

# FINANCIAL SUPERVISORY COMMISSION



Cook Islands

## PRUDENTIAL STATEMENT

No. 05-2005

### ROLE OF EXTERNAL AUDITORS IN BANK SUPERVISION

#### 1. Preamble

1.1 This Prudential Statement is issued by the Financial Supervisory Commission (FSC) pursuant to the provisions of Section 14(3) of the Banking Act 2003 and shall be applicable to all bank licensees, both domestic and international. The purpose of this Prudential Statement is to outline minimum requirements and clarify the role of external auditors in the supervision of banks.

1.2 In developing this Prudential Statement, the FSC made reference to a Policy Statement issued by the Reserve Bank of Fiji and implements recommendations of the Basel Committee on Banking Supervision and the International Federation of Accountants and guidelines issued by the World Bank.

#### 2. Background and Outline of the Approach

2.1 As banking business grows in complexity, the tasks of both supervisors and external auditors are becoming more demanding. In many respects, both face a similar challenge and increasingly their roles are being perceived as complementary. Supervisors and auditors share the same concerns regarding matters such as the continuity of a licensed bank, the adequacy of its internal controls and the maintenance of reliable accounting systems and procedures. With co-operation and co-ordination of efforts, supervisors and auditors contribute more effectively to the supervisory process. This optimises overall supervision while allowing each party to concentrate on the core of their own responsibilities.

2.2 It should be noted that the basic responsibility for providing complete and accurate information to the supervisor remains with the management of a bank. In that regard, the auditor's role when required under legislation or when requested to contribute to the supervisory process is to report on that information or the application of particular procedures to enable the supervisor to effectively make informed judgements about the bank. At no time does the auditor assume any of the responsibilities of the supervisor but is simply assisting the supervisor in the supervisory process.

2.3 There are many areas where the work of the supervisor and 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 banks operations. Similarly external auditors may obtain helpful insights from information originating from the banking supervisor. For example a supervisory inspection report or other communications with the bank can be useful to auditors in as much as they provide an independent assessment in important areas such as the adequacy of loan provisions and focus attention on specific areas of supervisory concern. Banks should ensure that their external auditors have access to all supervisory and examination reports of the FSC and all minutes of meetings and correspondence between the FSC and the bank.

2.4 Under this Prudential Statement, a bank's auditor-client relationship with its auditor will be safeguarded under normal circumstances. Information privileged to clients that is not available to the public will be protected as permitted under existing laws and regulations. Banks should note, however, that the Prudential Statement allows bilateral consultations between the FSC and a bank's external auditor under Sections 43 and 44 of the Banking Act 2003 (see 4.1.1 and 4.1.4 below).

2.5 The supervision by the FSC relies on a mixture of off-site supervision and on-site examination in carrying out its supervisory responsibilities. At present, the role carried out by external auditors is limited to providing FSC a report on the annual financial statements required under Section 42 Banking Act 2003 which the bank must submit to the FSC. The external auditor is also obliged to disclose certain information or to prepare a special report pursuant to Sections 43 and 44 of the Banking Act 2003. The auditor's opinion provides the FSC with an independent attestation of the reliability and accuracy of information examined, lends credibility to such statements and thereby assists in promoting confidence in the banking system and its supervision.

2.6 In seeking to make more effective use of external auditors in the supervisory process, the FSC has reviewed the existing arrangements for external auditors. It has also taken into account the arrangements between supervisors and external auditors in other countries, and guidelines from the Basel Committee and the World Bank on the role of an external auditor in relation to bank supervision.

2.7 Under this Prudential Statement, requests for information are normally to be channelled through the bank to the external auditor (subject to Section 43 of the Banking Act, see also 4.1.1 and 4.1.4 below). Banks will need to ensure that their external auditor is aware of and satisfactorily complies with the requirements set out in this Prudential Statement. The approval of auditors to be appointed to carry out the audit responsibilities of a bank pursuant to Section 41 Banking Act 2003 will be conditional on the auditor being willing and able to comply with the requirements set out in this Statement and in any other relevant supervision rules, regulations, orders or directives issued by the FSC.

### **3. Requirements under the Banking Act 2003**

3.1 A licensed bank must obtain prior approval from the FSC of its appointed auditor as required under Section 41 of the Act. This is regardless of whether a registered auditor has already been appointed in accordance with Sections 10 and 116 of the International Companies Act 1981-82 (ICA).

3.2 For the FSC to be satisfied and approve the appointed auditor, a licensed bank should submit details and adequate documentation to indicate full compliance with Section 41(2) of the Act. This should include all the following:

- the auditor's CV, to include the extent of his bank audit experience;
- copies of any professional certification or qualifications;
- details of any membership of or association with any professional bodies within the accountancy profession, particularly any that undertake a standard setting function.

The documentation should also include a statement signed by the auditor that he is aware of and agrees to comply with Section 42 (Financial Reports) and 43 (Duty to Disclose) of the Act as well as Practice Note 4-2004 (Item 3) on Bank Licensees – Fit and Proper Persons with respect to significant shareholders and officers.

