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Joint task force
Established by the
International auditing Practices Committee
and the Basle Supervisors' Committee

Exposure draft

The relationship between bank supervisors and external auditors

Preface

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 in necessary that there be greater mutual understanding and, where appropriate, more communication between the bank supervisors and external auditors. Recognising this need, the Basle supervisors' Committee[1] and the International Auditing Practices Committee[2] set up a joint task force under the chairmanship of Mr. Y.H Malegam to examine the possibilities

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1. The Basle Supervisors' Committee (formally entitled the Committee on Banking regulation and Supervisory Practices) is a Standing Committee of the bank supervisors in G-10 countries (Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) and Luxembourg, it reports to the central bank governors of the Group of Ten and meets regularly at the Bank for International Settlements in Basle.

2. The International Auditing Practices Committee is a Standing Committee of the International Federation of Accountants. Its membership comprises representatives of thirteen countries: Australia, Canada, France, the Federal Republic of Germany, India, Japan, Jordan, Mexico, the Netherlands, Norway, the Philippines, the Unites Kingdome and the United States.

for closer co-ordination between bank supervisors and external auditors.

The attached paper prepared by the task force reviews the respective roles of bank supervisors and external auditors, suggests certain criteria for the growing contribution in many countries of external auditors to the supervisory process and stresses the need for a continuing dialogue between the two.

The paper is being considered by the Basle Supervisors' Committee and the International Auditing Practices Committee for issuance as a joint statement which, it is hoped, will lay down a sound basis for promoting co-ordination between bank supervisors and external auditors. It has been approved for circulation at this stage as an exposure draft on which comments are invited. A separate project is being undertaken by the joint task force on the development of a guideline for the audit of international commercial banks.

COMMENTS ON THIS PAPER SHOULD BE SUBMITTED IN WRITING TO THE SECRETARY OF THE TASK FORCE, BASLE SUPERVISORS' COMMITTEE, BANK FOR INTERNATIONAL SETTLEMENTS, 4002 BASLE, SWITZERLAND BY END-APRIL 1988.

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I. INTRODUCTION

I.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 supervision of their financial soundness, usually referred to as prudential supervision, by central banks and other official agencies. Banks' financial statements are also subject to examination by external auditors. The auditor's opinion lends credibility to such statements and thereby assists in promoting confidence in the banking system

I.2 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 are supervisors relying to a greater extent on the results of the auditors' work, but they are increasingly turning to the accounting profession to undertake additional tasks which contribute to the performance of their supervisory responsibilities. At the same time, auditors, in carrying out their functions, are looking to the supervisors for information which can help in discharging their functions more effectively.

I.3 The International Auditing Practices Committee and the Basle Supervisors' Committee share the view that greater mutual understanding and, where appropriate, communication would improve the effectiveness of bank audit and supervision to the benefit of both disciplines.

I.4 There are three parties involved in the process of ensuring that banking business is conducted prudently, namely management of the bank itself, the bank's external auditors and the supervisory authorities. The roles and responsibilities of each participant in different countries derive from both law and custom. This paper is not concerned with challenging or changing these roles or responsibilities. However, there have been occasions when supervisors have failed to understand the precise nature of the external auditors' role and have mistakenly relied on their work for inappropriate objectives. There may also have been some misunderstanding by auditors of the role of the supervisor.

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

- defines the primary responsibility of management (section II);
- examines the essential features of the roles of supervisors and auditors (sections III and IV);
- reviews the extent to which the roles overlap (section V);
- suggests a mechanism for more effective co-ordination between supervisors and auditors in the fulfilment of their separate tasks (sections VI to VIII).

I.6 The paper has been drawn up 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. It is hoped that the views expressed herein will have relevance for all situations, although it will obviously address the situations in some countries more directly than those in others.

II. THE RESPONSIBILITY OF THE BANK'S MANAGEMENT

II.1 The primary responsibility for the conduct of the business of a bank vests in the management, and ultimately in the board of directors who appoints it. Management's responsibility includes ensuring:

- that those entrusted with banking tasks are professionally competent and that there are sufficiently experienced staff in key positions;
- that proper control systems exist and are functioning;
- that the operations of the bank are conducted with due regard to prudence including the assurance that adequate provisions are maintained for losses;
- that statutory and regulatory directives, including directives regarding solvency and liquidity, are observed;
- that the interests not only of the shareholders but also of the depositors and other creditors are adequately protected.

