Basel Committee
on Banking Supervision

The relationship between banking supervisors and banks' external auditors

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BANK FOR INTERNATIONAL SETTLEMENTS

Proposed International Auditing Practice Statement

The relationship between banking supervisors and banks' external auditors

This International Auditing Practice Statement has been prepared in association with the Basel Committee on Banking Supervision.* It was approved for publication as an exposure draft by the International Auditing Practices Committee and by the Basel Committee.

Banks play a vital role in economic life and the continued strength and stability of the banking system is a matter of general public concern. The separate roles of bank supervisors and external auditors are important in this regard. The growing complexity of banking makes it necessary that there be greater mutual understanding and, where appropriate, more communication between bank supervisors and external auditors.

The purpose of this Statement is to provide information and guidance on how the relationship between bank auditors and supervisors can be strengthened to mutual advantage, and it takes into account the Basel Committee's Core Principles for Effective Banking Supervision. However, as the nature of this relationship varies significantly from country to country the guidance may not be applicable in its entirety to all countries. The International Auditing Practices Committee and the Basel Committee hope, however, that it will provide a useful clarification of the respective roles of the two professions in the many countries where the links are close or where the relationship is currently under study.

Comments on this exposure draft should be submitted by 12 June 2001. Comments may be submitted by post to the Basel Committee on Banking Supervision, CH-4002 Basel, Switzerland, faxed to +41 61 280 9100 or e-mailed to bengt.mettinger@bis.org. Comments may alternatively be submitted to EDComments@ifac.org or faxed to the IFAC Secretariat (+1 973 286 9570). Unless respondents request confidentiality, their comments are a matter of public record.

* The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

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Introduction

1. Banks play a central role in the economy. They hold the savings of the public, provide a means of payment for goods and services and finance the development of business and trade. To perform these functions securely and efficiently, individual banks must command the confidence of the public and those with whom they do business. The stability of the banking system, national and international, has therefore come to be recognised as a matter of general public interest. This public interest is reflected in the way banks in all countries, unlike most other commercial companies, are subject to prudential supervision by central banks or specific official agencies.

2. Banks' financial statements are also subject to audit by external auditors. The auditor conducts the audit in accordance with applicable ethical and auditing standards, including independence, due professional care, objectivity and adequate planning and supervision. When these conditions are met, the auditor's opinion lends credibility to such statements and thereby assists in promoting confidence in the banking system. As the business of banking grows in complexity, both nationally and internationally, the tasks of both bank supervisors and external auditors are becoming more and more demanding. In many respects bank supervisors and external auditors face a similar challenge and increasingly their roles are being perceived as complementary. Not only do supervisors benefit from the results of the auditors' work, but they may also turn to the auditors to undertake additional tasks when these tasks contribute to the performance of their supervisory responsibilities. At the same time, auditors, in carrying out their functions, also look to the supervisors for information that can help in discharging their functions more effectively.

3. The International Auditing Practices Committee and the Basel Committee share the view that greater mutual understanding and, where appropriate, communication improves the effectiveness of bank audits and supervision to the benefit of both disciplines.

4. The roles and responsibilities of a bank's management, the bank's external auditors and the supervisory authorities in different countries derive from both law and custom. This Statement is not concerned with challenging or changing these roles or responsibilities. Rather, it is intended to provide a better understanding of the precise nature of the roles of bank management, external auditors and banking supervisors, since a misconception of such roles could lead to inappropriate reliance being placed by one on the work of the other.

5. This Statement seeks to remove these possible misconceptions and to suggest how each might make more effective use of the work performed by the other. The Statement accordingly:

- defines the primary responsibility of the board of directors and management[1] (paragraphs 8–14);
- examines the essential features of the role of external auditors (paragraphs 15–28);
- examines the essential features of the role of supervisors (paragraphs 29–45);

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[1] The notions of "board of directors" and "senior management" are used not to identify legal constructs but rather to label two decision-making functions within a bank. The Basel Core Principles refer to the functions of the board of directors to describe the functions of those charged with the governance of a bank. The principles set out in this paper are to be applied in accordance with the corporate governance structure of the country in which the bank is based. It also might be useful to consult the Basel Committee's paper "Enhancing Corporate Governance for Banking Organisations" published in September 1999.

- reviews the relationship between the supervisor and the auditor (paragraphs 46–56); and

- describes additional ways in which auditors and the auditing profession can contribute to the supervisory process (paragraphs 57–71).

6. In September 1997 the Basel Committee published its Core Principles for Effective Banking Supervision, known as the Basel Core Principles. The Basel Core Principles (which are used in country assessments by organisations such as the World Bank and the International Monetary Fund) are intended to serve as a basic reference for an effective supervisory system in all countries and internationally. This Statement has been prepared taking into account the Basel Core Principles.

