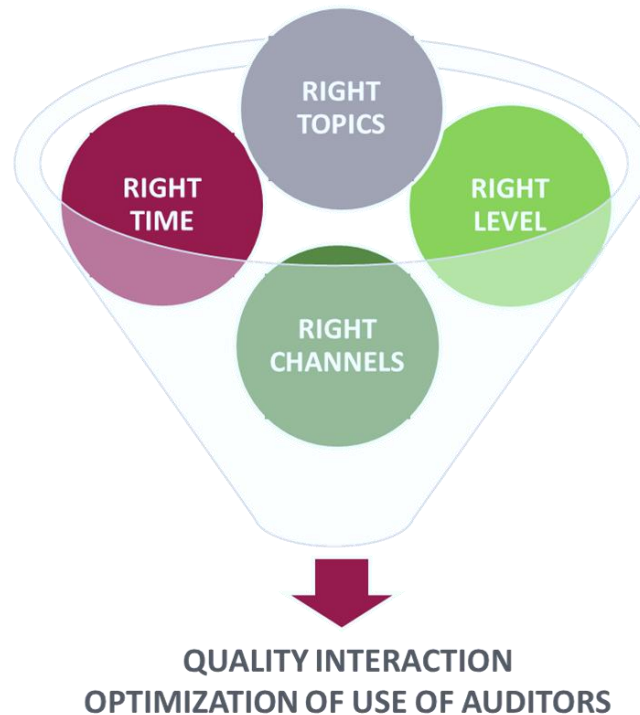
In Austria, according to the Austrian Banking Act, external auditors of banks are obliged to audit an additional appendix (prudential report) together with the external audit of financial statements.

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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auditors

Timing and frequency of communication

Observation

While most supervisors mentioned the ability to have ad-hoc meetings with external auditors, the communication with external auditors often takes place only after the audit opinion has been issued.

Possible Actions

Policy Actions:

- ▶ Setting up a joint framework of engagement (term & scope of relation)

Working Practices:

- ▶ Meeting and exchanging information earlier and more regularly within the audit process. Establishing ad-hoc meetings and keeping flexibility to avoid routine



Examples of good practices and regulation

Trilateral meetings have been introduced 2x/year for large banks and 1x/year for other banks (except for small banks). The National Bank of the Netherlands 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 once a year to discuss matters of strategic nature.

Channels of Communication



Supervisors
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Channels of communication

Observation

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

European supervisors prefer discussing some matters directly with external auditors, without the presence of the bank under supervision. (bilateral meetings)

Possible Actions

Working Practices:

Using as applicable:

- ▶ Formal/informal Oral/written channels; Ad-hoc/structured meetings
- ▶ Bilateral or Trilateral meetings
- ▶ Primary relationship holders, colleagues and staff of their respective teams and/or experts



Examples of good practices and regulation

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.

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



Accounting Standards

- Topics covered under IAS 39 or IFRS 9 standards, such as **loan valuation and provisioning** as well as the **asset valuation** are important to supervisors



Risk and Control Environment

- The effectiveness of an entity' internal control, risk management and IT systems are key inputs when assessing its risk profile and the going concern assumption



Prudential Information

- **Compliance with prudential regulations and consistency of financial statement's disclosures** with published prudential information

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

Observation

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

Possible Actions

Working Practices:

- ▶ Discussing with external auditor areas that may impact the audit strategy
- ▶ Using the audit strategy and plan as an input to the supervisory work plan
- ▶ Discussing the audit plan and strategy for SIBs



Examples of good 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, the entity's assets valuation, and the effectiveness of its internal controls are topics of particular interest to supervisors that can be discussed with external auditors.

Possible Actions

Working Practices:

- ▶ Requiring independent validation and verification of the valuation framework and controlling procedures by internal/external experts
- ▶ Discussing with auditors the processes to obtain a detailed understanding of internal controls and assumptions used in the valuation process



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)

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 do contribute to enhanced audit quality

Information sharing: supervisors to auditors

Observation

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

Possible Actions

Policy Actions:

► Creating “gateway” rules to allow the sharing of information with external auditors.

Working Practices:

► 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 good practices and regulation

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. 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 do
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Appointments of external auditors

Observation

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

Policy Actions:

▶ Setting up a principles-based framework

Working Practices:

▶ Monitoring the selection and appointment of external auditors to ensure it is fair, objective, transparent, independent of the bank's management and well documented

▶ Encouraging the appointment of external auditors who are able and willing to develop good working relationships and dialogue with supervisors



Examples of good practices and regulation

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.

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's 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

Other Communication



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

Audit Oversight Bodies & Quality Assurance

Observation

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

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

Possible Actions

Policy Actions:

▶ Signing a MoU between the AOB and supervisory authority which would detail circumstances in which supervisors would communicate directly with the AOB

Capacity Building:

▶ Promoting and contributing to 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, and providing information on the supervisory process



Examples of good practices and regulation

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

Observation

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

Policy Actions:

► Requiring banks to have an audit committee and ensuring that most members are independent of the audited entity and have the appropriate skills

Capacity Building:

► Promoting and contributing to the development of a Corporate Governance guide which sets up the role and responsibilities of audit committees

Working Practices:

► Meeting with chairs of audit committees of systemically important institutions



Examples of good practices and regulation

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

THANK YOU!



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