CODE OF PRACTICE
FOR CENTRAL BANK'S ENGAGEMENT WITH
EXTERNAL AUDITORS OF FINANCIAL INSTITUTIONS

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(DRAFT)

Contents

1. INTRODUCTION

1.1 The role of the external auditor is to express an opinion on a financial institution's audited financial statements. The auditor is required to conduct the audit in accordance with International Standards on Auditing (ISA). Those standards require that the auditor complies with ethical requirements and plans and performs the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. In a regulatory context, the ability of regulators to rely on the audited information furnished by financial institutions[1] is an integral part of the supervisory process. Against this background, the Basel Committee on Banking Supervision (BCBS), in March 2014, issued guidance on external audits of banks to improve the external audit quality of banks and enhance the effectiveness of prudential supervision and hence financial stability. The document provided guidelines for, *inter alia*, the prudential supervisor's (regulator's) relationship with external auditors of banks. Similar principles would also be appropriate for application to other financial institutions.

1.3 Auditors are duty-bound to follow the standards and principles established in the ISA in the conduct of audits of entities. Similarly, the Central Bank of Trinidad and Tobago (the Central Bank) seeks to adhere to the standards established by the BCBS for the supervision of banking entities. The relationship between external auditors and the Central Bank is premised on both parties operating within a particular regulatory framework as well as within the limits and requirements placed on them by the standards to which they subscribe.

1.4 The Central Bank has long recognized the importance of leveraging the work of external auditors in assessing the safety and soundness of financial institutions. This policy stance is reflected in the various pieces of legislation governing financial institutions under its regulatory purview. Notwithstanding the legislative provisions, the Central Bank is cognizant of the need to deepen the regulator/ external auditor relationship and is seeking to adopt best practices with respect to communication as documented in this Code of Practice.

2. PURPOSE OF THE CODE

2.1. The aim and objective of this Code of Practice is to enhance the regulatory process by promoting an effective relationship between the external auditor[2] of an individual financial institution and the Central Bank in a context that would foster enhanced supervisory review and also contribute to high quality external audits. As a consequence, this Code sets out principles that establish, in the context of a particular financial institution:

a) the nature of the relationship between the Central Bank and external auditor;

[1] A financial institution refers to (i) institutions licensed under the Financial Institutions Act, 2008 (FIA) (ii) institutions registered under the Insurance Act, Chap 84:01 (IA) and institutions deemed systemically important by the Minister of Finance, namely the Agricultural Development Bank, the Home Mortgage Bank, the National Insurance Board, the Trinidad and Tobago Mortgage Finance Company and the Unit Trust Corporation of Trinidad and Tobago.

[2] This Code of Practice is not intended to cover the relationship of the Central Bank with the Institute of Chartered Accountants of Trinidad and Tobago (ICATT).

b) the form and frequency that communication between the two parties should take; and

c) the responsibilities and scope for sharing information between the two parties, subject to the availability and accessibility of information to either party.

2.2. The nature of the relationship and information sharing between the Central Bank and external auditors should be considered in the general context of the respective roles and responsibilities of the Central Bank, external auditors, and a financial institution's board and management.

a) The Central Bank is primarily concerned with maintaining the stability of the financial system and fostering the safety and soundness of financial institutions in order to protect the interests of the depositors, policyholders and pension plan members and beneficiaries. Therefore, the Central Bank monitors the present and future viability of financial institutions and uses their financial statements in assessing their condition and performance.

The Central Bank is also concerned with the maintenance of a sound system of internal controls as a basis for safe and prudent management of the financial institution's business. It must be satisfied that each financial institution maintains adequate records prepared in accordance with consistent accounting policies and practices that enable the Central Bank to appraise the financial condition of the financial institution and the profitability of its business, and that the institution publishes or makes available on a regular basis financial statements that fairly reflects its condition.