II.2 Management is responsible for preparing financial statements in accordance with national law. Such statements must give "a true and fair view of" (i.e. present fairly) the bank's financial position and the results of its operations in accordance with generally accepted national accounting principles as they apply to banks. The management also has the responsibility to provide all information to the supervisory agencies which such agencies are entitled by law or regulation to obtain.

II.3 Management is responsible for the establishment and the efficient operation of the internal audit function in a bank. This function constitutes a separate component of internal control undertaken by specially assigned staff within the bank with the objective of determining whether, amongst other things, internal controls are well designed and properly operated. Management is responsible for ensuring that the internal audit function is adequately staffed with persons of the appropriate skills and technical competence who are free from operating responsibilities and who report to top management, and that timely and appropriate action is taken on their findings.

II.4 These 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 the reported results of the bank's operations to be subject to audit by independent auditors.

III. THE ROLE OF THE BANKING SUPERVISOR

III.1 The customary role of the supervisor, and one that is often written into statute, is to protect the interests of bank depositors. In practice, however, this role has increasingly combined with a wider duty to safeguard the soundness and stability of the banking system. In some countries, supervision may also be directed towards ensuring compliance with monetary or exchange rate policies. However, in this paper the focus is on the prudential aspect of the supervisor's role.

III.2 The ultimate power on which the supervisors' authority is based is the power to authorise or license an entity to conduct a banking business and to withdraw such authorisation. In order to qualify for and retain a banking licence, 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 authorisation are generally to be found in most systems of supervision:

- persons who control and manage the business of a bank must be honest and trustworthy and must possess appropriate skills and experience;
- the bank must have adequate capital to withstand the risks inherent in the nature and size of its business;
- the bank must have sufficient liquidity to meet outflows of funds.

Further and more detailed requirements may be prescribed in many countries, 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 banks' managements conduct their business prudently and have adequate financial resources to overcome adverse circumstances and protect depositors from loss.

III.3 Failure by a bank to observe the various conditions or requirements for authorisation will provide grounds for the supervisor to consider withdrawing the licence. But withdrawal of a licence, effectively terminating the business, may well precipitate insolvency and, therefore, is generally a sanction of last resort, to be used only when it is clear that no other possibilities for corrective action remain. As a less drastic procedure, in order to remedy incipient weaknesses, supervisors generally have powers to issue formal directives to a bank requiring it to take action to strengthen some aspect of its business, for example, by injecting additional capital or improving internal controls. However, recourse to legal powers is relatively rare and ongoing supervision is generally conducted on the basis of informal guidance and persuasion.

III.4 One of the main pillars 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. Capital can be measured against the aggregate amount of the entity's assets or liabilities, or against individual activities, whether on or off-balance-sheet, weighted according to their perceived risk. Capital is also often used as a standard against which to measure or to limit the risks inherent in the types of transactions undertaken by banks.

III.5 The most significant risk for a bank, in terms of historical loss experience, is credit risk - the risk that a borrower will not be able to repay his loan when due. It is not the supervisor's role to direct banks' lending policies but he has an interest in seeing that banks have effective credit review procedures and apply them consistently. He 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.

III.6 The quality of its assets is one of the most important determinants of a bank's stability but one of the most difficult to assess. In addition to supervisory requirements, the application of generally accepted accounting principles to banks means that current assets are written down to their realisable value and that adequate provisions are made for bad and doubtful debts. This is a matter of judgement and it is a responsibility of the supervisor to ensure that banks adopt a careful and prudent approach. For example, supervisors may seek to ensure that banks adequately recognise the risk arising from their loans to heavily-indebted countries, perhaps by laying down guidelines or requirements for minimum levels of provisions.

III.7 Accurate and prudent valuation of assets is of great importance for supervisors because it has a direct bearing on the determination of the amount of net assets held by a bank and the amount of shareholders' equity (capital plus retained earnings). As already indicated, capital is widely used as the supervisory standard against which exposures are measured or limited. In general, unless he makes his own independent examination, the supervisor relies in large part on the management's judgement of the correct valuation of assets and on the auditor's examination of that valuation.

III.8 Bank supervisors also seek to monitor and limit a range of other banking risks, such as liquidity and funding risk, interest rate and investment risk, foreign exchange risk and off-balance-sheet risk. As techniques of banking have evolved in recent years, considerable supervisory effort has been devoted to developing systems of measurement to capture the extent of exposure to these types of risk. In many countries, clear supervisory limits covering these risks have been established.