7. The Statement has been prepared in full awareness of the significant differences that exist in national institutional frameworks, notably in accounting standards, in supervisory techniques and in the extent to which, in some countries, the auditors currently perform tasks at the request of the supervisory authorities. In some countries, bank supervisors and auditors already have closer relationships than are indicated in the Statement. The arrangements suggested in the Statement are complementary to and do not replace existing relationships. While the Statement is not intended to be prescriptive, it is hoped that the views expressed herein will have relevance for all situations, although they will obviously address the situations in some countries more directly than those in others.

The Responsibility of the Board of Directors and the Bank's Management

8. The primary responsibility for the conduct of the business of a bank is vested in the board of directors and the management appointed by it. This responsibility includes ensuring:

- that those entrusted with banking tasks have sufficient expertise and integrity and that there are experienced staff in key positions;

- that adequate policies, practices and procedures related to the different activities of the bank are established and complied with, including:

  - the promotion of high ethical and professional standards;

  - systems that accurately identify and measure all material risks and adequately monitor and control these risks;

  - adequate internal controls, organisational structures and accounting procedures;

  - the evaluation of the quality of assets and their proper recognition and measurement;

  - "know your customer" rules that prevent the bank being used, intentionally or unintentionally, by criminal elements;

  - the promotion of a positive attitude in respect of control functions;

- that appropriate management information systems are established;

- that statutory and regulatory directives, including directives regarding solvency and liquidity, are observed; and

- that the interests not only of the shareholders but also of the depositors and other creditors are adequately protected.

9. Management is responsible for preparing financial statements in accordance with the national financial reporting framework. This responsibility includes ensuring that the auditor who examines and reports on such statements is provided with all necessary information that can materially affect the financial statements and consequently the auditor's report thereon.[2] Management also has the responsibility to provide all information to the supervisory agencies that such agencies are entitled by law or regulation to obtain.

10. Management is responsible for the establishment and the effective operation of a permanent internal audit function in a bank appropriate to its size and to the nature of its operations. This function is part of the ongoing monitoring of the system of internal controls because it provides an independent assessment of the adequacy of, and compliance with, the bank's established policies and procedures. In fulfilling its duties and responsibilities, the senior management should take all necessary measures so that the bank can rely continuously on an adequate internal audit function.

11. In order to be fully effective, the internal audit department must be independent of the organisational activities audited and also must be independent from the every day internal control process. Every activity and every entity of the establishment should fall within the scope of the internal audit function. The professional competence of each internal auditor and of the internal audit department as a whole is essential for the proper performance of the internal audit function. Therefore, the internal audit department should be adequately staffed with persons of the appropriate skills and technical competence who are free from operating responsibilities. The internal audit department should regularly report to the board of directors and senior management on the performance of the internal control system and on the achievement of the internal audit department's objectives. Senior management should approve a procedure ensuring the consideration and, if appropriate, the implementation of the internal audit department's recommendations.

12. Under the standards and guidance provided by International Standard on Auditing 610 "Considering the Work of Internal Auditing" (ISA 610), external auditors can consider the work of internal auditors. The external auditor considers the organisational status of the internal audit department in order to determine the degree of reliance on the work of the department.

13. In many countries, audit committees have been set up to meet the practical difficulties that may arise in the board of directors' task to ensure the existence and maintenance of an adequate system of internal controls. In addition, such a committee reinforces both the internal control system and the internal audit function. In order to reinforce the audit committee's effectiveness, the internal and external auditor should be allowed and encouraged to attend the meetings of the audit committee.

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[2] In some countries, branches of overseas banks are only required to provide financial information, including abbreviated financial statements, prepared in accordance with group accounting policies or national regulations. This financial information may or may not be subject to an audit requirement. The guidance in this statement is also intended for application in an appropriate and practical manner to the audit of bank branches where such audits are required.

14. The responsibilities of the management are in no way diminished by the existence of a system for the supervision of banks by central banks or other official agencies or by a requirement for a bank's financial statements to be subject to audit by external auditors.

The Role of the Bank's External Auditor

15. The primary objective of an audit of a bank by an external auditor is to enable an independent auditor to express an opinion as to whether the published financial statements of the bank are prepared, in all material respects, in accordance with the identified financial reporting framework. The financial statements ordinarily will have been prepared according to the financial reporting framework of the country in which the bank has its head office,[3] and in accordance with any relevant regulations laid down by regulators in that country. Financial reporting frameworks may differ from country to country, and the financial reporting regime for banks in any given country may be quite different from the regimes for other commercial entities. The auditor's opinion on the financial statements, therefore, will be expressed in terms of the relevant national framework and regulations. It is possible for financial statements prepared under different frameworks and regulations to differ substantially while still being in accordance with the national requirements.

