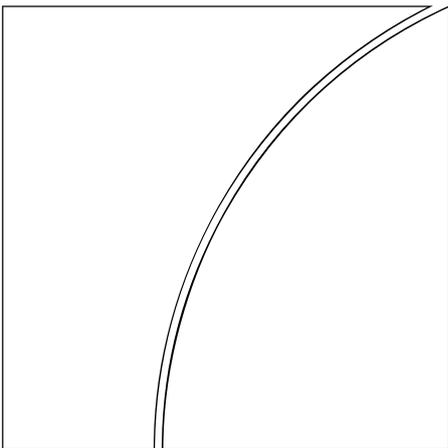


# Basel Committee on Banking Supervision



## The relationship between banking supervisors and banks' external auditors

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BANK FOR INTERNATIONAL SETTLEMENTS



## Preface

This paper has been prepared in association with the International Auditing Practices Committee (IAPC) of the International Federation of Accountants, and has been approved for publication by the Basel Committee and by IAPC.\*

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 banking 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 banking supervisors and external auditors.

The purpose of this paper 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 Basel Committee and the IAPC hope, however, that it will provide useful guidance about the respective roles of the banking supervisors and external auditors in the many countries where the links are close or where the relationship is currently under study.

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\* IAPC is issuing the document as an International Auditing Practice Statement. Such statements are issued by IAPC to provide practical assistance to auditors in implementing the International Standards on Auditing (ISAs) or to promote good practice. Statements do not have the authority of ISAs. The document is based on ISAs extant at 1 October 2001.



## Table of Contents

Preface .....	1
Introduction.....	1
The Responsibility of the Bank's Board of Directors and the Management .....	2
The Role of the Bank's External Auditor .....	4
The Role of the Banking Supervisor .....	8
The Relationship Between the Banking Supervisor and the External Auditor.....	12
Additional Requests for the External Auditor to Contribute to the Supervisory Process .....	15
The Need for a Continuing Dialogue Between Banking Supervisors and the Accountancy Profession .....	17



# The relationship between banking supervisors and banks' external auditors

## 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, both nationally and internationally, has therefore come to be recognized as a matter of general public interest. This public interest is reflected in the way banks in almost all countries, unlike most other commercial enterprises, 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 external auditor conducts the audit in accordance with applicable ethical and auditing standards, including those calling for independence, objectivity, professional competence and due care, and adequate planning and supervision. The auditor's opinion lends credibility to the financial statements and promotes confidence in the banking system.

3. As the business of banking grows in complexity, both nationally and internationally, the tasks of banking supervisors and external auditors are becoming more and more demanding. In many respects, banking supervisors and external auditors face similar challenges and, increasingly, their roles are being perceived as complementary. Not only do banking supervisors benefit from the results of the auditors' work, but they may also turn to the external auditor to undertake additional tasks when these tasks contribute to the performance of their supervisory roles. At the same time, external auditors, in carrying out their role, also look to banking supervisors for information that can help in discharging their responsibilities more effectively.

4. The International Auditing Practices Committee and the Basel Committee share the view that greater mutual understanding about the respective roles and responsibilities of banking supervisors and external auditors and, where appropriate, communication between them improves the effectiveness of audits of banks' financial statements and supervision to the benefit of both disciplines.

5. The roles and responsibilities of a bank's board of directors<sup>1</sup> and management, the bank's external auditors, and the banking supervisors in different countries derive from law, custom and, for external auditors, professional practice. This paper is not intended to challenge or change these roles or responsibilities. Rather, it is intended to provide a better understanding of the nature of the roles of bank's boards of directors and management, external auditors, and banking supervisors, since misconceptions about such roles could lead to inappropriate reliance being placed by one on the work of another. This paper seeks

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<sup>1</sup> The notions of "board of directors" and "management" are used, not to identify legal constructs, but rather to label two decision-making functions within a bank. Under the Glossary of Terms for ISAs, management comprises officers and others who also perform senior management functions. 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. The Basel Committee's paper *Enhancing Corporate Governance for Banking Organisations* published in September 1999 should be referred to.

to remove possible misconceptions and suggests how each might make more effective use of the work performed by the other. The paper accordingly:

- (a) sets out the primary responsibility of the board of directors and management (paragraphs 8-13);
- (b) examines the essential features of the role of external auditors (paragraphs 14-27);
- (c) examines the essential features of the role of banking supervisors (paragraphs 28-45);
- (d) reviews the relationship between the banking supervisor and the bank's external auditor (paragraphs 46-55); and
- (e) describes additional ways in which external auditors and the accountancy profession can contribute to the supervisory process (paragraphs 56-70).

