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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉI- REACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 20 Bealtaine 2015

Wednesday, 20 May 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D'Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O'Keeffe.
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

sions with the banks about those business models solely in the context of how it impacts on our audit or the financial statements. I don't ... I don't ... that's where it would begin and end in terms of our interaction with that.

Senator Sean D. Barrett: Thank you, gentlemen. Thank you, Chairman.

Chairman: Thanks very much. Okay, that brings me to wrapping matters up. And, in doing so, I would like to thank Mr. Murphy and Mr. McDonnell for their participation today and for their engagement with the inquiry. The witnesses are now excused and I just want to take a brief suspension because there's some lines of inquiry, notification stuff that ... we just need to have a quick sit-down before we go to lunch. So with that said, I'll just suspend for two or three minutes to excuse the witnesses and we'll just resume in private session to deal with those matters promptly then. So Mr. McDonnell and Mr. Murphy, you are excused.

Mr. John McDonnell: Thank you, Chairman.

Sitting suspended at 1.15 p.m., resumed in private session at 1.17 p.m. and suspended again at 1.30 p.m. until 2.30 p.m.

Ernst and Young - Mr. Paul Smith and Mr. Dargan Fitzgerald

Chairman: I now propose that we go back into public session for this afternoon's engagement, is that agreed? Okay, and the committee is now back in public session for session 2. This is a public hearing with Mr. Paul Smith, former managing partner at Ernst and Young, and Mr. Dargan Fitzgerald, audit partner, Ernst and Young. The Committee of Inquiry into the Banking Crisis is now resuming in public session and can I ask members and those in the public Gallery to ensure that their mobile devices are switched off.

Today we continue our hearings with senior auditors who had roles during and after the crisis. This afternoon we will hear from witnesses from Ernst and Young, Mr. Paul Smith, former managing partner, and Mr. Dargan Fitzgerald, audit partner. Mr. Paul Smith is a former managing partner with Ernst and Young. He held this position from 2000 to July 2009, having been re-elected on three consecutive occasions.

Dargan Fitzgerald is head of Ernst and Young's insurance and audit practice in Ireland. He is a partner in Ernst and Young since 2000, and within Ernst and Young is the EBS's auditing partner. Mr. Smith and Mr. Fitzgerald are both very welcome here this afternoon.

Before I start hearing from the witnesses, I wish to advise the witnesses that by virtue of section 17(2)(l) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to this committee. If you are directed by the Chairman to cease giving evidence in relation to a particular matter and you continue to do so, you are entitled thereafter only to a qualified privilege in respect of your evidence. You are directed that only evidence connected with the subject matter in these proceedings is to be given.

I would remind members and those present that there are currently criminal proceedings ongoing, and further criminal proceedings are scheduled during the lifetime of the inquiry, which overlap with the subject matter of the inquiry. Therefore, the utmost caution should be taken not to prejudice those proceedings, and in this regard, I remind members and those present, that Mr. Paul Smith and Mr. Dargan Fitzgerald are here today to discuss their roles as auditors with

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Ernst and Young of EBS. While Ernst and Young also acted as auditor to Anglo Irish Bank, due to the current criminal proceedings before the courts, Ernst and Young's role as auditor of Anglo will not be examined by the joint committee at today's hearing, so as not to prejudice those particular proceedings.

So with that said, members of the public are reminded that photography is prohibited in the committee room. To assist the smooth running of the inquiry, we will also display certain documents on the screens here in the committee room. For those sitting in the Gallery, these documents will be displayed on screens to your left and right, and members of the public and journalists are reminded that the documents are confidential and they should not publish any of the documents so displayed.

The witnesses have been directed to attend this meeting of the Joint Committee of Inquiry into the Banking Crisis and you have been furnished with booklets of core documents. These are before the committee and will be relied upon in questioning and form part of the evidence of the inquiry. So with that said, I now ask the clerk to administer the oath.

The following witnesses were sworn in by the Clerk to the Committee:

Mr. Paul Smith, former Managing Partner, Ernst and Young.