When the Central Bank conducts an onsite examination, the conclusions drawn from the examination are customarily communicated to the financial institution. These communications can be useful to external 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. The Central Bank may also develop certain prudential ratios or guidelines that are made available to the financial institutions and that can be of assistance to external auditors in performing analytical reviews[3].

b) A financial institution's Board is responsible for ensuring that management fulfills the following as it relates to an external audit. In particular, the Board is responsible for:

i. ensuring that the financial statements are prepared and presented fairly in accordance with International Financial Reporting Standards (IFRS);
ii. establishing accounting procedures that provide for the maintenance of documentation sufficient to support the financial statements;
iii. establishing and maintaining effective internal controls and procedures for financial reporting;

[3] The relationship between banking supervisors and banks' external auditors, Basel Committee on Banking Supervision, Bank for International Settlements, January 2002

iv. ensuring that the external auditor has complete and unhindered access to, and is provided with, all necessary information that may have material effect;
v. providing all information to supervisory agencies as required by law;
vi. preventing and detecting fraud and other irregularities.
vii. engaging, monitoring and compensation of the external auditor;
viii. discussing and resolving disagreements between management and the auditor on financial reporting;
ix. reviewing reports received from the auditor on critical accounting policies, discussions with management and any material communications with management; and
x. reviewing and monitor management's planned actions to implement auditor recommendations on the internal control environment;

c) External auditors are responsible for:
   i. expressing an opinion on financial statements which are audited in accordance with ISA. The external audit involves procedures which include, but are not limited to, assessment of the risks of material misstatement of the financial statements, whether due to fraud or error;
   ii. considering internal control relevant to the financial institution's preparation and fair presentation of the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the financial institution's internal control;
   iii. evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management; and evaluating the overall presentation of consolidated financial statements (where applicable).

d) While the external auditor's relationship with regulators is designed to enhance the effectiveness of both the audit and the supervisory process, it should not detract from the independent role the external auditor plays in forming judgments and opinions on a financial institution's financial statements.

3. LEGISLATIVE REQUIREMENTS

3.1. The legislative powers of the Central Bank as it relates to the audits of financial institutions and requirements of auditors can be found in the Insurance Act Chapter 84:01 (IA) and the Financial Institutions Act, 2008 (FIA). Specifically:

a) section 51(1) of the IA empowers the Inspector to request from the auditor any information necessary to ascertain the ability of insurance companies to meet their obligations.
b) sections 78 and 84 of the FIA empower the Central Bank to request any information it may require on a financial institution from the external auditor and to have access to the auditor's working papers.

c) The Central Bank may, under these pieces of legislation, request information with respect to the following:

i. preparation of financial statements,
ii. conduct of special investigations;
iii. compliance review in relation to AML/CFT statutory obligations;
iv. risk management;
v. internal controls; and
vi. governance of the financial institutions.

3.2. Both the FIA and the IA place certain obligations on the external auditor.

a) Under sections 83 and 84 of the FIA, the external auditor is required to:
   i. audit the statutory returns of the financial institution;
   ii. report on the adequacy of the financial institution's accounting records;
   iii. communicate in writing to the financial institution about control deficiencies arising from the audit of financial statements of that financial institution;
   iv. report on accounting issues that have led to a misrepresentation of the financial position of the financial institution;
   v. report on contraventions of any legislative provisions relating to capital adequacy and liquidity requirements; and
   vi. report on any irregular transactions or conditions that pose significant risks to the financial institution.

b) In relation to registrants under the IA, sections 57 (1) and (3) and 64 (3) and (4)(b) require the external auditor to:
   i. audit the accounts of insurance companies annually;
   ii. report whether the preparation of the accounts have been done in accordance with the IA;
   iii. report whether the revenue account and profit and loss accounts are a fair representation of the results of the company's operations;
   iv. report whether the balance sheet fairly presents the state of the company's affairs;
   v. report whether the reserves relating to unexpired policies have been calculated in accordance with the IA;
   vi. report on whether the provisions regarding outstanding claims are adequate;
   vii. state whether the records of accounts have been adequately maintained and are up to date;
   viii. report to the on matters in respect of which they were unable to obtain information or are not completely satisfied with such information; and
   ix. provide the Inspector or any person authorized by the Central Bank with any books or papers specified (section 64 (3)) and to explain the contents or any books or papers relevant to the institution's insurance business where necessary (section 64(4)(b)).

3.3. The external auditor therefore plays an important role as it assesses the risk profile of the financial institution through its audit of financial statements and statutory returns and assessments of internal controls, risk management and governance in the execution of the audit. The Central Bank places reliance on the external auditor to opine on whether the financial statements present fairly in all material respects. It is understood that the external auditor is required to plan and perform the audit to obtain reasonable assurance of whether the financial statements are free from material misstatement. Similarly, in the context of enhancing the overall audit, as well as, the relationship between the external auditor and the Central Bank, the external auditor would gain a better understanding of, and insight into the financial institution's vulnerabilities and risks where either the Central Bank provides pertinent information or the external auditor has access to Central Bank's reports, correspondence and directives to the financial institutions.