16. The auditor's report is ordinarily addressed either to the shareholders or the board of directors, but may be available to many other parties, such as depositors, other creditors and supervisors. The auditor's opinion helps to establish the credibility of the financial statements. The auditor's opinion, however, should not be interpreted as an assurance as to the future viability of the bank or an opinion as to the efficiency or effectiveness with which the management has conducted the affairs of the bank, since these are not the objectives of the audit.

17. The auditor designs audit procedures to reduce to an acceptably low level the risk of giving an inappropriate audit opinion when the financial statements are materially misstated. The auditor assesses the inherent risk of material misstatements occurring (inherent risk) and the risk that the entity's accounting and internal control systems will not prevent or detect and correct material misstatements on a timely basis (control risk). The auditor assesses the control risk as being high unless the auditor is able to identify controls that are likely to prevent or detect and correct a material misstatement and conducts tests of the control that support a lower assessment of control risk. Based on the assessment of inherent and control risk, the auditor carries out substantive procedures to reduce the overall audit risk to an acceptably low level.

18. The auditor assesses the risk that fraud and error may cause the financial statements to contain material misstatements and designs audit procedures to obtain reasonable assurance that misstatements arising from fraud and error that are material to the financial statements taken as a whole are detected.[4] In making that assessment, the auditor considers such matters as management's characteristics and influence over the control environment, industry conditions, and the bank's operating characteristics and financial

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[3] In some countries, reporting in accordance with international accounting standards, such as those of the International Accounting Standards Committee, also is permitted.

[4] IAPC has issued an exposure draft to revise ISA 240, Fraud and Error. This draft IAPS is based on the existing standard. The final practice statement will be revised to ensure conformity with the revised ISA 240 once that document is issued.

stability. In some countries, when the auditor determines that evidence of fraud exists, the auditor must disclose this information to the bank's supervisor.

19. In carrying out the audit of a bank, the external auditor recognises that banks have the following characteristics, which generally distinguish them from most other commercial enterprises, and which the auditor takes into account in assessing the level of inherent risk:

- banks have custody of large volumes of money, including cash and negotiable instruments, whose physical security has to be assured. This applies both to the storage and the transfer of money and makes banks vulnerable to misappropriation or fraud. Banks therefore need to establish formal operating procedures, well defined limits for individual discretion and rigorous systems of internal control;

- as compared to other commercial businesses, banks operate with very high leverage, the ratio of capital to total assets is low, which increases banks' vulnerability to adverse economic events and increases their risk of failure;

- banks have assets that can rapidly change in value and whose value is often difficult to determine. A small decrease in asset values can have a material effect on capital and potential regulatory solvency;

- banks have exclusive access to clearing and settlement systems for checks and fund transfers;

- banks often derive a significant amount of their funding from short-term deposits (insured and/or uninsured). A loss in confidence in a bank can quickly result in a liquidity crisis;

- banks have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for actions in breach of trust. Banks therefore need to establish operating procedures and internal controls designed to ensure that they deal with assets only in accordance with the terms on which they hold them;

- banks engage in a large volume and variety of transactions both in terms of number and value. This necessarily requires complex accounting and internal control systems and widespread use of computerised information systems;

- banks ordinarily operate through a wide network of branches and departments that are geographically dispersed. This necessarily involves a greater decentralisation of authority and dispersal of accounting and control functions with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries;

- banks often enter into significant commitments without any initial transfer of funds other than the payment of fees (for example, derivatives). These items may involve only memorandum accounting entries and consequently the failure to record such items may be difficult to detect; and

- banks are regulated by governmental authorities and regulatory requirements often influence generally accepted accounting and auditing practices within the industry. Non-compliance with regulatory requirements, for example, concerning special valuation rules for substandard assets, could have implications for the bank's financial statements.

20. A detailed audit of all transactions of a bank not only would be time-consuming and extremely expensive but also wholly impracticable. The auditor therefore bases the audit on the assessment of the inherent risk of material misstatement, the assessment and testing of the internal control systems designed to prevent or detect and correct material misstatements, and on substantive procedures performed on a test basis. Such procedures will comprise one or more of the following: inspection, observation, inquiry and confirmation, computation and analytical procedures. In particular, the auditor is concerned about the recoverability and consequently the carrying value of loans, investments and related assets and about the identification and adequate disclosure in the financial statements of all material commitments and liabilities, contingent or otherwise.

21. While the external auditor has sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of the internal audit department can be useful to the external auditor in the audit of the financial statements. The auditor, therefore, as part of the audit evaluates the internal audit function insofar as the auditor believes that it will be relevant in determining the nature, timing and extent of the audit procedures.

22. Judgement permeates the auditor's work. The auditor has to use professional judgement in areas such as:

- assessing inherent and control risk and the risk of material misstatement due to fraud and error;
- deciding upon the nature, timing and extent of the audit procedures;
- evaluating the results of those procedures; and
- assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.