Mr. Dargan Fitzgerald, Audit Partner, Ernst and Young.

Chairman: Thank you again, Mr. Fitzgerald and Mr. Smith, and in whichever sequence you choose, if I can ask and call on you to make your opening statements to the inquiry, please.

Mr. Paul Smith: Thank you very much. Good afternoon. My name is Paul Smith. I joined Ernst and Young in 1973, specialising in tax, and became a partner in 1982. I was based in the firm's Irish tax desk in New York between 1994 and 1996, before returning to Ireland. I was managing partner from 2000 until 2009, when I retired from the firm.

I hope my remarks today can assist the committee with its inquiry. I will briefly outline my role and responsibilities as managing partner before and during the banking crisis. I will explain how we undertook our audits of EBS, the role auditors played generally, and my reflections on lessons learned from the banking crisis.

As I outline in my written evidence, I was responsible for the strategy, management and leadership of the firm, working with my colleagues in the firm's management committee. I was also responsible for dealing with specific issues referred to me as managing partner, from time to time. An important part of my role was to represent the partnership externally, and within the EY network internationally.

EY Ireland has several divisions and practice areas, covering various professional disciplines and sectors. One of these is our financial services group, and the partners in this group carried out the audits of banks and other financial institutions. The partners and staff of this group were specialists, highly experienced and conferred regularly. They had available to them the depth of resources and expertise, both in Ireland and internationally, that were required to operate to the highest professional standards when providing services to large and complex financial institutions. The partner in charge of the financial services group kept me and my colleagues in the management committee up to date on significant developments in the sector and on matters relating to individual clients, where necessary.

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

While I was not involved in the planning and execution of individual audits, I understood the fundamental principles underpinning the firm's approach. Significant issues would be referred to me if they required my attention. The management committee and I engaged particularly closely with the financial services group as the banking crisis unfolded. We knew that our colleagues were responding to the challenging environment, increasing the extent of their audit work, and that significant additional resources were allocated.

While I was aware of the increasing challenges facing Irish banks, no issues were referred to me as managing partner at any time with respect to our audit of EBS. Nor, as far as I am aware, did we ever receive any complaint from EBS. I appreciate that the committee may have questions about our audit. As I am not an auditor, and as no issues were referred to me with respect to the audits, I have proposed that my colleague, Dargan Fitzgerald, should appear alongside me, and the committee has invited him to do so. He was the audit partner of EBS for 2007 and 2008. Dargan is EY's audit compliance principal, and an audit partner specialising in the audit of financial institutions, and is better placed to answer detailed questions on the EBS audits, and on audit procedure generally, than I am. I have read the evidence Dargan has supplied to the committee, and I agree with it to the extent of my own expertise. I have also discussed this opening statement with Dargan and my former colleagues in EY Ireland.

While I don't claim to be an auditing expert or to have reviewed the EBS audit files, I am confident that the EY audit team properly performed its responsibilities as statutory auditors of the financial statements of EBS. I believe that EY undertook its duties as statutory auditor professionally and diligently, in accordance with international auditing standards. The audit opinion on the EBS financial statements reflected the applicable statutory requirements. In accordance with normal practice, the audit team also reported in greater detail to the audit committee and to the board of EBS, drawing their attention to any management and control issues identified during the course of the audit. Finally, the audit team also communicated with the Financial Regulator as required.

Our audit reports offered all stakeholders reasonable assurance about the state of EBS at a particular point in time. In particular, the financial statements presented by the directors were true and fair. The presentation complied with accounting standards. It is worth noting that our audit opinions have not been subsequently challenged. EBS has not restated its accounts for 2007 or 2008. Statutory audits are not designed to provide advice on future business models, or commercial decision making. Neither is it the auditor's role to advise on risks to the business, particularly business risks, which are market wide and not confined to a single entity or job review. During ... dealing with these risks, it is the responsibility of the management, their advisers and regulators. It is inappropriate for auditors to advise on these questions. To do so would compromise their independence. It is fundamental that auditors do not audit their own advice.