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 organizations such as the World Bank and the International Monetary Fund) are intended to serve as a basic reference for an effective supervisory system internationally and in all countries. This paper has been prepared taking into account the Basel Core Principles.

7. The paper has been prepared with full awareness of the significant differences that exist in national institutional and regulatory frameworks, notably in accounting standards, in supervisory techniques and in the extent to which, in some countries, external auditors currently perform tasks at the request of banking supervisors. In some countries, banking supervisors and external auditors already have closer relationships than are indicated in this paper. The arrangements suggested in this paper do not replace, existing relationships. While this paper is not intended to be prescriptive, it is hoped that the guidance expressed in it will be relevant to all situations, although it will obviously address the situations in some countries more directly than in others.

## **The Responsibility of the Bank's Board of Directors and the 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, among other things, ensuring that:

- those entrusted with banking tasks have sufficient expertise and integrity and that there are experienced staff in key positions;
- 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, organizational 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 adoption of a suitable control environment, aimed at meeting the bank’s prescribed performance, information and compliance objectives;
  - the testing of compliance and the evaluation of the effectiveness of internal controls by the internal audit function;
- appropriate management information systems are established;
  - the bank has appropriate risk management policies and procedures;
  - statutory and regulatory directives, including directives regarding solvency and liquidity, are observed; and
  - 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 appropriate financial reporting framework and for establishing accounting procedures that provide for the maintenance of documentation sufficient to support the financial statements. This responsibility includes ensuring that the external auditor who examines and reports on the financial statements has complete and unhindered access to, and is provided with, all necessary information that can materially affect them and, consequently, the auditor’s report on them.<sup>2</sup> 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. In many countries, audit committees have been set up to meet the practical difficulties that may arise in the board of directors fulfilling its task of ensuring 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 auditors should be allowed and encouraged to attend the meetings of the audit committee. Regular meetings of the audit committee with the internal and external auditors help enhance the external auditors independence and the credibility of the internal auditors, and assist the audit committee to perform its key role on strengthening corporate governance. In some countries, law or regulations prescribe that such meetings must take place.

11. When so required by the board of directors or by applicable law or regulations, 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 assessment of the adequacy of, and compliance with, the bank’s established policies and procedures and assurance as to the adequacy, effectiveness and sustainability of the bank’s risk management and control procedures and infrastructure independent of those with day-to-day responsibility for complying with those policies and procedures. In

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<sup>2</sup> 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 external audit requirement. The guidance in this paper is also applicable in an appropriate and practical manner to such external audits.

fulfilling its duties and responsibilities, management should take all necessary measures to ensure that there is a continuous and adequate internal audit function.

12. In order to be fully effective, the internal audit function should be independent of the organizational activities it audits or reviews and also should be independent from the every day internal control process. Every activity and every division, subsidiary or other component of the banking organization should fall within the scope of the internal audit function's review. The professional competence of each internal auditor and of the internal audit function as a whole is essential for the proper performance of that function. Therefore, the internal audit function should be adequately staffed with persons of the appropriate skills and technical competence who are free from operating responsibilities. The internal audit function should regularly report to the board of directors and management on the performance of the internal control and risk management systems and on the achievement of the internal audit function's objectives. Management should establish and approve a procedure ensuring the consideration and, if appropriate, the implementation of the internal audit function's recommendations.

13. The responsibilities of the board of directors and management are in no way diminished by the existence of a system for the supervision of banks by banking supervisors or by a requirement for the bank's financial statements to be audited by an external auditor.

## **The Role of the Bank's External Auditor**

14. The objective of an audit of a bank's financial statements by an external auditor is to enable an independent auditor to express an opinion as to whether the bank's financial statements are prepared, in all material respects, in accordance with an 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,<sup>3</sup> 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 applicable 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 applicable national requirements. For this reason, ISA 700, "The Auditor's Report on Financial Statements" requires the auditor to identify the country of origin of the financial reporting framework used to prepare the financial statements when that financial reporting framework is not International Accounting Standards.

15. The external auditor's report is appropriately addressed as required by the circumstances of the engagement, ordinarily to either the shareholders or the board of directors. However, the report 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 providing assurance on 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 objectives of the audit.

