BANGKO SENTRAL NG PILIPINAS

OFFICE OF THE GOVERNOR

MEMORANDUM NO. M-2014-011

To : ALL BSP-SUPERVISED FINANCIAL INSTITUTIONS

Subject : BSP's Expectations for an Effective External Audit Function

The Monetary Board, in its Resolution No. 363 dated 27 February 2014, approved the issuance of the attached guiding principles on the BSP's Expectations for an Effective External Audit Function covering the responsibilities of the board of directors and management of financial institutions; roles of the external auditors; and the relationship between the BSP and external auditors. These principles take into account international best practices and shall be used by BSP in assessing the quality of governance over controls and independent oversight as well as in the evaluation of the continuing qualification of the external auditors to be included in the list of BSP selected external auditors.

For information and guidance.

FOR THE MONETARY BOARD:

AMANDO M. TETANGCO, JR.
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Bangko Sentral ng Pilipinas' Expectations for an Effective External Audit Function

I. Introduction

It is the mandate of the Bangko Sentral ng Pilipinas (BSP) to safeguard the resilience and stability of the financial system. Hence, the BSP must ensure that all BSP-supervised financial institutions (FIs) adhere to safe and sound banking practices and command the confidence of the public and those with whom they do business. In this regard, the BSP, to the extent possible, shall endeavor to uphold the principles of fairness, accuracy and transparency in all documents required to be published by FIs to empower the public to make informed decisions.

The audited financial statements (AFS) reflect important information available to the public such as the financial condition, results of operations and level of risk exposures of an FI. The AFS also disclose any material information that affects or will affect the risk exposures of an FI. The breadth and depth of information in the AFS will undoubtedly aid the decision making process of stakeholders. It is therefore important that the AFS embody the principles of fairness, accuracy and transparency to enhance confidence of the public not only on a particular bank but on the entire financial system as well.

The AFS bears the opinion of the external auditor based on the audit conducted. In this regard, the external auditor is expected to conduct the audit in accordance with internationally recognized ethical and auditing standards, including those calling for independence, objectivity, professional competence, due care and adequate planning and supervision.

The public relies on the auditor's opinion as it lends credibility to the financial statements of an FI. The regulators also depend on the assessment done by external auditors as this provides critical inputs in the evaluation of the safety and soundness of an FI. The tasks of the regulators such as the BSP, and external auditors are viewed as complementary. Mutual recognition of the respective roles of BSP and the external auditor, as well as how said roles complement each other, improves not only the effectiveness of the external audit function but also the quality of supervision performed by BSP.

Accordingly, the BSP is issuing the following guiding principles for an effective external audit function to set-out its expectations from management and external auditors and to strengthen its relationship with the latter. These principles take into account international best practices[1] and shall be used by BSP

[1] These include the following papers issued by the Basel Committee on Banking Supervision: (i) External Audits of Banks (Consultative Document) issued in March 2013; (ii) External Audit Quality

in assessing the effectiveness of the oversight of the board of directors over the FIs' and the quality of the external audit function.

II. Guiding Principles

1. The Responsibility of the FI's Board of Directors and the Management

a. Consistent with the principles embodied under Circular No. 749 dated 27 February 2012, as amended, the duties and responsibilities of the FI's Board of Directors and the board level Audit Committee in relation to controls, independent oversight and checks and balances systems, include, among others, ensuring that:

Board of Directors

(i). Adequate governance structures and control processes related to the different activities of the FI are established and complied with, including:

- Systems that accurately identify and measure all material risks and adequately monitor and control these risks;
- Adequate internal controls, organizational structures and accounting procedures leading to a suitable control environment aimed at meeting the FI's prescribed corporate strategy, performance, information system and compliance objectives;
- The evaluation of the quality of assets and their proper recognition and measurement; and
- Requirements on the gathering and disclosure of material and relevant information on financial accounts including related party transactions.

(ii). Adequate governance structures and control processes for areas or exposures that may pose significant risk to an FI such as fair value measurement and financial instruments. The Board's oversight responsibilities for the FI's use of fair value accounting include:

- Reviewing and approving written policies related to fair valuations;
- Continuing review of significant valuation model performance for issues escalated for resolution and all significant changes to valuation policies;
- Ensuring adequate resources are devoted to the valuation process;
- Articulating the FI's tolerance for exposures subject to valuation uncertainty and monitoring compliance with the Board's overall policy settings at an aggregate firm wide level;
- Ensuring independence in the valuation process between risk taking and control units;

- Ensuring appropriate internal and external audit coverage of fair valuations and related processes and controls;
- Ensuring consistent application of accounting standards and disclosures within the applicable accounting framework;
- Ensuring the identification of significant differences, if any, between accounting and risk management measurements and their proper documentation and monitoring; and
- Ensuring adequate documentation of significant differences between the valuations used for financial reporting purposes and for regulatory purposes

(iii). Appropriate management information systems are established; and

(iv). The interests of stakeholders are adequately protected.