But I do understand why people ask why auditors didn't warn the banks of the risks of their decisions. The first thing to say is that it is now clear that the combined risks were underestimated by all stakeholders at the crucial time, that is, the period leading up to the peak of the boom. Second, it is important to view this question in the light of the statutory role of an auditor and the parameters and limitations of that role. The focus of auditors was on the risk that previous years' financial statements had been materially misstated. Therefore, at the start of an audit, we're looking back at the decisions that have already been made and the income and expenditure of the company of the year that has passed. Third, it was the responsibility of each bank's board, under the supervision of the prudential regulator, to run its business and to determine its commercial strategy and its appetite for risk. If we had issues about a particular

commercial strategy, then our role would be to ensure that those charged with the governance of the client were aware of those issues and that the impact of the financial statements at the year end was correctly reflected.

In terms of our role at the time, however, the auditor's primary function was to carry out a statutory audit of the company's financial statements and to express an independent opinion on them. I believe that the statutory audit does play an important role. It provides an independent, professional opinion, based on an audit conducted in accordance with international auditing standards. It records the auditor's opinion as to whether the financial statements conform to international accounting standards and whether they provide a true and fair view of the company's position and results over a particular period. Financial statements are inherently historic, reflecting the position up to the previous year end. Of necessity, decisions by a company and the regulator are based on more current, but non-audited information, such as the company's own management information, the books and records which the company is legally required to keep and the detailed returns supplied by the company to the Financial Regulator.

It is important for me to acknowledge that the banking crisis has had devastating consequences for individuals and families all over Ireland. The effects have been humbling for anyone involved in financial services and I understand the loss and the anger of people who have suffered. Everyone connected to the financial services industry at the time has reflected on their own role in the crisis and how the regulatory environment can be improved. It is important that this reflection happens and EY and the audit firms generally are no exception to that. As I have explained, auditors perform the role required of them but that is no cause for complacency. We believe that many users of financial statements generally understood the purpose and limitations of an audit but we accept that many observers expected more from the audit process than a statutory audit was actually designed to deliver.

Since the crisis, EY Ireland, our international colleagues and various authorities have considered how audit can be made more useful. Changes have been made in several areas and Dargan will refer to these in his opening statement. But more can be done. I'd like to use my remaining few minutes to suggest areas where some changes could be made in the future to improve the usefulness of audit. I understand that auditors are now better able to communicate to the regulator. This communication with the regulator, in my opinion, should be in both directions. Specifically, the regulator should be permitted and encouraged to exchange information with auditors. That is my first recommendation.

I am sure my colleagues will continue to support strengthening the role of audit committees and internal audit functions within companies. I understand that progress has been made on this point, but that it's a continual process, and Dargan can answer questions on that subject. And that is my second recommendation. My third and final recommendation is based on discussions I have had with former colleagues since being invited to appear before this committee. Insurance companies are required to provide detailed information to regulators in their regulatory returns and to ask an external auditor to provide an opinion on those returns. It seems logical to me that banks and other financial institutions could be subject to the same requirements. Their returns could be independently audited as well. That would improve the transparency of the system and increase regulators' confidence in the information that financial institutions provide. It would also ensure ... it would also serve to ensure that auditors were aware of current trends in the Financial Regulator. That is my third recommendation.

So, to sum up, I believe that EY performed its statutory duties, in accordance with auditing standards, and carried out high quality audits on the EBS financial statements and that those

financial statements provided transparency and reasonable assurance to investors, regulators and policy makers in respect of the company's financial performance during the period covered by the financial statements. I understand the distress and anger of people who have suffered as a result of the banking crisis and I've reflected on the causes of the crisis. And I've also commented on improvements since the crisis and suggested some further possible improvements. I welcome the opportunity to speak to the committee and I look forward to your questions.

Chairman: Thank you very much, Mr. Smith. Mr. Fitzgerald.

Mr. Dargan Fitzgerald: Thank you, Chairman. Good afternoon. My name is Dargan Fitzgerald, I am an audit partner, specialising in the audit of financial institutions, and EY Ireland's audit compliance partner. I was the audit partner for EBS for the years ending 31 December 2007 and 2008. I am happy to endorse the comments made by Paul and I would like to add some detail regarding our audit of EBS.