3.4. The legislation while it places responsibilities on the auditor to disclose and share information with the Central Bank, also under the FIA, indemnifies the auditor. Section 85(1) of the FIA permits external auditors to communicate, in good faith, to the Central Bank any information or opinion on a matter that the external auditor reasonably believes is relevant to any function of the Central Bank. While the Central Bank is intent on building its relationship with the auditor, it is however bound legislatively by several confidentiality requirements in the IA, FIA as well as the Central Bank Act as follows:

a) Section 6A (1) of the IA provides that the Central Bank may only share information on a registrant with a local or foreign regulatory agency or body **that regulates financial entities** ;

b) Section 8 (1) of the FIA prohibits the Central Bank from disclosing any information regarding the business or affairs of a licensee or its affiliate or any depositors or customers, that is obtained in the course of official duties. However, subsection (5) of section 8 also provides for, inter alia, the Central Bank or its officers or employees being able to disclose information that it considers necessary for the purpose of analysis of the financial condition of the licensee.

c) The Central Bank Act, section 56 (1) also prohibits the disclosure of information relating to the affairs of, inter alia, any financial institution, registrant under the Insurance Act or customers except as may be necessary for the due performance of the objects of the Central Bank and subject to the requirements of section 8 of the FIA.

4. THE PRINCIPLES

This Code of Practice is premised on the principles set out below and should be applied in a manner proportionate to the level of risk of the particular financial institution. The principles are as follows:

Principle 1: Regulators and external auditors should engage in regular dialogue.

Principle 2: Regulators and external auditors shall share all information relevant to carrying out their respective statutory duties or that is considered to be material to either party in a timely fashion.

Principle 3: Regulators and auditors shall seek an open, co-operative and constructive relationship.

Principle 4: Regulators and auditors shall respect their duty to treat information shared between the two parties or received from financial institutions confidentially.

4.1. Principle 1: Regulators and external auditors should engage in regular dialogue.

Communication between the Central Bank and the external auditor should be as frequent as necessary and take whatever form as agreed between the two parties to ensure that their statutory responsibilities are effectively fulfilled. The form, content and frequency of this dialogue will vary depending on the characteristics and circumstances of the financial institution.

Communication may be both through formal channels, such as scheduled bilateral (Central Bank and External Auditor) and/or trilateral (Central Bank, External Auditor and Financial Institution representative) meetings with relevant individuals, and through informal channels, such as telephone calls and unscheduled meetings as appropriate.

Subject to paragraph 4.3.1, there shall be at least one routine bilateral meeting per year for financial institutions that are categorized as Systemically Important Financial Institutions (SIFIs)[4] and other 'high risk' financial institutions (as determined by the Central Bank in accordance with its Supervisory Assessment Framework). Additional meetings between the Central Bank and external auditors of SIFIs may be necessary around the time of planning and concluding the annual external audit or an on-site examination.

4.2. Principle 2: Regulators and external auditors should share all information relevant in carrying out their respective statutory duties or information that is considered to be material to either party in a timely fashion

Alongside the legislative requirements outlined in 3, the overriding consideration should be to disclose information that, according to the judgment of the lead audit partner, would assist the regulator in carrying out its functions. Such information should be communicated in writing in a timely fashion by the external auditor directly to the Inspector of Financial Institutions (Inspector). It is not sufficient for the external auditor to rely on the financial institution to notify the Inspector (refer to section 83(1) of the FIA).

The Central Bank should disclose information to the external auditor that it judges to be relevant to the fulfillment of the external auditor's duties, without breaching its responsibility of confidentiality.

4.3. Principle 3: Regulators and external auditors shall seek an open, co-operative and constructive relationship

[4] SIFI means an institution that is determined to be systemically important based on a framework of recognition and identification through the Supervisory Assessment Framework of the Central Bank. These institutions will be identified and communicated to the external auditors. As such, those institutions deemed systemically important by the Minister of Finance may not necessarily fall into this categorization.

There should be an open and constructive two-way dialogue between the external auditor and the Central Bank to support the effective fulfillment of their respective statutory functions.

