Tarisa Watanagase: Banking supervision and external audits

Speech by Dr Tarisa Watanagase, Deputy Governor of the Bank of Thailand, at the Regional Meeting of SEANZA Forum of Banking Supervisors, Madrid, 21 September 2004.

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Distinguished guest speakers,
Ladies and Gentlemen,

Good morning, let me begin by thanking the SEANZA forum and especially Mr. Reyes, the Chairman of SEANZA and Deputy Governor of Bangko Sentral ng Pillipinas for inviting me to share my thoughts on banking supervision and external audits.

I would like to spend the next fifteen minutes discussing three main issues. First, I will outline why the relationship between banking supervisors and external auditors matters; second, I will cover our experience with external auditors from both the regulatory and supervisory perspectives; and I will close by offering a few remarks on the challenges ahead for supervisors and external auditors of Thai banks.

While the auditors' duties are to report on the reliability of banks' financial statements to the board of directors and shareholders, the supervisors' main concerns are to maintain the stability of the banking system. Despite these differences in our respective goals, the day-to-day work of external auditors can complement that of bank supervisors.

First, many countries are moving towards a risk-based approach to banking supervision, an approach which emphasizes a thorough assessment of an institution's internal control environment and risk management systems. As banking supervisors, we can leverage off the auditors' significant experience in testing for the adequacy of an institution's internal control environment, as we begin to implement this risk-based framework. Second, external audits help to ensure the accuracy of financial statements that are provided to the public, which in turn helps to promote market discipline and foster a safe and sound banking system.

Ladies and Gentlemen,

Now, I would like to present our experience with external auditors from both the regulatory and supervisory perspectives. First on the regulatory side, the value of this relationship was initially recognized in 1962 when the Commercial Banking Act provides the Bank of Thailand with the authority to accept or oppose the appointment of a bank's external auditor. Based on this act, the framework for external auditor qualifications and reporting requirements to the Bank of Thailand was issued in 2000, after extensive consultations with the Institute of Certifed Accountants and Auditors of Thailand (ICAAT), the Securities and Exchange Commission (SEC) and other relevant regulatory bodies. Let me provide some specifics on auditor qualifications with respect to our law.

First, qualifed auditors must never have had their auditing license revoked or suspended by the auditing licensing body. Second, auditors that are not authorized to audit entities under the supervision of the SEC or other government agencies are not permitted to audit banks. Third, the Bank of Thailand prohibits any external auditors to consecutively serve a bank for more than fve years.

Fourth, the banks are accountable for having their external auditors submit their audit program to the Bank of Thailand every year and for allowing the auditors to supply all documents to supervisors upon request. In addition, the auditors must report the banks' material non-compliance with any laws or regulations derived from the Commercial Banking Act as well as any material internal control deficiencies. If any auditors fail to meet these requirements, the Bank of Thailand will either oppose the appointment of such auditors and/or revoke their existing appointment.

On the supervisory side, the greatest reduction in supervisors' workload is in internal control and irregularities assessment. Our supervisors use these two reports to determine the breadth and depth of on-site examination planning. For example, if supervisors determine that the external auditors' work on internal control assessment is adequate, our examination efforts in this area may be reduced. Delegation of these two tasks aligns with the Basel guidelines, as they are both within the external auditors' technical and practical competence.

The Bank of Thailand has long recognized that to derive the greatest benefits from external auditors, the auditors need to have a good understanding of not only prudential regulations, but also key supervisory concerns at the client banking institutions. In this regard, the Bank of Thailand meets with external auditors at the beginning of each year, in order to exchange views on common areas of concerns and to gain greater insights on the planned audit scope for the coming year, for example, the quality of risk management, the reliability of assigned collateral and foreclosure values.

In addition to ongoing meetings with external auditors, there are periodic discussions at the agency level between the Bank of Thailand and the accountancy bodies. Regularly, the Bank of Thailand seeks comments from the Institute of Certifed Accountants and Auditors of Thailand prior to the issuance of new regulations. Likewise, the Bank of Thailand's supervisors are regularly invited to be a member of the auditing standard committee whose responsibilities involve the development and improvement of Thai auditing standards.

In summary, the Bank of Thailand has signifcantly benefited from the increasing coordination between supervisors and external auditors. Despite these benefts, there are several challenges ahead in our relationship with external auditors that merits careful deliberation.

First, supervisors should be sensitive to the independence of the external auditors, particularly when the auditors provide various types of consulting services to the bank, which often times may be far more lucrative than external auditing fees. In Thailand, the Ministry of Commerce released a ministerial regulation in 1991 to prohibit external auditors from providing auditing services to any entities where their independence cannot be maintained. However, this regulation still leaves the assessment of independence to the external auditors themselves. If necessary, regulators may consider limiting the scope of non-auditing services or requiring the auditors to submit a request for approval prior to engaging in non-auditing activities in the same entity that they provide auditing service. One good example is the Sarbanes Oxeley Act, which was issued in the U.S. in 2002 disallowing audit firms from providing specifc functions to their audit clients such as bookkeeping, financial information system design and appraisal service, etc.

Second, the work of the auditors should never replace supervisory responsibilities. Audited financial statements are not prepared to serve supervisory purposes and external auditors are not trained as bank supervisors. Accounting policies and definitions used by auditors may be different from those required by supervisors under Thai regulatory standards, although in general they tend to be the same. For example, there are differences between supervisory guidelines and accounting requirements on asset classification and provisioning. Whereas the supervisory guidelines prescribe minimum specific ratios of loan provisions depending on the quality of loans, the accounting standard is less specifc and only requires banks to set aside appropriate provisions. Second, the method used by regulators to set aside provisions is based on an "expected loss model", while the accounting standards require provisions based on an "incurred loss model". These conceptual differences can lead to different outcomes on such critical issues as the volume of classified asset, the adequacy of provisions, and therefore, capital adequacy. It's useful to be mindful of these differences and understand the context that leads to the need to maintain these differences.

In closing, I want to reiterate that external auditors have truly been one of our key partners in the quest for greater financial stability. Thailand's financial industry is currently in the midst of structural changes with the implementation of our Financial Sector Master Plan. One of the goals of the master plan is to promote greater competition, which in turn, may result in the evolution of bigger and more complex financial institutions. Against this background, our supervisors will need to fully embrace a risk-based supervisory philosophy and its focus on the quality of internal controls and risk management systems. Therefore, our relationship with external auditors will become even more important in the years ahead as we seek to strengthen banks' risk management systems and enhance fnancial stability.

Thank you.