Paul has addressed a long-standing question on the role of audit and the apparent misapprehension that it was the role of auditors to advise on banks' prospective commercial lending strategies, strategies which proved extremely successful for some banks for some years, but which ultimately left the banks exposed in the global recession. As Paul mentioned, auditors do not advise on the business models which our clients adopt. We do not advise clients on the wisdom or prudence of their commercial decisions. Stakeholders do not and should not look to audits to provide commentary on business risks. Auditor independence is a fundamental principle and we could not provide an independent audit while simultaneously advising management.

When considering the impact of the banking crisis on EBS and the commercial strategies it adopted, the turning point as identified by various investigations into the crisis appears to have been the board's decision in 2005 to follow the example of its competitors by increasing its exposure to development property lending. While the board of EBS has since described that commercial strategy as, I quote, "a mistake", I have no reason to doubt that it was adopted in good faith by the EBS board at that time. I know that the board was satisfied that such a commercial strategy was in the best interests of EBS. As far as I am aware, the Financial Regulator did not raise an objection at the time. EY Ireland was not consulted on the decision to adopt this strategy. Our firm had no role in the EBS decision to adopt that commercial strategy in 2005. On the contrary, as statutory auditors, it was important that we were independent of this commercial decision making. Nevertheless, if, during our audit work, we became aware of control weaknesses or of issues which gave rise to a significant risk of misstatement of the financial statements, then we would draw these matters to the attention of those charged with governance. There were various issues that we identified and raised with management over the years, as can be seen from the core documents which are before the committee.

However, future commercial decision making and its associated risks and financial consequences were matters for the board. It was the auditors' role to express our view as to whether the financial statements fairly presented the institution's financial performance for the particular period. In our opinion, the EBS financial statements did so. For example, the 2008 annual report presented by the directors, which accompanied the financial statements, acknowledged the unsuccessful commercial strategy and the resulting losses and impairment provisions as at 31 December 2008. The 2008 annual report, presented by the directors, also disclosed that those provisions and losses were likely to increase in subsequent periods.

Now with hindsight, the banks' business models and lending practices have attracted universal criticism. I agree that, in the light of what transpired from 2008 onwards, many of the

banks' earlier commercial decisions have proven extremely damaging. The exposure of individual institutions in Ireland and elsewhere became increasingly obvious as the credit crisis developed. By the time Lehman Brothers collapsed, it was evident that the banks were in serious difficulty. By that time, far less development lending was taking place in Ireland in any event. The board of EBS had taken the decision to stop development property lending by April 2008. However, by then the damage had been done before the frailties of the system had been laid bare when global liquidity abruptly dried up.

The need for foresight on the part of those responsible was greatest at the time at which the banks embarked on development lending at what, with hindsight, we now know was the height of the boom. I cannot say that the auditing profession foresaw these developments any more than any other stakeholders did. However, unlike the directors and the prudential regulator, our primary responsibility was to provide an opinion on the past year's financial statements and to consider the risk that those historic financial statements were misstated. A statutory audit is not designed to anticipate future trading risk. That would be akin to a corporate finance role, a very different function. The auditors did not make any assessment prior to the 2008 audit that EBS's business strategy left them unacceptably exposed in the event of a future financial crisis, nor, as I have outlined, was it the auditors' responsibility to do so. We were aware, as auditors, that EBS had changed its commercial strategy, increasing its development lending. This was following a strategy which was widely viewed as being successfully pursued by other Irish banks. Our approach to the audit of the last year's financial statements reflected our understanding of the strategy being pursued. It was not our role as auditor to advise on the mix of commercial and residential lending which EBS should adopt in the future. Nevertheless, if the auditors had been concerned about the wisdom of EBS increasing its development property lending, what could or should they have done? Disagreement with the bank's commercial decisions would not have been a basis to resign or to qualify the previous years' financial statements, unless, for example, those financial statements were misstated or there were corporate governance issues which had led the auditors to doubt the integrity of management. Furthermore, the auditors were constrained by client confidentiality and could only have divulged confidential information to the Financial Regulator in limited circumstances, such as where there had been a regulatory breach. None of these three scenarios had occurred in the case of EBS. Accordingly, the auditors' only option would have been to ensure that the directors were fully aware of management's actions. In this case, as is clear from their annual reports, the directors of EBS were aware of and had endorsed the increase in development lending.