23. An auditor plans and conducts the audit to obtain reasonable assurance that misstatements in the bank's financial statements which, individually or in aggregate, are material in relation to the financial information presented by those statements are detected. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. The assessment of what is material is a matter for the auditor's professional judgement, but it is influenced by the auditor's perception of the needs of the users of the bank's financial statements. Materiality may also be influenced by other considerations such as legal and regulatory requirements, whether relating to the financial information as a whole or to individual items thereof. Therefore, an auditor may apply different levels of materiality for different components of the financial statements. Similarly, the level of materiality used by an auditor when reporting on a bank's financial statements may be different from the level used when making special reports to a bank's supervisor.

24. In forming an opinion on the financial statements, the auditor carries out procedures designed to obtain reasonable assurance that the financial statements are prepared in all material respects in accordance with an identified financial reporting framework. Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that even some material misstatements may remain undiscovered. The risk of not detecting a material misstatement resulting from fraud is greater than the risk of not detecting a material misstatement resulting from error, because fraud usually involves acts designed to conceal it, such as collusion, forgery, deliberate failure to record transactions or intentional misrepresentation being made to the auditor. Therefore, the auditor plans and performs his audit with an attitude of

professional scepticism, recognising that circumstances may exist which cause the financial statements to be materially misstated.

25. A matter of particular concern to the auditor is obtaining assurance that the financial statements have been prepared in accordance with an acceptable financial reporting framework. The financial statements of banks are prepared in the context of the legal and regulatory requirements prevailing in different countries and accounting policies are influenced by such regulations. Regulatory requirements of, or accounting principles and practices generally accepted in, one country may result in financial statements that give a different view of a bank's financial position and results from the view that would be given under International Accounting Standards or the accounting principles and practices of a different country.[5]

26. When the auditor discovers an error material to the financial statements, including the use of an inappropriate accounting policy or asset valuation or a failure to disclose essential information, the auditor asks management to adjust the financial statements to correct the error. If management refuses to make the correction the auditor issues a qualified or an adverse opinion on the financial statements. Such a report will have a serious effect on the credibility and even stability of the bank, and management therefore usually takes the steps necessary to avoid it. Likewise, an auditor issues a qualified opinion if management has not provided the auditor with all the required information or explanations.

27. As a supplementary but not necessarily integral part of the audit role, the auditor ordinarily communicates certain information to management. This information customarily contains comments on such matters as deficiencies in internal control or other errors or omissions that have come to the auditor's attention during the course of the audit, but which do not warrant a modification of the audit report because additional procedures have been performed to compensate for a weakness in control or because the errors have been corrected in the financial statements or are immaterial in this context. In some countries, an auditor also submits, either as part of a statutory requirement or by convention, a long-form report to management or to the supervisory authorities on specified matters such as the composition of accounting balances or of the loan portfolio, liquidity and earnings, ratios, the adequacy of internal control systems, an analysis of banking risks, or compliance with legal or supervisory requirements.

28. In some countries, the external auditors are required to report promptly to the supervisors any fact or decision that is liable to

- constitute a material breach of laws or regulations;
- affect the continuous functioning of the bank; or
- lead to a modified report.

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[5] The auditor's opinion will generally not be affected even if the accounting principles and practices applied result in financial statements that are materially different from financial statements prepared in accordance with International Accounting Standards and the accounting principles and practices of another country. This would not preclude the provision of an 'emphasis of matter' paragraph commenting on such differences.

The Role of the Banking Supervisor

29. The key objective of prudential supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors. In addition, supervision also is often directed toward verifying compliance with laws and regulations governing banks and their activities. However, in this Statement the focus is on the prudential aspect of the supervisor's role.

30. Banking supervision is based on a system of licensing which allows supervisors to identify the population to be supervised and to control entry into the banking system. In order to qualify for and retain a banking license, entities must observe certain prudential requirements. These requirements may differ from country to country in their precise specification; some may be closely defined in regulation and others may be more broadly drawn, allowing the supervisory authority a measure of discretion in their interpretation. However, the following basic requirements for a banking license ordinarily are to be found in most systems of supervision:

- the bank must have suitable shareholders and members of the board (this notion includes integrity and standing in the business community as well as the financial strength of all major shareholders);
- the management of the bank must be honest and trustworthy and must possess appropriate skills and experience to operate the bank in a sound and prudent manner;
- the organisation and internal control of the bank must be consistent with the bank's business plans and strategies;
- the bank should have a legal structure in line with its operational structure;
- the bank must have adequate capital to withstand the risks inherent in the nature and size of its business; and
- the bank must have sufficient liquidity to meet outflows of funds.

31. Further and more detailed requirements are often prescribed, including minimum numerical ratios for capital and liquidity adequacy. Whatever the precise form of the regulations, however, their objective is to set conditions to ensure that a bank conducts its business prudently and has adequate financial resources to overcome adverse circumstances and protect depositors from loss.