Communication channels between both parties should always be open and an environment that facilitates frank discussions should exist. This can be achieved through the adoption of the following measures:

a. Financial institutions should advise the Central Bank of the contact details of the audit partner responsible for the external audit;

b. Financial institutions should advise the external auditor of the contact details of its lead examiner and/or relationship officer in the Central Bank;

c. Meetings between the external auditor and the Central Bank should be governed by the following principles:

I. The Central Bank shall share with the external auditor information which it believes will assist the auditor in the conduct of its audits;
II. The external auditor shall share with the Central Bank any information that it believes may assist the Central Bank in the exercise of its supervisory functions;
III. All communications between the Central Bank and the external auditor shall be deemed confidential[5];
IV. Material information shall be shared between both parties at the earliest convenience even if a meeting between both parties is not planned;
V. Contractual agreements between external auditors and financial institutions should not hinder information sharing with the Central Bank. Specifically, the terms of the audit engagement should include a provision that acknowledges that the Central Bank and the financial institution's external auditor may discuss any issue that is of relevance to the Central Bank's oversight of the financial institution and that this communication will not be determined to be a breach of duty by either party.

d. At all times, both parties should aim to create an open and co-operative relationship that supports the other in carrying out their statutory functions.

4.3.1. Bilateral Meetings

<u>Systemically Important Financial Institutions (SIFIs)</u>:
Bilateral meetings shall be held at least once a year with the auditors of a financial institution designated a SIFI by the Central Bank through its supervisory assessment framework. Where the Central Bank plans an on-site examination of a SIFI, a meeting shall be scheduled with the external auditor prior to the on-site examination. Subsequent to this, or in the instance where an on-site examination is not being undertaken in that year, the Central Bank may initiate meetings with the auditor as deemed appropriate, to consider any assessment of risks and anticipated issues.

<u>Other Financial Institutions</u>:

[5] Section 8(1) of the FIA requires inter alia all information regarding the business or affairs of a license to be kept confidential.

Where the Central Bank plans an on-site examination of a financial institution other than one designated a SIFI, a meeting should be scheduled with the external auditor prior to the on-site examination. Further bilateral meetings may be requested by either party once it is deemed necessary.

Persons proposed to attend bilateral meetings are as follows:

a) Pre- onsite examination:
   i. Central Bank – Relationship Officer of the financial institution, Manager Supervision, Deputy Inspector of Supervision
   ii. External Auditor – Lead Audit Partner or their delegate

The scope of this meeting will be institution specific and guided by the focus of the onsite examination.

b) Other Meetings:
   i. Central Bank – Relationship Officer, Senior Examiner and Manager, Supervision
   ii. External Auditor – Lead Audit Partner

Appendix I provides guidance on the potential scope of the other bilateral meetings.

4.3.2. Trilateral Meetings

a) The Central Bank may arrange trilateral meetings annually or less frequently if it is not considered necessary. The Central Bank, through its Corporate Governance requirements[6], expects that the financial institution's Audit Committee will ably monitor the effectiveness and adequacy of the financial institution's internal and external audit functions. It is because of this reliance that the Central Bank proposes the holding of trilateral meetings, which would include the Central Bank, the external auditor, the internal auditor, the Chair of the Audit Committee or an Independent Director where no Audit Committee exists, to discuss areas of concern and/or mutual interest regarding the financial institution.

b) Trilateral meetings may be scheduled by the Central Bank after an onsite examination, completion of the annual external audit process or of any specific work requested by the Central Bank under Section 83(2) of the FIA. This meeting may be held in addition to a bi-lateral meeting, once it is deemed necessary by the Central Bank.

c) Trilateral meetings held in accordance with 4.3.2 (a) above may include discussions of mutual interest on the following:
   i. the audit process and any material issues raised by the external auditor with the financial institution arising out of the audit;
   ii. other relevant issues affecting the preparation or presentation of the financial statements, including material changes in accounting treatment or practice and compliance with IFRS;
   iii. the operation and effectiveness of internal controls within the financial institution generally or within a significant group entity or business line;

[6] Refer to Section 8 of the Corporate Governance Guideline issued by the Central Bank.

iv. the operation and effectiveness of the internal audit and compliance functions within the financial institution, including the role and work of the Audit Committee;
v. the operation and effectiveness of the financial institution's arrangements for the monitoring, management and control of all material risks in its business; and
vi. any other issues that the relevant parties may deem necessary to discuss.

d) Prior to each meeting, an agenda should be prepared and circulated by the Central Bank.