I agree with Paul that we carried out high-quality audits of EBS's financial statements throughout the period. In preparing for the session, I discussed the changes that have taken place since the financial crisis with Paul and also the changes that could happen in future. I will briefly outline the changes that have been implemented already.

First, dialogue with regulators is an important consideration. At the time, auditors did not have an open channel of communication with the Financial Regulator. Bound by client confidentiality, auditors were limited in the information they could divulge, except in exceptional circumstances such as a suspected regulatory contravention. I should be clear that, as audit partner, I had no particular concerns or no particular information in respect of EBS which I felt should be divulged to the Financial Regulator. That said, the desirability of a more open and two-way dialogue with prudential regulators is a clear lesson from the crisis. Progress has indeed been made on this point. The Central Bank's auditor protocol provides a framework for auditors to raise issues about financial institutions with the prudential regulator, now the Central Bank of Ireland. This is welcome and consideration should be given to placing this on a formal

basis and to enabling communication in both directions. The Financial Regulator, who has greater market-wide visibility, may well be able to inform the auditor's approach to the audit, ensuring that the auditor can take account of the regulator's concerns during their audit work.

The second area where progress has been made is on accounting standards. Accounting standards provide a common international approach to the presentation of financial statements, just as auditing standards promote consistency in approaches to audit. Changes have been made to accounting standards to allow financial institutions to report unexpected losses in their loan book, as well as reporting actual incurred losses. The need for this change was recognised internationally in the wake of the banking crisis. The standard setters have worked hard to engage with all stakeholders following the crisis, including EY, and I welcome this change.

Thirdly, I support strengthening the role of audit committees. I believe that audit committees should be strong, dedicated and fully engaged in carrying out their functions. They are there to represent shareholders and to challenge management. Strong audit committees ensure financial reporting is scrutinised and challenged. Again, this is an area where progress has been made but more could be done.

Finally, and perhaps most significantly, changes have been made in prudential regulation and in capital requirements for banks through Basel III and other regulatory initiatives. The committee will be well aware of the scope of these changes and of their impact. Prudential regulation and international capital requirements, the responsibilities of the board, especially non-executive directors and management, all play their own roles. However, it is important to emphasise that audit forms only one part of the wider system of assurance available to stakeholders. It is important that audit, as part of this system of assurance, continually improves and becomes more useful to all stakeholders. Therefore, as we look to the future, I'm happy to endorse Paul Smith's three recommendations.

That concludes my statement and I welcome any questions the committee might have.

Chairman: Thank you very much, Mr. Fitzgerald, and I also thank you for your earlier contribution, Mr. Smith. If I can now invite Deputy Joe Higgins. Deputy, you have 25 minutes.

Deputy Joe Higgins: Yes. Gentleman, and just to reiterate that you were also auditors for Anglo Irish Bank but due to current criminal proceedings before the courts and to avoid any danger of prejudice to those proceedings, it's not for today ... in relation to Anglo, it's for another day.

So, Mr. Fitzgerald, if I could ask you, when you audited EBS in 2007 and 2008, you provided an unqualified independent audit opinion. Could you just say, in a nutshell, what that means technically?

Mr. Dargan Fitzgerald: Certainly. So the audit opinion spans typically two pages and "in a nutshell" is possibly slightly challenging, as it actually covers a number of different statutory and legal requirements. The principle of those is that it confirms that the financial statements have been prepared, in our opinion, fully in compliance with international financial reporting standards. It also complies ... it also confirms that the financial statements are reported in a framework fully in compliance with relevant company law. In this ... in this case, relevant law may include building societies Acts, given that it was a building society.