III.9 Supervisors attach considerable importance to the need for banks to have a well-designed organisational structure and to operate efficient information and control systems for the management of risk. Similarly, the supervisor is concerned to ensure that accounting records are properly maintained and that standard accounting procedures are followed so that:

- the whole banking operation is effectively and efficiently handled;
- management has a sound basis for monitoring, controlling and planning the different exposures undertaken;
- the possibility of staff management or customer fraud is reduced.

The growth in the complexity of financial markets has created a matching need for systems of internal control desired to meet the needs of a growing number of new types of transactions. The development of sophisticated real-time electronic data processing 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.

III.10 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 failing. 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 form an opinion about the competence of management and to ensure that it has a clear idea of its strategy. Similarly, he 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.

III.11 According to the nature of the supervisory rules, the method of ensuring that they are followed tends to vary from country to country. In essence, there are two main techniques which can be used:

(a) on-site examinations;
(b) the collection and interpretation of regular reporting returns and other statistical data.

Supervisory systems make use of both techniques, although the degree of reliance placed on one or other will vary from country to country.

III.12 On-site examination is demanding in terms of supervisory resources and cannot, except in the case of very small banks, regularly address more than a small part of the institution's activities. In some countries, examination techniques tend to concentrate on the quality of the loan assets and the documentation supporting them and the adequacy of internal controls set by management. In other countries, examination focuses not only on loan assets but also on other types of exposure referred to in III.8. Where loan quality classification systems are in use, the inspectors will routinely examine a sample of loans to check whether they have been correctly classified. Inspectors will also pay attention to policies with regard to provisions for bad and doubtful debts and will judge whether provisions are adequate in the light of the perceived quality of the loan-book. In the case of banks with wide-ranging activities or complex networks, attention will also be focused on the extent to which control is exercised and the risk managed on a global basis. In special circumstances, where the supervisory authority is already aware of particular problems, the examination would be more narrowly focused.

III.13 The examination of reporting returns and statistical data is less costly and the expense is shared more evenly between the banks (whose own internal information systems must be adapted to provide data) and the supervisory authority (which is responsible for designing the returns and interpreting the data). The reporting returns will normally provide a detailed breakdown of the composition of the balance sheet (including off-balance-sheet items) and of the profit and loss account. The information should, in principle, be sufficient to enable the supervisor to form a view of a bank's exposure to the various categories of risk. Examination of reporting returns submitted at regular intervals allows the supervisor to monitor developments in the business in a more frequent and timely manner than is the case with on-site inspection. However, reporting returns have the following limitations:

- they are generally designed for completion by the banking system as a whole and may not capture adequately new types of risk or the particular activities of an individual institution;
- their usefulness in providing early warning to the supervisor depends on the quality of banks' own internal information systems and the accuracy with which the returns are completed;
- even with reliable, comprehensive data, experienced judgement is needed to interpret the results.

IV. THE ROLE OF THE BANK'S EXTERNAL AUDITOR

IV.1 The primary objective of an audit of a bank by an external auditor is to enable the auditor to express an opinion as to whether the published financial statements of the bank give a "true and fair view of" (i.e. present fairly) the bank's financial position and the results of its operations for the period for which such statements are prepared. The auditor's report is addressed to the shareholders but is used by many other parties, such as depositors, other creditors and supervisors. The auditor's opinion helps to establish the credibility of the financial statements. The user, however, should not interpret the auditor's opinion 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.

IV.2 To form an opinion on the financial statements, the auditor seeks to obtain reasonable assurance as to whether the information contained in the underlying accounting records and other source data are reliable and sufficient as the basis for the preparation of financial statements and also whether the relevant information is properly communicated in the financial statements. For this purpose, the auditor:

- makes a study and evaluation of the accounting systems and internal controls on which he wishes to rely;
- tests the operation of those controls to assist in determining the nature, extent and timing of other auditing procedures;
- carries out such tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the circumstances.

IV.3 In carrying out the audit of a bank, the independent auditor recognises that certain features of banks may cause special problems:

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

(b) 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 electronic data processing;

(c) banks in most countries normally operate through a wide network of branches and departments which 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;

(d) a bank will usually assume significant commitments without any transfer of funds. These items, normally called "off-balance-sheet" items, may not involve accounting entries and consequently the failure to record such items may be difficult to detect; and

(e) banks are regulated by governmental authorities and regulatory requirements often influence generally accepted accounting and auditing practices within the industry.