32. In addition to licensing new banks, most banking supervisors have the authority to review and reject any proposal to transfer significant ownership or a controlling interest in existing banks to other parties.

33. Ongoing supervision ordinarily is conducted on the basis of recommendations and persuasion. However, banking supervisors have at their disposal recourse to legal powers to bring about timely corrective action when a bank fails to meet prudential requirements, where there are violations of laws or regulations, or where depositors are faced with a substantial risk of loss. In extreme circumstances, the supervisor may have the authority to revoke the bank's license.

34. One of the foundations of prudential supervision is capital adequacy. In most countries there are minimum capital requirements for the establishment of new banks and capital adequacy tests are a regular element in ongoing supervision. In the consultative

package "The New Basel Capital Accord" issued by the Basel Committee in January 2001, the Basel Committee proposes a capital adequacy framework based on three complementary pillars: minimum capital requirements, a supervisory review process and market discipline.

- The first pillar defines the minimum capital requirements for three broad categories of risks: credit risk, market risk and operational risk.

- The second pillar, the supervisory review process, relies on the following principles. Banks must have sufficient solvency in relation to its risk profile and supervisors must have the ability to require banks to hold capital in excess of the minimum. Banks should assess internally and on an ongoing basis their capital adequacy based on their present and future risk profile and supervisors should review the banks' internal capital adequacy assessment procedure. Finally, supervisors must intervene early, taking into account the relatively illiquid nature of most bank assets and the limited options most banks have in raising capital quickly.

- The third pillar, market discipline, enhances the role of market participants in encouraging banks to hold adequate levels of capital. In this respect, banks must disclose quantitative and qualitative information about their capital and risk profile.

35. Banks are subject to a variety of risks. Supervisors monitor and may limit a range of banking risks, such as credit risk, market risk (including interest and foreign exchange risk), liquidity and funding risk, operational risk, legal risk and reputational risk. Increasingly, supervisors are attempting to develop systems of measurement that will capture the extent of exposure to specific risks (for example, the risks involved in derivative financial instruments). These systems often form the basis for specific controls or limits on the various categories of exposure.

36. The most significant of banking risks, in terms of historical loss experience, is credit risk - the risk that a borrower will not be able to repay the principal and interest on a loan when due. It is not the supervisor's role to direct banks' lending policies, but it is essential for the supervisor to be confident that the bank has adopted a sound system for managing credit risk. The supervisor also evaluates the effectiveness of a bank's policies and practices for assessing loan quality. The supervisor seeks to be satisfied that the methods employed and judgements made by management to calculate allowances produce an aggregate amount of specific and general allowances that is adequate to absorb estimated credit losses, on a timely basis, in accordance with appropriate policies and procedures. In addition, the supervisor also seeks to ensure that credit risk is adequately diversified by means of rules to limit exposures, whether in terms of individual borrowers, industrial or commercial sectors or particular countries or economic regions.

37. Although it is difficult to assess, the quality of a bank's loans and other assets is one of the most critical determinants of its financial condition. Accordingly, accurate and prudent valuation of assets is of great importance for supervisors because it has a direct bearing on the determination of the reported amount of the bank's capital. As already indicated, capital is widely used as the supervisory standard against which exposures are measured or limited. While the proper valuation of assets is one of the primary responsibilities of management, the valuation process often involves considerable judgement. In general, unless the supervisor performs its own evaluation of this process to determine its accuracy and compliance with documented policies and procedures, the supervisor relies in large part on the management's judgement of the proper valuation of assets and on the external auditor's examination of those valuations.

38. Supervisors attach considerable importance to the need for banks to have in place internal controls that are adequate for the nature, scope and scale of their business. The purpose of internal controls is to ensure that the business of the bank is conducted in a prudent manner in accordance with policies and strategies established by the bank's board of directors; that transactions are only entered into with the appropriate authority; that assets are safeguarded and liabilities controlled; that accounting and other records provide complete, accurate and timely information; and that management is able to identify, measure, monitor and control the risks of the business.

39. The development of sophisticated real-time computerised information systems has greatly improved the potential for control, but in turn has brought with it additional risks arising from the possibility of computer failure or fraud.

40. Supervisors are concerned to ensure that the quality of management is adequate for the nature and scope of the business. In regulatory environments in which on-site inspections are regularly carried out, the examiners have an opportunity to notice signs of management deficiencies. Elsewhere, the supervisor normally arranges to interview management on a regular basis and pursues other opportunities for contacts where they arise. Whatever the nature of the regulatory environment, the supervisor tries to use these opportunities to understand management's business plans and strategies and how it expects to achieve them. Similarly, the supervisor seeks to discover whether the bank is properly equipped to carry out its functions in terms of the skills and competence of its staff and the equipment and facilities at its disposal. The information gained from these contacts with management assists the supervisor in forming an opinion about management's competence.