Deputy Joe Higgins: And in view of what happened subsequently to EBS and some of its loans and with hindsight, would you now provide those same opinion that the accounts gave a

true and fair view?

Mr. Dargan Fitzgerald: Yes, I would provide the same opinions, in my view, and, in making that overall comment to you, I would comment that the ... you mentioned subsequent events after that and you mentioned the effect and benefit of hindsight and I think even with the benefit of hindsight, the important reference point, as I mentioned, is the applicable financial reporting framework of the time and the fact that the accounts are drawn up to a particular point in time, in this case ... in the case of the 2008 financial statements, 31 December 2008.

Deputy Joe Higgins: And, Mr. Fitzgerald, when NAMA acquired EBS loans, NAMA imposed a 57% haircut on the nominal value of those loans. I think it was from something like €900 million to €400 million. Why was this cut so drastically high?

Mr. Dargan Fitzgerald: Well, Deputy, first of all, I am not sure I can really comment as I wasn't involved in that process and, you know, the approaches taken by NAMA in relation to the banks and the actions it carried out resulted, I understand, in different levels of discount, depending on the nature of the portfolios taken over. So, I actually can't speculate as to how exactly those numbers were arrived at. It's probably important to bear in mind that ... that two calendar years, I think, at least, had elapsed by the time that process took place with NAMA and so I think the importance of the phase of the economic cycle, with reference to audited financial statements, is very crucial. And, again, the point I'd refer to is that the financial statements for 2008 are drawn up to a point of time and that the audit opinion confirms that they give a true and fair view in accordance with the applicable accounting standards relevant at that time.

Deputy Joe Higgins: And when you were auditing EBS, were you satisfied with the valuation methodology used by EBS in assessing the value of land and development loans and the potential impact on the subsequent provisioning? And you may be aware of heavy criticism by NAMA's chief executive and chair, when they were in here, in a general comment on the banks in relation to the valuation and the type of securities, etc. Were you satisfied?

Mr. Dargan Fitzgerald: In broad terms, I must say the answer to your question is "Yes" and, if I just give a little bit of background, in terms of our review of the loan book generally, we, as you would expect, take a view based on a sample weighted towards higher value and more risky loans and our audit work comprises a number of tests of those loans. It also rests on tests we have carried out during our audit of the systems and processes that lead to the booking and recording of the loans. And, in that context, when we come to the year end or balance sheet part of our audit, as it's called, we also examine the loan files and review further documentation and obtain appropriate explanations from management in relation to the status of the loan as of the balance sheet date. And, in doing that work, we also review any property valuations that have been carried out. Sometimes these are formally required by the bank and they are third-party valuations from external valuers. In some cases, they're values derived internally from either analysis of cash flows or updating of previous valuations. In any of the work we carried out, generally, I must say, the work was very satisfactory. We had few, if any, occasions where we were unable to obtain a satisfactory explanations for management for the decisions they had taken in relation to any valuation for impairments on loans and that's ... given the fact that the market at the time was showing the beginnings of considerable uncertainty in relation to the values of collateral in cases where loans were already stressed.

Deputy Joe Higgins: Okay, thank you. Mr. Fitzgerald, the Financial Regulator reviewed EBS residential mortgages lending in 2007 and found that 7.35% of home loans were outside policy; 24.3% of home loans-----

Chairman: To reference that document there for you, Deputy, it's pages 17 to 18-----

Deputy Joe Higgins: Yes, that's page 17-----

Chairman: -----of the Financial Regulator-----

Deputy Joe Higgins: -----of the core documents. 24.31% of home loans approvals exceeded affordability; and buy-to-let cases ... 15.82% were outside policy. And in a further letter from the regulator, which is page 21, in relation to the level of exceptions to policy ... "The level of exceptions to the Credit Policy for the eleven months to 30 November 2007, was 29.2%" but in 2006 it had been 42.1%. Is that an inordinate exception level and was Ernst and Young concerned about the extent of loans that fell outside policy?