Audit Committee[2]

(i). The Audit Committee is responsible for providing oversight over the FI's audit functions. In addition to the duties expected of the Audit Committee under Circular No. 749, as amended, an FI's Audit Committee shall, likewise, perform the following functions:

- Appoint, dismiss and re-appoint external auditors based on fair and transparent criteria such as (i) core values, culture and high regard for excellence in audit quality, (ii) technical competence and expertise of auditing staff, (iii) independence, (iv) effectiveness of the audit process, and (v) reliability and relevance of the external auditor's reports;
- Regularly review and monitor the external auditor's technical competence, independence, objectivity and overall effectiveness of the external audit process;
- Set compensation of the external auditor in relation to the scope of its duties;
- Establish a system of reporting where the external auditor can communicate directly to the Audit Committee on a timely basis;
- Establish a system that addresses, in a timely and effective manner any findings of fraud or error on the financial statements;
- Continually engage the external auditor on matters concerning audit quality; and
- If the external auditor resigns or communicates an intention to resign, the Audit Committee should follow up on the reasons/explanations giving rise to such resignation and consider whether it needs to take any action in response to those reasons.

[2] A required board committee under Circular No. 749 dated 27 February 2012.

(ii). In assessing the effectiveness of the external auditor's work, the Audit Committee should closely coordinate with the external auditor during all phases of the external audit engagement, as follows:

- It should discuss and agree to the terms of the engagement letter issued by the external auditor prior to the approval of the engagement. Where relevant, the engagement letter should reflect changes in circumstances relevant to the external audit;
- It should obtain an understanding of the scope and audit approach which shall be adopted by the external auditor for purposes of meeting the FI's financial reporting requirements;
- It should ascertain and take steps to address the major areas of concern identified by the external auditor during the course of its audit. These issues may cover significant accounting estimates, valuation methodologies and accounting policies adopted;
- It should review management representation letters before these are transmitted to the external auditor to ensure that items in the letter are complete and appropriate;
- It should assess the extent of cooperation provided by the FI's management during the conduct of the external audit; and
- It should understand and duly assess the external auditor's opinion regarding the capability of FI management and the adequacy of accounting/information systems to comply with financial and prudential reporting responsibilities.

(iii). In order to reinforce the Audit Committee's effectiveness in performing its key role in strengthening corporate governance, the Audit Committee shall maintain effective communication channels with the external auditor through regular and structured dialogues in the course of the external audit. Such communications should focus on the key accounting or auditing issues that, in the external auditor's judgment, give rise to a greater risk of material misstatement of the financial reports, as well as other external audit concerns of the Audit Committee. Internal and external auditors should be allowed and encouraged to attend the meetings of the Audit Committee. During regular meetings of the Audit Committee, matters that may be raised include audit findings that would impact on the FI's compliance with regulatory requirements, disclosures and other accounting concerns.

Management

Management, in general, is responsible for the implementation and consistent adherence by all personnel to the policies approved by the board of directors in relation to controls, independent oversight and checks and balances systems, ensuring, among others, that:

(i). Financial statements are prepared in accordance with accounting standards on the prescribed financial reporting framework. Documentation sufficient to support the financial statements is maintained. This responsibility includes ensuring that the external auditor who audits 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, to the extent allowed by law. Management also has the responsibility to provide all information to regulatory agencies that are entitled to such information by law or regulation;

(ii). Management is responsible for maintaining, monitoring and evaluating the adequacy and effectiveness of the internal control system on an ongoing basis, and for reporting on the effectiveness of internal controls on a periodic basis. This function shall include an assessment of the adequacy of, and compliance with, the FI's established policies and procedures and assurance as to the adequacy, effectiveness and sustainability of the FI's risk management and control procedures and infrastructure. In fulfilling its duties and responsibilities, management should take all necessary measures to ensure that there is a continuous, adequate and effective internal audit process.

b. Given that transparency is an essential element for sound corporate governance, the board of directors and management should have an effective oversight on the FI's disclosure practices. Disclosures should be accurate, clear and presented in a manner that shareholders, depositors, other relevant stakeholders and market participants can understand easily.

c. The responsibilities of the board of directors and management are in no way diminished by the existence of a system for the supervision of FIs by BSP or by a requirement for the FI's financial statements to be audited by an external auditor.