41. Effective supervision requires the collection and analysis of information about supervised banks. For example, supervisors collect, review and analyse prudential reports and statistical returns from banks. These include basic financial statements as well as supporting schedules that provide greater detail. These reports are used to check adherence to certain prudential requirements and they also provide a basis for discussions with the bank's management. Off-site monitoring can often identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious.

42. Supervisors must have a means of validating supervisory information either through on-site inspections or use of external auditors. On-site work, whether done by own supervisory staff or commissioned by supervisors but undertaken by external auditors, should be structured to provide independent verification that adequate corporate governance exists at individual banks and that information provided by banks is reliable.

43. To enhance their understanding of a bank's corporate governance and system of operation, some supervisory authorities meet periodically with the bank's audit committee. This provides an opportunity for the audit committee to discuss any concerns it may have about the management of the bank and enables the supervisor to form a view as to the audit committee's effectiveness.

44. All the work performed by external auditors that is of interest to banking supervisors should be carried out by auditors who:

- are properly licensed and in good standing;
- have relevant professional experience and competence;
- are subject to a quality assurance program;

- are independent in fact and appearance of the bank audited;
- are objective and impartial; and
- comply with the "Code of Ethics for Professional Accountants", issued by the International Federation of Accountants.[6]

45. Supervisors have a clear interest in ensuring high standards of bank auditing. Moreover, an important concern of supervisors is the independence of the auditor who performs the audit of a bank, particularly when the auditor also provides certain types of non-audit services to the bank. Accordingly, supervisors seek to maintain close contact with national professional auditing bodies in order to address issues of mutual interest.

The Relationship between the Supervisor and the Auditor

46. In many respects the supervisor and the auditor have complementary concerns regarding the same matters though the focus of their concerns may be different. Thus:

- the supervisor is primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks in order to protect the interests of the depositors. Therefore, the supervisor monitors the present and future viability of banks and uses their financial statements in assessing their condition and performance. The auditor, on the other hand, is primarily concerned with reporting on the financial position of the bank and on the results of its operations. In doing so, the auditor considers the appropriateness of management's use of the going concern assumption. The auditor considers the period of assessment used by management and, when that period is less than 12 months from the balance sheet date, asks management to extend the assessment period to at least 12 months from the balance sheet date. If management refuses to do so, ISA 570 requires the auditor to consider the need to modify the auditor's report as a result of the limitation of the auditor's work. The auditor also inquires of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the bank's ability to continue as a going concern;
- the supervisor is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the bank's business. The auditor, in most situations, is concerned with the assessment of internal control to determine the degree of reliance to be placed on the system in planning and performing the audit; and
- the supervisor must be satisfied that each bank maintains adequate records prepared in accordance with consistent accounting policies and practices that enable the supervisor to appraise the financial condition of the bank and the profitability of its business, and that the bank publishes or makes available on a regular basis financial statements that fairly reflects its condition. The auditor is concerned with whether adequate and sufficiently reliable accounting records are

[6] The independence rules contained in Section 8 of the Code of Ethics for Professional Accountants are currently under revision.

maintained in order to enable the entity to prepare financial statements that do not contain material misstatements and the auditor to express an opinion on those statements.

47. When a supervisor uses audited financial statements in the course of supervisory activities, the supervisor needs to bear in mind the following factors among others:

- that supervisory needs may not be the primary purpose for which the financial statements were prepared;

- that the objective of an audit is to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement;

- the accounting policies used in the preparation of the financial statements;

- that financial statements include information based on judgements and estimates made by the management and examined by the auditor;

- that the financial position of the bank may have been affected by subsequent events since the financial statements were prepared; and

- that, given the different purposes for which internal control is evaluated and tested by the supervisor and the auditor, the supervisor cannot assume that the auditor's evaluation of internal control for the purposes of the audit will necessarily be adequate for the purposes for which the supervisor needs an evaluation.

48. Nonetheless, there are many areas where the work of the supervisor and of the auditor can be useful to each other. Communications from auditors to management and other reports submitted by auditors can provide supervisors with valuable insight into various aspects of a bank's operations. It is the practice in many countries for such reports to be made available to the supervisors.

49. Similarly, auditors may obtain helpful insights from information originating from the supervisory authority. When a supervisory inspection or a management interview takes place, the conclusions drawn from the inspection or interview are customarily communicated to the bank. These communications can be useful to auditors inasmuch as they provide an independent assessment in important areas such as the adequacy of the allowance for loan losses and focus attention on specific areas of supervisory concern. Supervisory authorities may also develop certain informal prudential ratios or guidelines which are made available to the banks and which can be of assistance to auditors in performing analytical reviews.