IV.4 A detailed audit of all transactions of a bank would not only be time-consuming and extremely expensive but also wholly impracticable. The auditor therefore bases his examination on the testing and evaluation of the internal control systems designed to ensure the accuracy of the accounting records and security of the assets, on the use of sampling techniques and analytical procedures and on the verification and assessment of the assets and liabilities. In particular, he 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.

IV.5 While the auditor has sole responsibility for his report and for determining the nature, timing and extent of his procedures, much of the work of the internal audit department can be useful to the auditor in his examination of the financial information. The auditor, therefore, as part of his audit evaluates the internal audit function in so far as he believes that it will be relevant in determining the nature, timing and extent of his procedures.

IV.6 Judgement permeates the auditor's work. The auditor has to use his judgement, inter alia, in:

- deciding upon the extent of his audit procedures;
- evaluating the results of those procedures;
- assessing the reasonableness of the judgement and estimates made by management.

IV.7 An auditor plans and conducts the audit to have a reasonable expectation of detecting misstatements in the bank's financial statements, which individually or in aggregate, are material in relation to the financial information presented by those statements. The auditor considers materiality at both an overall level and in relation to individual account balances and disclosures. Materiality may also be influenced by other considerations such as legal and regulatory requirements. Therefore, different materiality levels may be considered by the auditor for different aspects of his work. The assessment of what is material is a matter for the auditor's professional judgement. It is influenced by his perception of the needs of the user of the bank's financial statements and by his assessment of the risk that material misrepresentations in those statements may remain undetected and, if so, of the consequences thereof.

IV.8 In forming his opinion on the financial statements, the auditor carries out procedures designed to obtain reasonable assurance that the financial statements are properly stated in all material respects. 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 misstatement may remain undiscovered. The risk of not detecting 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. Unless the auditor's examination reveals evidence to the contrary, the auditor feels entitled to accept representations as truthful and records and documents as genuine. However, the auditor plans and performs his audit with an attitude of professional scepticism, accepting that he may encounter conditions or events during his examination that would lead him to question whether fraud or error exist.

IV.9 A matter of particular concern to the auditor is obtaining assurance that appropriate accounting policies have been followed by the bank and that these have been consistently employed. 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.

IV.10 When the auditor discovers an error material to the financial statements, including the use of an inappropriate accounting policy, an asset valuation with which he does not agree or a failure to disclose essential information, he requires that the financial statements be adjusted to correct the error. If management refuses to make the correction the auditor qualifies his opinion on the financial statements. Such a qualification would have a serious impact on the credibility and even stability of the bank, and management therefore usually takes the steps necessary to avoid it. Likewise, an auditor would also qualify his opinion if he has not been provided with all the information or explanations he requires.

IV.11 As a supplementary but not necessarily integral part of his role, the auditor normally furnishes management with a management letter. This letter customarily contains comments on such matters as deficiencies in internal control or other errors or omissions which have come to the auditor's attention during the course of the audit, but which do not warrant a qualification in his audit report because he has been able to carry out additional procedures to compensate for a weakness in control or because the errors have been corrected in the financial statements or are immaterial. 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, or compliance with legal or supervisory requirements.

V. THE RELATIONSHIP BETWEEN THE SUPERVISOR AND THE AUDITOR

V.1 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 the stability of the bank in order to protect the interests of the depositors. Therefore, he monitors its present and future viability and uses financial statements to assist in assessing its developing activities. 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 for a period. However, in doing so, he also makes a judgement as to the bank's continuing viability during the period immediately following the period for which the financial statements are prepared, in order to support the "going concern" basis on which such statements are prepared;
- 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 he can place on the system in planning and carrying out his work;
- the supervisor is concerned with the existence of proper accounting as a prerequisite for the measurement and control of risk. The auditor is concerned with such a system to ensure that the financial statements are properly prepared.

V.2 It is therefore necessary that, when a supervisor uses audited financial statements in the course of his supervisory activities, he recognise that the statements have been prepared for a purpose which is different from the purposes for which he may wish to use the statement. In particular, he needs to bear in mind:

- the accounting policies used in the preparation of the statements and their appropriateness for the purposes for which he wishes to use them;
- the "going concern" basis on which the financial statements are drawn up and according to which asset and liability values are determined;
- that financial statements are prepared on the basis of judgements and estimates made by managements and assessed by the auditor, which makes the information contained, to some extent, subjective;
- that the financial position of the bank may have been affected by subsequent events since the accounts were drawn up;
- that, given the different purposes for which internal control is evaluated and tested by the supervisor and the auditor, he cannot assume that the auditor's evaluation of internal control for the purposes of his audit will necessarily be adequate for the purposes for which he needs an evaluation.