2. The Role of the FI's External Auditor

a. The objectives of the external auditor are to: (i) Form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework based on an evaluation of the conclusions drawn from the audit evidence obtained; and (ii) Express that opinion clearly through a written report that also describes the basis for the opinion.

b. In forming this opinion, the external auditor shall identify and assess the risks of material misstatement in the FI's financial statements, taking into consideration the FI's operations, control environment and its components as well as the FI's financial reporting systems. The assessment shall also take into account qualitative aspects of the FI's accounting practices, including indicators of possible biases in management's judgments. The external auditor should, likewise, assess and communicate to the Audit Committee the results of its assessment on the capability of FI management, the strength of the FI's control environment, and the adequacy of the FI's accounting/information systems to comply with financial and prudential reporting responsibilities.

c. The external auditor shall conclude whether it has obtained reasonable assurance that the financial statements, as a whole, are free from material misstatement, whether due to fraud or error. That conclusion shall include an evaluation of the following:

   (i) Whether sufficient appropriate audit evidence has been obtained;
   (ii) Whether uncorrected misstatements are material, individually or in aggregate; and
   (iii) Compliance with the applicable framework.

   If material error or fraud is discovered, the external auditor shall immediately bring such information to the attention of the Audit Committee. Moreover, the external auditor shall report to the BSP such material error or fraud and other matters as prescribed under existing regulations.

d. In particular, the external auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

   (i) The financial statements adequately disclose the significant accounting policies selected and applied;
   (ii) The accounting policies selected and applied are appropriate and consistent with the applicable financial reporting framework;
   (iii) The accounting estimates made by management are reasonable;
   (iv) The methodologies, assumptions and valuation practices including provisioning for loan losses are appropriate and consistent with the applicable financial reporting framework;
   (v) The information presented in the financial statements are relevant, reliable, comparable and understandable;
   (vi) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
   (vii) The terminologies used in the financial statements, including the title of each financial statement, are appropriate.

e. In carrying out the audit of an FI's financial statements, the external auditor recognizes that FIs have characteristics that generally distinguish them from most other business enterprises, and which the external auditor takes into account in assessing the level of inherent risk. Examples of key audit areas and exposures that merit special audit consideration for an FI include, but need not be limited to, impairment and loan loss provisioning, financial instruments measured at fair value, liabilities, related party transactions and disclosures.

(i) The BSP requires external auditors to assess FI's compliance with certain BSP rules and regulations as prescribed under existing regulations. In this respect, the BSP requires external auditors to directly report to the BSP material breaches in said rules and regulations such as but not limited to capital adequacy ratio and loans and other risk assets review and classification. While the provisioning requirements under the prescribed financial reporting framework and BSP rules and regulations may differ, external auditors are expected to look into the soundness of the assumptions and methodologies used under both regimes. In addition, external auditors should also look into the adequacy and propriety of documentation of significant differences between the valuations used for financial reporting purposes and for regulatory purposes.

(ii) External auditors should also assess the adequacy and propriety of disclosures on related party transactions. The external auditors should exercise sound judgment on whether mere compliance with disclosure requirements prescribed under the applicable financial reporting framework already provide sufficient information to make a conclusion on whether the transactions are done at arm's length terms.

f. 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 external auditor, therefore, as part of the audit assesses the internal audit function insofar as the external auditor believes that it will be relevant in determining the nature, timing and extent of the external audit procedures.

g. Judgment permeates the external auditor's work. The auditor uses professional judgment in areas such as:

   (i) Assessing inherent and control risk and the risk of material misstatement due to fraud or error;
   (ii) Deciding upon the nature, timing and extent of the audit procedures;
   (iii) Evaluating the results of those procedures; and
   (iv) Assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.

   While many areas of financial reporting require significant judgments (i.e., by management when implementing the standards and auditors when interpreting the standards during the audit process), the BSP expects that similar transactions will be accounted for in a manner that is consistent with the accounting standards and consistent across FIs.

h. External audits performed in accordance with auditing and ethics standards are an important element in enhancing market confidence. This is particularly the case with respect to valuations of financial instruments, including disclosures about the valuation methodologies, and the extent of off-balance sheet risks to which FIs are exposed. Auditors play an important role in encouraging consistent and meaningful disclosures about valuation processes.

i. The external auditor should maintain an attitude of professional skepticism throughout the planning and performance of the audit, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Specific areas where professional skepticism is particularly important include, among others, fair value measurements, related party relationships and transactions, going concern assessments, and in auditing significant unusual or highly complex transactions.