Once given in writing, the FSC's approval of an auditor applies until further notice. The FSC reserves the right to withdraw approval if it is no longer satisfied, for example, as to the auditor's competence or integrity or for other good reason in accordance with international practice.

3.3 In case the appointed auditor is not based or does not have an office in the Cook Islands, information should likewise be provided on whether the audit will be undertaken solely by the appointed auditor or whether a counterpart auditor will assist. In case the appointed auditor will be assisted in the audit, the counterpart auditor to be assigned would also have to comply with 3.2 above.

3.4 External auditors are required to audit and report upon the financial statements of bank licensees. Section 42 lists matters which must be included in an auditor's report.

3.5 The financial statements audited under paragraph 3.4 above must be submitted by the bank licensee within four months after the close of the licensee's financial year to the FSC, see Section 42 (4).

3.6 In addition, the FSC may as provided for under Section 44, require a bank licensee to provide an additional report on the asset quality, and/or the adequacy of provisions for losses, and/or the adequacy of the accounting and control system and/or any other matters as determined by the Commission, prepared by the auditor.

3.7 The approved auditor of a bank licensee is required under Section 43 to disclose to the FSC information relating to the affairs of that licensee obtained in the course of holding the auditor's office, if in the auditor's opinion:

- the licensee is insolvent or likely to become insolvent or is likely to be unable to meet its obligations or is in serious financial difficulties; or
- a criminal offence involving fraud or dishonesty may have been committed; or
- serious irregularities have occurred, including irregularities that may place at risk the interests of depositors and creditors; or
- losses incurred that substantially reduce the capital of the licensee; or
- the licensee is unable to confirm that the claims of creditors are adequately covered by the licensee's assets; or
- the licensee has failed to comply with a directive or guideline issued by the Commission under Part 3 of the Banking Act 2003.

#### **4. Additional Requirements**

##### Meetings

4.1.1 Co-operation among the FSC, the external auditor and the bank should include periodic meetings among these parties. Under normal circumstances, meetings will be trilateral (among all three of the abovementioned parties). It is encouraged that the licensee's internal auditor be present at these meetings. Bilateral meetings (including just the supervisor and either the external auditor or the licensee) may be held in exceptional circumstances.

4.1.2 Meetings may be held prior to an external audit at the FSC's request. During these meetings, each party will provide information about areas of mutual interest. Specific attention will be given to areas that should be examined by the external auditor and any additional work that may be required by the FSC of him. Implementation by the licensee of the auditor's and the FSC's recommendations from its on-site examinations or off-site supervision is also to be discussed. Reports of and correspondence relating to on-site examinations and other supervisory issues should be made available by the licensee to their auditors (internal and external).

4.1.3 Meetings are also to be held after an audit to discuss the external auditor's reports and any matters arising from the external auditor's review. The licensee is expected to submit to the FSC any management letters relating to work undertaken by the auditor.

4.1.4 As indicated in paragraph 4.1.1, bilateral meetings between the FSC and the external auditor may also be held under exceptional circumstances. These meetings may be necessary where circumstances are of a serious or urgent nature and where it is assessed that such a serious matter to be communicated would require the exclusion of the other party for open and frank discussions. Where bilateral meetings between the FSC and the external auditor are held (in which the licensee is not represented), the external auditor will inform the licensee of the concerns raised at such meetings.

4.1.5 Meetings or discussions can also be called at any time considered necessary by one of the parties. Such meetings or discussions should be focussed with a view to containing costs.

#### Additional reporting requirements

In addition to the reporting requirements outlined above, licensees may be required within a time limit set by the FSC to provide to the FSC a report detailing the external auditor's opinion as to whether:

(a) the licensee has observed all prudential requirements set out under the FSC Prudential Statements No. 1-2004 *Bank Licensing, Requirements, Policies and Procedures*, No. 2-2004 *Minimum Eligible Capital Requirement*, No. 3-2004 *Asset Classification, Provisioning, and Non-Accrual of Interest*, No.4-2004 *Quarterly Bank Financial Report*, and any other Prudential Statements issued by the FSC from time to time; and

(b) the licensee has complied with statutory banking requirements, any conditions to the authority to carry on banking business, and any other conditions imposed by the FSC in relation to the licensee's operations.

In providing an opinion on whether the licensee has complied with the FSC's prudential requirements under paragraph 4.2.1, the issue of "materiality" may be considered by an external auditor in both regards as the "nature" or "amount" of the violation and the effect of its omission on the evaluation to be made by the FSC on whether the bank is operating in a safe and sound manner.

A licensee may apply for an extension of time to submit the reports required under paragraph 4.2.1 stating reasons for the delay.

4.2.4 The FSC may require as a part of paragraph 4.2.1 a licensee to provide a report from its external auditor on whether its Quarterly Financial Reports as required by Prudential Statement No. 4-2004 and any subsequent amendments have been accurately prepared.

## **5. Implementation**

This Prudential Statement applies to all financial institutions licensed under the Banking Act 2003, and every person who holds or at any time has held (where applicable) office as an auditor of such an institution, for financial years ending on or after 30 September 2005.