V.3 Nonetheless, there are many areas where the work of the supervisor and of the auditor can be useful to each other. Management letters and long-form reports submitted by auditors can provide supervisors with valuable insight into various aspects of banks' operations. It is the practice in many countries for such reports to be made available to the supervisors.

V.4 Similarly, auditors can obtain useful insights from information provided by 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 a useful source of information to auditors in as much as they provide an independent assessment in important areas such as the adequacy of provisions for bad and doubtful debts 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.

V.5 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 would therefore be advantageous for communications of this nature to be made in writing, so that they would form part of the bank's records to which the other party should have access.

V.6 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, though in a few countries procedures for bilateral contacts between the supervisor and the auditor exist. However, even where they do not exist, rare and exceptional circumstances may arise which justify direct communication between supervisors and auditors. For this reason, many countries have removed the confidentiality constraints from both parties to enable important and otherwise confidential information to be exchanged.

V.7 The sole condition for excluding the management of the bank from discussions would be that its presence would compromise their purpose. Some of the circumstances in which this could arise are:

- where the auditor becomes aware of facts which might endanger the existence of a bank;
- where either the auditor or the supervisor detects an indication of fraud at a senior level;
- where the auditor intends to resign in the course of an audit;

- where the auditor has an irreconcilable difference of view with management over a material aspect of the financial accounts, as a result of which he is intending to qualify his audit opinion;
- where the supervisor has information which can materially affect the financial statements or the auditor's report and which he believes may not be available to the auditor;
- where the auditor believes a matter should be communicated to the supervisor and management has failed to make such communication when requested to do so.

Where there is an Audit Committee, a supervisory board or a similar body, the party initiating bilateral consultation should consider whether it needs simultaneously to inform that body of the substance of the problem under discussion.

V.8 It is becoming increasingly common in a growing number of countries for the auditor to carry out specific assignments or to issue special reports in accordance with statute or at the request of the supervisor to assist the supervisor in discharging his functions. These duties are the subject of later sections of this paper. They may, inter alia, include reporting upon whether:

- specified cover ratios or other prudential requirements included in reporting returns have been accurately completed;
- licensing conditions have been complied with;
- the transactions of the bank which have come to the auditor's attention in the course of the audit are in accordance with specified laws applicable to banks.

V.9 The supervisor has a clear interest in ensuring high standards of bank auditing. Accordingly, he will seek to maintain close contact with the professional auditing bodies. 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 would also normally wish to investigate the circumstances in which a bank has failed to reappoint an auditor.

VI. CRITERIA FOR A POSSIBLE EXTENSION OF THE AUDITOR'S ROLE AS A CONTRIBUTION TO THE SUPERVISORY PROCESS

VI.1 It is necessary that requests to auditors to assist in specific supervisory tasks be made in the context of a well-defined framework, perhaps even written into national legislation. It is considered that the following criteria need to be established.

VI.2 Firstly, the normal relationship between the auditor and his client needs to be safeguarded. There must thus be either a statutory basis for the work or a contractual agreement between the bank and the supervisory authority. If there are no other statutory requirements or contractual arrangements, all information flows between supervisors and auditors need to be channelled through the bank except in exceptional circumstances. Thus, the supervisory authority would request the bank to arrange to obtain the information it requires from the auditor, and such information would be submitted to the supervisor through the bank. Any meetings between the auditors and supervisors would, except in special circumstances as described in paragraph V.7 above, be attended by representatives of the bank; and the bank's approval would be required for transmitting to the supervisory authority copies of management letters and long form reports.

VI.3 Secondly, before concluding any arrangements with the supervisor, the auditor should consider whether any conflicts of interest may arise. If so, these should be satisfactorily resolved before the commencement of the work, normally by obtaining the prior approval of the bank's management to undertake the assignment.

VI.4 Thirdly, 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 in quantitative terms the standard against which the bank's performance can be measured, e.g. by giving minimum levels or ratios which banks should meet 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.

VI.5 Fourthly, the tasks which the auditor is asked by the supervisor to perform need to be within his competence, both technical and practical. He may, for example, be requested to assess the extent of a bank's exposure to a particular borrower or country, but he would not without clear and specific guidance 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 programme of work over a period of time.