   Furthermore, the external auditor should consider the supervisory issues raised by the BSP especially in its assessment of the going concern assumption, particularly in the evaluation of the liquidity and solvency of the FI.

j. The external auditor should promote a two-way communication with those charged with the governance of the FI. The subject of the communication may include the following:

   (i) The responsibilities of the external auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
   (ii) Information relevant to the external audit; and
   (iii) Timely observations arising from the external audit that are significant and relevant to the FI's financial reporting process, including inappropriate accounting treatment that may result in tax violation.

k. The external auditor should document its discussion with the FI's Board of Directors and the Audit Committee. Where there are differences between BSP regulations and the applicable financial reporting framework, as when there is more than one option allowed, discussions on the treatment adopted in the financial statements should be duly minuted. The external auditors are nonetheless, expected to recommend compliance with BSP-prescribed accounting treatment particularly when such is likewise acceptable under the applicable financial reporting framework.

l. The external auditor is expected to charge only reasonable audit fees. In determining reasonable fees the following may be considered:

   (i) Expected hours needed to complete the scope of work envisioned in the audit plan;

(ii) Complexity of the activities and structure of the company;
(iii) Level of internal audit assistance;
(iv) Level of fees being charged by other audit firms; and
(v) Quality of audit services.

In this respect, the external auditor is expected to ensure that the audit fees will be set at an amount that will not in any way compromise the quality of the audit.

m. The external audit team is expected to be composed of members whose collective skills and competence are commensurate with the size and complexity of operations of the FI.

3. The Relationship between BSP and the External Auditor

a. The complementary role of the BSP and external auditors are ingrained in existing statutes. As provided under Section 58 of the General Banking Law of 2000 (Republic Act No. 8791), the Monetary Board may require a bank to engage the services of an external auditor whose terms of engagement may either be on a continuing basis where the auditor shall act as resident examiner, or on the basis of special engagements. In any case, the external auditor shall be responsible to the bank's board of directors and is required to furnish a copy of the report to the Monetary Board.

   Moreover, Section 61 of the same Republic Act requires banks to make available to the public their complete set of audited financial statements as well as such other relevant information including those on their majority-owned or controlled enterprises.

b. The external auditors reporting on adverse findings as prescribed under existing BSP regulations is useful to the ongoing monitoring of BSP on the financial condition and risk profile of FIs. The external auditor's report enables BSP to become aware of emerging problems and work with the FIs and other supervisors, as appropriate, to take necessary and timely steps to address the issues.

c. The BSP also engages external auditors in discussion involving accounting issues, to arrive at a consensus regarding the treatment of certain banking transactions. BSP looks forward to the development of this forum for resolving accounting issues.

d. In many respects, the BSP and the external auditor have complementary concerns regarding the same matters, though the focus of their concerns is different.

(i) The BSP is primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual FIs in order to protect the interests of the depositors. Therefore, the BSP monitors the present and future viability of FIs 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 FI's financial statements to the FI's shareholders, board of directors and other stakeholders. In doing so, the external auditor evaluates the appropriateness of management's use of the going concern assumption.

(ii) The BSP is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the FI'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.

(iii) The BSP must be satisfied that each FI maintains adequate records prepared consistently in accordance with applicable international accounting standards and practices to enable it to appraise its financial condition and the profitability of its business, and that the FI publishes or makes available on a regular basis financial statements that fairly reflect its condition. The external auditor is concerned with whether accounting records are adequately and sufficiently reliable 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.

(iv) Although the BSP and the external auditor have different concerns, there are areas where the work of the BSP and of the external auditor can be useful to each other. BSP increasingly utilizes audits to complement the supervisory process, including its use as an early warning system for emerging supervisory issues. Moreover, audited financial information is among the sources of information used in the risk-focused supervision process, which contributes to increased efficiency in banking supervision. For instance, the BSP makes use of the following information gleaned from an external auditor's work product:

1) External auditor's assessment of the FI's performance and risk management,
2) Material internal control weaknesses identified, and
3) Views and judgments on significant transactions, valuation and impairment methodologies, accounting policies.

e. Similarly, the external auditor can benefit from the work of the BSP such as when determining the extent of its audit procedures in ascertaining the carrying value of the assets and identification and adequate disclosure in the financial statements of all material commitments and liabilities, and the corresponding capital position of FIs. Significant supervisory issues raised by the BSP will also aid the external auditors in assessing the going concern assumption used by the FIs. For this purpose, FIs shall allow external auditors read-only access to the BSP Reports of Examination (ROE). External auditors, on the other hand, shall include a provision in their audit engagement letters that contents of the ROE shall be treated appropriately and confidentially.