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<sup>3</sup> In some countries, reporting in accordance with internationally accepted accounting standards, such as those issued or adopted by the International Accounting Standards Board, also is permitted.

16. 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 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 controls 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.

17. The auditor considers how the financial statements might be materially misstated and considers whether fraud risk factors are present that indicate the possibility of fraudulent financial reporting or misappropriation of assets. The auditor designs audit procedures to reduce to an acceptably low level the risk that misstatements arising from fraud and error that are material to the financial statements taken as a whole are not detected. ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" lists fraud risk factors whose presence may alert the auditor to the possibility of fraud existing. In some countries, when the auditor determines that evidence of fraud exists, the auditor is required to disclose this information to the bank's supervisor.

18. In carrying out the audit of a bank's financial statements, the external auditor recognizes that banks have the following characteristics that generally distinguish them from most other commercial enterprises, and which the auditor takes into account in assessing the level of inherent risk.

- They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.
- They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks' vulnerability to adverse economic events and increases the risk of failure.
- They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.
- They generally derive a significant amount of their funding from short-term deposits (either insured or uninsured). A loss of confidence by depositors in a bank's solvency can quickly result in a liquidity crisis.
- They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. Banks therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.
- They engage in a large volume and variety of transactions whose value may be significant. This necessarily requires complex accounting and internal control systems and widespread use of information technology (IT).

- They ordinarily operate through a network of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).
- They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.
- They are regulated by governmental authorities whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.
- Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.
- They generally have exclusive access to clearing and settlement systems for checks and fund transfers, foreign exchange transactions, etc They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.
- They may issue and trade in complex financial instruments, some of which may need to be recorded at fair value in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.

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

20. While the external auditor has the sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of internal auditing can be useful to the external auditor in the audit of the financial statements. The auditor, therefore, as part of the audit assesses 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.

21. ISA 610, "Considering the Work of Internal Auditing" requires external auditors to consider the activities of internal auditors and their effect, if any, on the nature, timing, and extent of the external auditor's procedures. The external auditor considers the organizational status of the internal audit function, the scope of its function, the technical competence of its

members and the professional care they exercise when assessing the work of the department.

22. Judgment permeates the auditor's work. The auditor uses professional judgment 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 judgments and estimates made by management in preparing the financial statements.

23. An external 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 assessment of what is material is a matter for the auditor's professional judgment, and is influenced by the economic decisions that users of the bank's financial statements will take on the basis of those financial statements. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by other considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. The process may result in different materiality levels depending on the aspect of the financial statements being considered. 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 banking supervisors. ISA 320, "Audit Materiality" discusses this in more detail.

24. In forming an opinion on the financial statements, the external 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. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error, because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions or intentional misrepresentation being made to the auditor. Such attempts at concealment may be even harder to detect when accompanied by collusion. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because boards of directors and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Therefore, the auditor plans and performs an audit with an attitude of professional scepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.

25. When the auditor discovers a misstatement material to the financial statements taken as a whole, 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 misstatement. If management refuses to make the correction the auditor issues a qualified or an adverse opinion on the financial statements. Such a report could 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 or a disclaimer of opinion if management has not provided the auditor with all the information or explanations the auditor requires.

26. As a supplementary but not necessarily integral part of the audit, the external auditor ordinarily communicates certain information to management. This information customarily contains comments on such matters as material weaknesses in internal control or misstatements 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 (either because additional procedures have been performed to compensate for a weakness in control or because the misstatements have been corrected in the financial statements or are immaterial in their context). The external auditor also communicates matters of governance to those charged with the governance of the bank. In some countries, the external auditor also submits, either as part of a statutory requirement or by convention, a long-form report to management or to the banking supervisor on specified matters such as the composition of account balances or of the loan portfolio, liquidity and earnings, financial ratios, the adequacy of internal control systems, an analysis of banking risks, or compliance with legal or supervisory requirements.

27. In some countries, the external auditor is required to report promptly to the banking supervisor any fact or decision that is liable to:

- constitute a material breach of laws or regulations;
- affect the bank's ability to continue as a going concern; or
- lead to a modified report.

## **The Role of the Banking Supervisor**

28. 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 paper the focus is on the prudential aspect of the banking supervisor's role.

29. 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 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 bank's management must be honest and trustworthy and must possess appropriate skills and experience to operate the bank in a sound and prudent manner;
- the bank's organization and internal control must be consistent with its 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.