VI.6 Fifthly, the auditor's task for the supervisor must have a rational basis. This means that the task must normally be complementary to his 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.

VI.7 Sixthly, certain aspects of confidentiality need to be protected. In particular, the auditor should not be expected to disclose any information obtained through his professional relationships with other clients, e.g. he should not make judgements about the bank's claims on a third party in the light of any confidential facts known to him as a result of an audit of the third party. This does not, however, absolve the auditor from making a judgment about a bank's claims on one of his other audit clients on the basis of information available to the bank or to the public.

VI.8 Finally, the basic responsibility for supplying complete and accurate information to the supervisor must remain with the bank management. The auditor's role is to verify and to lend additional credibility to that information. As such he does not assume any of the responsibilities of the supervisor but assists the supervisor to make his judgements more effectively.

VII. SPECIFIC DIRECTIONS IN WHICH THE AUDITOR'S ROLE CAN BE EXTENDED

VII.1 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 (or "hands-on") approach is followed by the supervisor, with frequent and rigorous inspection, the assistance which might be asked of the auditor would 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 banks' management, as opposed to inspection, or if supervisory resources are limited, the supervisor can profit from the assistance which the auditor can offer in providing his opinion on the reliability of the information obtained.

VII.2 Nowadays, however, few countries are practising a supervisory approach which does not contain elements of both approaches. As banking develops in complexity, inspection is proving more and more demanding in terms of supervisory resources. Supervisory authorities which practise on-site inspection are thus being 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.

VII.3 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.

VII.4 Examples of the specific supervisory tasks to which auditors are specifically suited are as follows:

(a) The verification of prudential returns in particular circumstances where supervisory concern has been aroused. In a number of countries, supervisors find it helpful to require banks to obtain the auditor's opinion that selected returns have been properly extracted from the bank's records.

(b) The evaluation of banks' information and control systems on the basis of criteria provided by the supervisor. With the increase in the complexity and volume of transactions and increasing reliance on electronic data processing systems, the need for adequate control systems becomes even more imperative.

(c) The expression of an opinion on adherence to appropriate accounting policies, particularly with regard to provisions against potential losses. Supervisors are increasingly looking to auditors for advice as to whether accounting policies followed are appropriate and whether policies for providing for bad and doubtful debts are adequate.

(d) The examination of the accounting records and control systems regarding the bank's fiduciary (including safe custody) activities, in countries where these are not considered as part of the normal audit function. Where the volume of fiduciary activities is material in the context of a bank's size, supervisors are concerned to ensure that these activities are properly segregated from the bank's own operations and that adequate controls are in place to ensure against possible fraud or misappropriation.

VII.5 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.

VIII. THE NEED FOR A CONTINUING DIALOGUE BETWEEN SUPERVISORY AUTHORITIES AND THE AUDITING PROFESSION

VIII.1 If supervisors are to derive benefit from the work of auditors on a continuing basis, supervisors need to take the auditing profession as a whole into their confidence in relation to current areas of supervisory concern. This can probably be achieved most effectively through periodic discussions at the national level between the supervisory authorities and the professional accounting bodies. Such discussions could cover areas of mutual concern, for example the treatment of claims on heavily-indebted countries. It would be 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 would assist in improving the standard of auditing generally for banks. It may well be advisable for the banks' own associations to be involved in discussions on some of these topics to ensure that the views of all parties are taken into account.

VIII.2 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 the evolution of the most appropriate accounting policies in the circumstances.

VIII.3 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.

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Appendix

Members of the joint task force established by the International Auditing Practices Committee and the Basle Supervisors' Committee

International Auditing Practices Committee

Chairman

Mr. Yezdi H. Malegam, S.B. Billimoria and Co., Bombay, India

Netherlands

Mr. Martin Steunebrink, Moret & Limperg, Amsterdam

United States

Mr. Kenneth F. Cooper, Touche Ross & Co., New York

Basle Supervisors' Committee

Germany (Federal Republic)

Mr. Wolf Dieter Bauer, Deutsche Bundesbank

Switzerland

Herr Kurt Lindegger, Eidg. Bankenkommission

United Kingdom

Mr. David J. Mallett, Bank of England

Secretariat

Mr. Richard Buski, Coopers & Lybrand, Toronto (representing the International Auditing Practices Committee)

Mr. Christopher J. Thompson, Secretary, Basle Supervisors' Committee

Mr. Charles A. Freeland, Bank for International Settlements