



Grant Thornton

Governance, Accounting and Auditing Policy Division
Policy and Risk Directorate
Central Bank of Ireland
PO Box 559
College Green
Dublin 2

By email to auditorprotocol@centralbank.ie

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24-26 City Quay
Dublin 2
Ireland

T +353 (0)1 6805 805
F +353 (0)1 6805 806
E info@ie.gt.com
www.grantthornton.ie

Dear sirs

CONSULTATION PAPER 56: THE AUDITOR PROTOCOL

Thank you for the opportunity to contribute to the consultation process for *Consultation Paper 56: Protocol between the Central Bank of Ireland and the Auditors of Regulated Financial Service Providers – ‘The Auditor Protocol’*.

We welcome the proposals to enhance the communications between auditors and the Central Bank, and we have made a number of recommendations intended to further strengthen and formalise these communications channels and facilitate the effective supervision of regulated entities.

The attachment to this letter contains our comments on the proposals in the Consultation Paper. Should you have any queries, please do not hesitate to contact me.

Yours sincerely

Aidan Connaughton
Head of Assurance Services
T +353 (0)1 6805 805
E aidan.connaughton@ie.gt.com

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L. Barrett BCL AITI, C. Blackwell FCA CIA CISA, C.J. Blackwell FCA, P. Burke ACA, A. Connaughton FCA, G.D. Costelloe FCA LL.B, N. Delaney ACA, B. Doherty FCA, S. Donovan FCA, S. Duignan, C. Feely FCA, B.P. Foster FCCA, D. Gleeson FCCA, J. Glennon ACA, P. Jacobs CA(NZ) FCCA, R.J. Leonard FCA, M. McAteer FCA FCCA, P. McCann FCA, N. Meenan FCA, T.M. Mullen FCA, J.A. Murphy FCA, S. Murray FCCA, M. Nearv FCA, J.M. Neville FCA, A.J. O'Carroll FCA, D. O'Connell ACA, J. O'Sullivan FCIS, P. Raleigh FCCA, A.J. Thornburv FCA, P. Vale ACA, F. Walsh FCA.

Introduction

Grant Thornton welcomes the emphasis being placed on the role of the statutory (external) auditor by CP56. The statutory audit process is an important control mechanism within all companies, and is a valuable means by which shareholders can be provided with assurance to support their reliance on the company's historical financial statements.

Background and scope of statutory audit

It is essential that the statutory audit is seen in its correct context. Specifically, the scope and objectives of an external audit are prescribed by the existing regulatory framework for companies, i.e. the Companies Acts 1963–2009 and Auditing Standards. An auditor is required to provide an opinion as to whether the financial statements of a company present a 'true and fair' view, and to state an opinion as to whether it is appropriate to assume that the company is a 'going concern' and whether there are material uncertainties about the company's ability to continue to operate as a going concern.

As such, the statutory audit focuses primarily on reporting to shareholders on historical information (the most recent financial statements) and to an extent on a company's current status, with regard to the appropriateness of preparing those financial statements on a going concern basis.

The scope and purpose of a statutory audit, as defined by the regulatory framework, is widely acknowledged as contributing to the much-discussed 'expectation gap', whereby an unqualified audit opinion is widely misunderstood to be a form of general approval of the overall current and future soundness a company, rather than a more specific opinion on its financial statements to date.

This limitation of the regulatory framework can only be remedied by legislative change to expand the role of an external auditor. We are pleased to note that there have already been proposals at both national and EU level to expand the scope of the statutory audit.

Statutory audit in the context of control functions

Good corporate governance of a company requires that its strategic objectives are clearly understood and aligned with the objectives of its shareholders; that risks to the achievement of those strategic objectives are identified and managed; and that internal controls mitigate risks to an appropriate level.

In light of the points noted above, it is clear that a statutory audit alone cannot provide sufficient assurance to shareholders or other stakeholders, particularly for companies that may be large, complex, risky or systemically important.

The principal control functions within a company, notably risk management, internal audit and compliance, have a scope and purpose that are complementary to external audit, and together should provide assurance that a company is appropriately governed.

The interests of shareholders and other stakeholders can therefore only be appropriately protected by a combination of external audit and the control functions within a regulated entity.