50. When communicating with management, both supervisors and auditors need to be aware of the benefits which can flow to each other from knowledge of the matters contained in such communications. It is therefore advantageous for communications of this nature to be made in writing, so that they form part of the bank's records to which the other party should have access.

51. In order to preserve the concerns of both parties regarding the confidentiality of information acquired while carrying out their respective functions, it is normal that, when contacts between the supervisor and the auditor become necessary, management of the bank is also present or at least informed. It is recommended that timely and appropriate measures be taken so that external auditors cannot be held liable for information disclosed in good faith to the supervisory authorities in accordance with applicable laws and regulations. These measures can take the form of legal initiatives or can be an agreement among the

bank, its management, the external auditor and the supervisory authority. This is particularly true when the presence of the management would compromise the discussion.

52. ISA 260 “Communications of Audit Matters With Those Charged With Governance” identifies matters of governance interest and requires auditors to communicate those matters on a timely basis to those charged with governance. Similarly, certain audit matters of governance interest are likely to be of interest to bank supervisors, particularly where those matters may require urgent action by the supervisor. When required by the supervisory, legal, and/or regulatory framework or by a formal agreement or protocol, the auditor communicates such matters to the bank supervisor on a timely basis. When there is no formal agreement or protocol, the auditor also communicates those types of matter to the bank supervisor unless, in the auditor’s judgement, there are reasons that justify not communicating such matters to the supervisor.

53. In addition to the matters identified in ISA 260,[7] the following are examples of the types of other matters that are likely to be of interest to the bank supervisor:

- information that indicates a failure to fulfil one of the requirements for a banking license;
- a serious conflict within the decision-making bodies or the unexpected departure of a manager in a key function;
- information that may indicate a material breach of laws and regulations or the bank’s articles of association, charter, or by-laws;
- the intention of the auditor to resign or the removal of the auditor from office; and
- material adverse changes in the risks of the bank’s business and possible risks going forward.

In many cases the auditor would also communicate these matters to those charged with governance.

54. In a number of countries, the auditor carries out specific assignments or issues special reports in accordance with statutes or at the request of the supervisor to assist the

[7] Ordinarily such matters include:

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- The selection of , or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity’s financial statements;
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- Audit adjustments, whether or not recorded by the entity, that have or could have a significant effect on the entity’s financial statements;
- Material uncertainties related to events and conditions that may cast significant doubt on the entity’s ability to continue as a going concern;
- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity’s financial statements or the auditor’s report. This communication includes consideration of whether the matter has, or has not, been resolved, and the significance of the matter;
- Excepted modifications to the auditor’s report;
- Other matters, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management; and
- Any other matters agreed upon in the terms of the engagement.

supervisor in discharging supervisory functions. These duties may include reporting upon whether:

- licensing conditions have been complied with;
- the systems for maintaining accounting and other records and the systems of internal control are adequate;
- the method used by the bank to prepare prudential reports is adequate and the information included in these reports, which may include specified cover ratios and other prudential requirements, is accurate;
- the organisation is adequate based on criteria provided by the supervisory authority;
- laws and regulations are complied with; and
- appropriate accounting policies are adhered to.

55. In some countries, the supervisor has statutory powers over the appointment of auditors, such as the right of approval or removal, and the right to commission an independent audit. These powers are intended to ensure that auditors appointed by banks have the experience, resources and skills necessary in the circumstances. Where there is no obvious reason for a change of auditor, supervisors will also normally wish to investigate the circumstances in which a bank has failed to reappoint the auditor.

56. Bank supervisors and internal and external auditors cooperate to make their contributions to the supervisory process more efficient and effective. The cooperation optimises supervision while allowing each party to concentrate on its own responsibilities. In some countries the cooperation may be based on periodic meetings of the supervisor and the external and internal auditors.

Additional Requests for the Auditor to Contribute to the Supervisory Process

57. A supervisor's request to an auditor to assist in specific supervisory tasks should be made in the context of a well-defined framework that is set forth in applicable law or a contractual agreement between the bank and the supervisor. These requests may in some cases be subject of a separate engagement. In this situation, the following criteria should be established.

58. First, the basic responsibility for supplying complete and accurate information to the supervisor must remain with the bank management. The auditor's role is to report on that information or on the application of particular procedures. As such, the auditor does not assume any of the responsibilities of the supervisor but, by providing this report, enables the supervisor to more effectively make judgements about the bank.

59. Second, the normal relationship between the auditor and the audited bank needs to be safeguarded. If there are no other statutory requirements or contractual arrangements governing the auditor's work, all information flows between supervisors and auditors typically are channelled through the bank except in exceptional circumstances. Thus, the supervisory authority will request the bank to arrange to obtain the information it requires from the auditor and such information will be submitted to the supervisor through the bank. Any meetings

between the auditors and supervisors will, except as indicated in paragraph 51 above, be attended by representatives of the bank, and the bank's approval will be required before the auditor transmits copies of communications to management and other reports to the supervisor.[8]

60. Third, before concluding any arrangements with the supervisor, the auditor considers whether any conflicts of interest may arise. If so, these need to be satisfactorily resolved before the commencement of the work, normally by obtaining the prior approval of the bank's management to undertake the assignment.