30. Further and more detailed requirements are often prescribed, including minimum numerical ratios for the adequacy of the bank's capital and liquidity. 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.

31. 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.

32. Ongoing banking supervision ordinarily is conducted on the basis of recommendations and guidance. 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, when there are violations of laws or regulations, or when depositors are faced with a substantial risk of loss. In extreme circumstances, the supervisor may have the authority to revoke the bank's license.

33. 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.

34. 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.

35. The most significant of banking risks, in terms of historical loss experience, is the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter (sometimes referred to as credit risk). It is not the banking 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 judgments 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.

36. 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 judgment. 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 judgment of the proper valuation of assets and on the fact that valuations that appear in the financial statements have been subjected to external audit.

37. 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 assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

38. The development of sophisticated real-time computerized 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. The introduction of E-Commerce has also introduced significant new risks and requires, in turn, additional controls.

39. 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.

40. 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.

41. Supervisors must have a means of validating the information they receive either through on-site inspections or the use of external auditors. On-site work, whether done by the banking supervisor's own staff or commissioned by the supervisor but undertaken by external auditors, is structured to provide independent verification of whether an adequate internal control system, meeting the specific criteria the supervisor mandates, exists at individual banks and whether the information provided by banks is reliable.

42. 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 or its board of directors. This provides an opportunity for the audit committee or the board of directors 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.

43. Banking supervisors are interested in ensuring that all the work performed by external auditors is 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 any other applicable ethical requirements.<sup>4</sup>

44. In some countries, the banking supervisor has statutory powers over the appointment of external auditors, such as the right of approval or removal, and the right to commission an independent audit. These powers are intended to ensure that the external auditors the banks appoint have the experience, resources and skills necessary in the circumstances. Where there is no obvious reason for a change of external auditor, supervisors will also normally investigate the circumstances that caused the bank not to reappoint the auditor.

45. Supervisors have a clear interest in ensuring high standards of bank auditing. Moreover, an important concern of supervisors is the independence of the external 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.

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<sup>4</sup> The auditor complies with relevant national ethical standards and the "Code of Ethics for Professional Accountants", issued by the International Federation of Accountants (the Code).

## **The Relationship Between the Banking Supervisor and the External Auditor**

46. In many respects the banking supervisor and the external auditor have complementary concerns regarding the same matters though the focus of their concerns is different.

- The banking 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 external auditor, on the other hand, is primarily concerned with reporting on the bank's financial statements ordinarily either to the bank's shareholders or board of directors. 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, Going Concern, 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 banking 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 external 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.
- The banking 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 reflect its condition. The external auditor is concerned with whether adequate and sufficiently reliable accounting records are maintained in order to enable the entity to prepare financial statements that do not contain material misstatements and thus enable the external auditor to express an opinion on those statements.

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

- Supervisory needs are not ordinarily the primary purpose for which the financial statements were prepared;
- An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement;
- The importance of the accounting policies used in the preparation of the financial statements as financial reporting frameworks require the exercise of judgment in their application and may allow choices in certain policies or how they are applied;
- Financial statements include information based on judgments and estimates made by the management and examined by the auditor;
- The financial position of the bank may have been affected by subsequent events since the financial statements were prepared;

- 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, given the different purposes for which internal control is evaluated and tested by the supervisor and the auditor; and
- The controls and accounting policies that the external auditor considers may not be the ones that the bank uses when preparing information for the banking supervisor.

48. Nonetheless, there are many areas where the work of the banking supervisor and of the external 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 the bank’s operations. It is the practice in many countries for such reports to be made available to the supervisors.

49. Similarly, external auditors may obtain helpful insights from information originating from the banking supervisor. 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 that are made available to the banks and that can be of assistance to auditors in performing analytical reviews.

50. When communicating with management, both banking supervisors and external auditors are aware of the benefits that 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 banking supervisor and the external 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 management would compromise the discussion, for example, where the auditor believes that management is involved in fraudulent conduct.