4.4. Principle 4: Regulators and auditors shall respect their duty to treat information shared between the two parties or received from financial institutions confidentially

The IA (Section 51) and the FIA (Section 85) permit the external auditors to share information with the Central Bank. In addition the Central Bank may share information with the external auditor where deemed necessary to fulfil its legislative obligations, subject to section 8 (5) (a) of the FIA and 56 (1) of the Central Bank Act. The FIA and IA also provide for external auditors to communicate in good faith with the Central Bank without contravening other duties they are subject to (as discussed in Section 3).

5. DEEMED SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

It is necessary to develop relationships with financial institutions that are deemed systemically important (see institutions referenced in footnote 1 on page 3) but are not currently subject to a legislative framework which explicitly places them under the regulatory ambit of the Central Bank. As such, engagement with the external auditor would not be subject to the same legislative requirements listed in section 3. While the Central Bank is in the process of developing legislative frameworks to bring these deemed entities under its regulatory ambit, there will be a need to engage with the external auditors of these entities. This may entail these external auditors seeking relevant permissions from the entities to share information with the Central Bank as well as the Central Bank indicating to these entities the importance of auditor engagement in fulfilling its supervisory responsibilities.

6. PERIODIC REVIEW

6.1 This Code of Practice will be subject to annual review and will be updated to reflect changes to legislation, auditing practice and other relevant developments as necessary; and

6.2 Either party may initiate discussions for amendment to or updating of the Code of Practice.

APPENDIX I

Proposed scope for other bilateral meetings may include, but not limited to, the following:

i. Risk assessment and scope – both the external auditor's and Central Bank's assessments in light of the external environment and the financial institution's performance, changes in business lines, drivers of income, strategy, risk appetite etc.;
ii. Weaknesses identified in previous external audits;
iii. Overview of weaknesses identified through the supervisory process;
iv. Discuss current key risks the financial institution poses to the Central Bank's objectives, skilled persons' report findings and other supervisory reviews;
v. Audit strategy/approach and views on materiality;
vi. Observations on control functions of the financial institution (e.g. risk management function, internal audit, compliance);
vii. Views and judgments on key risk areas based on audit/supervisory work performed to date, including specific significant transactions, material valuations and impairment decisions etc.;
viii. Assessment of risks relating to going concern assumption;
ix. Accounting policy application and changes;
x. Sources of potential management bias;
xi. Culture and tone set from the top;
xii. Observations on any areas of potential reputational risk for the financial institution;
xiii. Observations arising from any work on regulatory reporting, including capital;
xiv. Changes in corporate governance and internal governance structures of the financial institution;
xv. Actions from previous years;
xvi. Discussion on the external audit findings as originally presented to the firm and the adequacy of the financial institution's response to these findings;
xvii. Discussion on areas where management of the financial institution applied significant judgement and its impact on the external auditor's view of the financial statements and on the risk profile of the financial institution. This discussion would include the level of professional skepticism applied by the external auditor;
xviii. Any issues that affected communications between the external auditor and/or the Central Bank and/or the financial institution during the year that could be improved; and
xix. The future strategy of the financial institution and the impact that it may have on external audit and regulatory issues.

GLOSSARY

Bilateral Meeting	a meeting held between the Central Bank and a financial institution's external auditor (see Section 4.3.1).
External Audit	An external audit in this document refers to the annual audit of a financial institution under taken in fulfilment of section 77 of the FIA or 57 of the IA.
External Auditor	an independent firm of accountants, appointed by a financial institution pursuant to Section 81 of the FIA, to conduct an external audit on behalf of that financial institution.
Independent Director	a person as defined in the FIA – Section 36(6)(c).
Onsite Examination	refers to an examination of a financial institution conducted by the Central Bank. On-site examinations are generally used to determine the safety and soundness of the financial institution's operations and financial condition. Examiners evaluate the quality of the financial institution's assets; the effectiveness of internal controls, policies, and risk management systems; and compliance with relevant laws and regulations.
Regulator	means the Central Bank of Trinidad & Tobago as established under the Insurance Act, Chapter 84:01 and the Financial Institutions Act, 2008.
Skilled person	refers to an expert with the appropriate knowledge and/or skills relating to the business of a licensee and experience to prepare an objective report on the matters concerned. A skilled person may be an individual or a firm and includes, but is not limited to, the following: • auditor; • actuary; • accountant; • lawyer; or • any other person with the relevant business, technical or technological skills.
Trilateral Meeting	a meeting which includes the Central Bank, external auditor and the financial institution (see Section 4.3.2).