61. Fourth, the supervisory requirements must be specific and clearly defined in relation to the information required. This means that the supervisor needs, as far as possible, to describe the standards against which the bank's performance can be measured, so that the auditor can report whether or not they have been achieved. If, for example, information is required on the quality of loan assets, the supervisor has to specify what criteria are to be used in classifying the audited loans according to risk category. Similarly, wherever possible, some understanding must be reached between supervisors and auditors regarding the concept of materiality.

62. Fifth, the tasks which the auditor is asked by the supervisor to perform need to be within the auditor's competence, both technical and practical. The auditor may, for example, be requested to assess the extent of a bank's exposure to a particular borrower or country. However, without clear and specific guidance, the auditor will not be in a position to judge whether any particular exposures are excessive. In addition, audits are carried out at intervals and not continuously, so that, for example, it is not reasonable to expect the auditor to carry out a complete evaluation of internal control or to monitor a bank's compliance with all supervisory rules except through an ongoing program of work over a period of time.

63. Sixth, the auditor's task for the supervisor must have a rational basis. This means that except in special circumstances the task must be complementary to the regular audit work and can be performed more economically or more expeditiously than by the supervisor, either because of the auditor's specialised skills or because duplication is thereby avoided.

64. Finally, certain aspects of confidentiality need to be protected, in particular the confidentiality of information obtained by the auditor through professional relationships with other clients and not available to the bank or the public.

65. The way in which the auditor's role can be extended depends on the nature of the national supervisory environment. For example, if an active approach is followed by the supervisor, with frequent and rigorous inspection, the assistance which might be asked of the auditor will normally be minimal. If, on the other hand, there is a history of less direct supervision, primarily based on the analysis of reporting returns provided by bank's management, as opposed to inspection, or if supervisory resources are limited, the supervisor can benefit from the assistance which the auditor can offer in providing assurance on the information obtained.

66. Nowadays, however, many countries are practising a supervisory approach which contains elements of both inspection and analysis of reporting returns. As banking develops in complexity, inspection is proving more and more demanding in terms of supervisory resources. Many supervisory authorities which practice on-site inspection are thus being

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[8] Many banks furnish copies of communications to management and other audit reports directly to the supervisor.

driven to place greater reliance on reporting returns and to look to the auditors for assistance in those areas for which their skills are particularly suited.

67. Where supervisors have hitherto relied solely on the analysis of prudential returns, it is found that a certain degree of on-the-spot examination is a desirable safeguard. In these countries, therefore, the supervisors are relying more than before on the auditors to assist them by performing specific tasks (see paragraph 54).

68. In those countries where contacts between the auditors and the supervisors have been close over a long period, a bond of mutual trust has been built up and extended experience has enabled each to benefit from the other's work. Experience in those countries indicates that the conflicts of interest that auditors may in principle perceive as preventing close collaboration with supervisors assume less importance in practice and do not present an obstacle to a fruitful dialogue.

The Need for a Continuing Dialogue between Supervisory Authorities and the Auditing Profession

69. If supervisors are to derive benefit from the work of auditors on a continuing basis, supervisors should discuss current areas of supervisory concern with the auditing profession as a whole. This can be achieved through periodic discussions at the national level between the supervisory authorities and the professional accounting bodies. Such discussions could cover areas of mutual concern. It is of considerable assistance to auditors in making informed judgements if they were to have as clear an understanding as possible of the supervisory authorities' knowledge and attitude on such matters. In the course of such discussions, supervisors should also have an opportunity to express their views on accounting policies and auditing standards generally and on specific audit procedures in particular. This assists in improving the standard of auditing generally for banks. It is advisable for the banks' own associations to be involved in discussions on these topics, for example, through the head of the internal audit department, to ensure that the views of all parties are taken into account.

70. Discussions between supervisory authorities and the professional accounting bodies could also usefully range over major auditing issues and topical accounting problems, such as the appropriate accounting techniques for newly developed instruments and other aspects of financial innovation and securitisation. These discussions could assist in the evolution of the most appropriate accounting policies in the circumstances.

71. Both supervisory agencies and the accountancy profession are concerned to ensure that there is uniformity between different banks in the application of appropriate accounting policies. Supervisory agencies are often able to exercise a more persuasive influence over banks in achieving uniform policies because of their regulatory powers, while auditors are often better placed to monitor the actual application of such policies. A continuing dialogue between supervisory agencies and the profession could therefore significantly contribute towards the harmonisation of accounting standards at the national level.