The role of the board and audit committee

The control functions report to the board and its sub-committees. The roles of sub-committees including the audit and risk committees, have been defined in the Corporate Governance Code for Credit Institutions and Insurance Undertakings, and require the board, through its committees, to monitor and supervise the performance of control functions, and to assess external auditor independence and the effectiveness of the audit process.

The Central Bank, as part of the existing supervision structures, maintains a dialogue with the board and audit committee, and it is this mechanism that should form the primary communication channel to enable the Central Bank to obtain information about the regulated entity.

Auditors' duty to report to the Central Bank of Ireland

There are existing requirements for auditors to report to the Central Bank in relation to the audits of regulated entities. These are mandated under legislation including the Central Bank and Financial Services Authority of Ireland Act 2004 ("CBFSAI Act"), and individual acts, specific to various types of regulated entities, referred to in the CBFSAI Act as 'prescribed enactments'. We believe that further additions to the obligations of auditors should use a similar model and therefore must be made via legislative change.

Recommendations

Our principal recommendation is that the objectives of the audit protocol should be incorporated into a broader and more fundamental review of the nature and scope of the statutory audit as it exists within the regulatory framework.

A review of the statutory audit process should aim to close the 'expectation gap' and to provide additional assurance to shareholders and stakeholders of all companies. The review should consider matters such as:

- whether auditors should review the adequacy of the compliance statement required under section 25 of the Corporate Governance Code (this is, according to the guidelines on the compliance statement, not currently required);
- whether auditors should review other regulatory returns;
- whether auditors should review and report on the adequacy of control functions and within companies;
- whether auditors should review and report on the adequacy of risk management and internal control within companies;
- whether enhanced disclosures, discussion and justification should be required for relevant information, including the auditor selection process, and the assessment of audit quality;
- whether the provision of non-audit services by auditors should be restricted or prohibited;
- whether restrictions on the auditor selection process should be implemented, e.g. mandatory audit firm rotation;
- whether the role of the audit committee should be further enhanced and emphasised.

The review should, at a minimum, cover the audits of regulated entities, but should also be considered for all public interest entities.

It must be noted that no external audit process, no matter how detailed and comprehensive, can ever eliminate the prospect of adverse outcomes or corporate failure. Nonetheless, greater assurance and a stronger external audit process are still possible, but this can only be achieved consistently and comprehensively if done via legislation.

In addition to these principal recommendations, we have included a number of more detailed comments relating to specific aspects of the draft audit protocol in the appendix to this document.

Conclusion

In summary, Grant Thornton is very supportive of closer working relationships between the Central Bank of Ireland and auditors of regulated entities. However, we do not believe that a protocol alone is sufficient to facilitate such closer relationships. The draft protocol states that it “does not extend in any way the nature and purpose of the statutory audit as required under legislation” — we believe that the nature and purpose of the statutory audit must be changed if greater value is to be obtained from the external audit process.

Appendix—additional comments

- Background, paragraph 1: this paragraph notes that the “traditional role of the external audit has been to provide confidence to investors and other stakeholders”. It should be clarified that the duty of care owed by auditors is solely to the shareholders, not to any other stakeholders, and in fact it is this traditional position that contributes to the expectation gap and prompts our recommendations above.
- Proposed Scope and Implementation, paragraph 8 refers to the risk-based approach to applying this protocol. Obviously clarification of how this will operate will be needed. Additionally, it should be clarified whether this implies that there will be a group of entities (i.e. lower-risk ones) to which none of these proposals will apply; if so, the implications of that should be carefully considered.
- Appendix 1, paragraph 5 refers to “material information”. Clearly it is important that further clarification is provided to ensure that auditors and the Central Bank have a consistent understanding of what information is considered “material”.
- Appendix 1, paragraph 7 refers to the requirement to amend the terms of the audit engagement. It is important to clarify how this will be enforced and what sanctions are available should either party to the audit engagement contract refuse to agree to such a term.
- Appendix 1, paragraph 10: we recommend providing further clarification of the purpose and objectives of the pre-audit meeting. In particular, it should be clarified whether an objective of the meeting is to allow the Central Bank to influence the scope of the audit. If so, then we believe that this raises issues related to legal duties of auditors, audit fees and timing, implications for the audit terms of engagement, and potentially issues of consistency of audit scope across different regulated entities. Thus if the intention is to influence the audit scope, then we believe that this will be better achieved through legislation rather than via a protocol.