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.<sup>5</sup> Audit matters of governance interest

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<sup>5</sup> 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;

include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with ISAs, to design procedures for the specific purpose of identifying matters of governance interest. Certain audit matters of governance interest are likely to be of interest to banking supervisors, particularly where those matters may require urgent action by the supervisor. When required by the supervisory, legal, or regulatory framework or by a formal agreement or protocol, the auditor communicates such matters to the banking supervisor on a timely basis. In situations where there are no such requirements, agreements or protocols, the auditor encourages the bank's management or those charged with governance to communicate on a timely basis matters that, in the auditor's judgment, may be of urgent interest to the banking supervisor.<sup>6</sup> Furthermore, even if there is no requirement to do so, the auditor considers communicating such matters to the banking supervisor when management or those charged with governance do not do so. In such circumstances, the auditor considers whether the law protects the auditor when such communications are made.

53. The following are examples of types of other matters that may come to the attention of the auditor and may require urgent action by the banking 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 external auditor also communicates these matters to those charged with governance.

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- 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. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
  - Expected modifications to the auditor's report;
  - Other matters warranting attention by those charged with governance, 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.

<sup>6</sup> Clear requirements concerning the auditor's communication to banking supervisors are already established in many countries either by law, by supervisory requirement or by formal agreement or protocol. This is of mutual interest for both auditors and banking supervisors. In countries without such requirements, banking supervisors and accountancy bodies are encouraged to consider initiatives or support for appropriate measures in this regard.

54. In a number of countries, the external auditor carries out specific assignments or issues special reports in accordance with statutes or at the request of the banking supervisor to assist the supervisor in discharging its 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 reports for the banking supervisor is adequate and the information included in these reports, which may include specified ratios of assets to liabilities and other prudential requirements, is accurate;
- the organization is adequate based on criteria provided by the supervisory authority;
- laws and regulations are complied with; and
- appropriate accounting policies are adhered to.

55. Banking supervisors and internal and external auditors cooperate with each other 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 External Auditor to Contribute to the Supervisory Process**

56. A supervisor's request to an external 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 the subject of a separate engagement. In this situation, the following criteria should be established.

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

58. Second, the normal relationship between the external auditor and the audited bank needs to be safeguarded. If there are no other statutory requirements or contractual arrangements governing the external auditor's work, all information flows between the banking supervisor and the auditor typically are channelled through the bank except in exceptional circumstances. Thus, the banking supervisor 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 external auditor and the banking supervisor will, except as indicated in paragraphs 51 and 52 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.<sup>7</sup>

59. Third, before concluding any arrangements with the banking supervisor, the external 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.

60. 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 loans according to risk category. Similarly, wherever possible, some understanding must be reached between banking supervisors and external auditors regarding the concept of materiality.

61. Fifth, the tasks that the banking supervisor asks the external auditor 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 external auditor, in addition to the work necessary to conduct the audit, 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.

62. Sixth, the external auditor's task for the banking 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 specialized skills or because duplication is thereby avoided.

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

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

65. Currently, however, many countries are practicing a supervisory approach which contains elements of both inspection and analysis of reported information. As banking develops in complexity, inspection is proving more and more demanding in terms of

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<sup>7</sup> Many banks furnish copies of the external auditor's communications to management and other special reports directly to the banking supervisor.

supervisory resources. Many supervisory authorities that practice on-site inspection are thus being driven to place greater reliance on reported information, and look to the external auditor for assistance in those areas for which the auditor's skills are particularly suited.

66. Where banking supervisors have previously relied solely on their analysis of prudential returns, they have 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 external auditors to assist them by performing specific tasks (see paragraph 54).

67. In those countries where contacts between external auditors and banking supervisors have been close over a long period, a bond of mutual trust has been built up and extended experience of collaboration 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 Banking Supervisors and the Accountancy Profession**

68. If banking supervisors are to derive benefit from the work of external auditors on a continuing basis, supervisors should discuss current areas of supervisory concern with the accounting profession as a whole. This can be achieved through periodic discussions at the national level between the supervisory authorities and the professional accountancy bodies. Such discussions could cover areas of mutual concern. It is of considerable assistance to auditors in making informed judgments 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 general standard of audits of banks' financial statements. It is advisable for the banks' own industry associations to be involved in discussions on these topics, for example, through the head of the internal audit function, to ensure that the views of all parties are taken into account.

69. Discussions between banking supervisors and professional accountancy bodies could also usefully include 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 banks' adoption of the most appropriate accounting policies.

70. Both banking supervisors and the accountancy profession have an interest in achieving uniformity among banks in their application of appropriate accounting policies. Banking supervisors are often able to exercise a persuasive influence over banks in achieving uniform policies because of their regulatory powers, while external auditors are often better placed to monitor or review 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 for banks at the national level.