Mr. Dargan Fitzgerald: Thank you. So, a couple of comments. First of all ... and I'm familiar with the references that you gave in those two documents, thank you. First of all, I just need to distinguish between the role of the Financial Regulator in issuing such letters and our role as external auditors and you'll appreciate that the Financial Regulator's role as a supervisor is based on its detailed programme of work which has a very different scope and aim compared with the ambit and role of the external auditor. So, I would say, firstly, as a general comment to the committee, that one may not be comparing like with like in asking for external auditor comment on such things. We have a very clearly defined role in relation to what we do with such regulatory correspondence when we ask for it and, of course, come across it. This is governed by one of the auditing standards - compliance with laws and regulations. And we are required to understand the content of such reports and then assess how they impact our ... our audit. And, as I mentioned in some of my previous comments, our audit is ... the possible effect on our audit is in relation to the risk of misstatement of the reported balance sheet or income statement amounts. So, I just want to make the point that such comments by the Financial Regulator do not directly impact or correspond with or feed into external auditor assessment other than they may ... they may inform our risk assessment as to where we should focus our effort of our audit. So you-----

Deputy Joe Higgins: I know, Mr. Fitzgerald, that you're the fourth cohort of auditors that have come before the inquiry and all have been extremely insistent on emphasising the narrowness, perhaps, if I put it like that, or the narrow parameters of the audit role. But do you say that the auditor has no role in reviewing loans, such as I quoted from the regulator, that fall outside of policy?

Mr. Dargan Fitzgerald: I would say they don't necessarily have a role in reviewing them in the same way and from the same perspective as the Financial Regulator does. The Financial Regulator may be more concerned with aspects of adherence to procedures and they may be more concerned with aspects of documentation of procedures, whereas the external auditor's role is, as I mentioned, to assess whether any of the items highlighted by the regulator do, and I must say it is in a background way ... whether they affect the risk assessment of the auditor in carrying out the auditor's tests. So that is not to say that if there was something that alarmed the auditor, it should not be taken into account. If it had a pervasive effect on financial reporting, it absolutely would be taken into account. I think it's important, in relation to the items you've highlighted, to understand that as when we, as auditors, take samples of loan files, we do look for characteristics relating to both the administration and the credit approval of the loan and we carry out tests of the underlying data. Exceptions to policies may be relevant, although sometimes those exceptions just show that there's been a particular activity level in a particular sector. They may not indicate that anything is wrong with the financial reporting; they're more

internally procedural. So, in summary, my answer, Deputy, is we take it into account or we may take it into account but we don't necessarily actually retest it or factor it directly into our work. I hope that's helpful.

Deputy Joe Higgins: Mr. Fitzgerald, not just ... your ... as you said, I think, or it's a fact anyhow, that EBS turned to property and development loans to achieve growth and profits and that this was a characteristic of all the financial institutions in the bubble, some, to what has been referred to, as an excessive degree - what one of the witnesses here, Mr. Black, a regulator ... a former regulator from the United States, called "crazy growth". Would a person of your experience and your firm's experience, notwithstanding the narrowness of the parameters of audit as you see it, would that not have set alarms bell ringing in, say, 2005, 2006, as the bubble expanded?

Mr. Dargan Fitzgerald: Well, to answer your question and your comments, first of all, just to highlight that I mentioned that in public record in their annual reports, the reference to development property lending is explained as having taken ... decisions having been taken place in 2005. I think, as a matter of fact, the substantial, or relatively substantial, development property lending, the bulk of it, took place, I think, in 2006 and 2007, a relatively short period before in, as I think I mentioned and it's in the public record, in April 2008, that development lending was ceased. So, it's actually a relatively short period for any problems to emerge with loans or, indeed, the extent of the exposure to be reassessed. And I would just say in that context that development property lending was disclosed in the various footnotes to the financial statements, as you are aware, and I also would comment that my view is that it was not a ... I'm sure it did not seem at the time to be a very large proportion of the balance sheet of the building society.

Deputy Joe Higgins: Yes. Did you have any occasion in relation to any concern about exceptions to lending policy to report that in any formal way? As you said, it's in the accounts, but did you have ... was attention drawn to this in any formal way as a result of any concerns Ernst and Young had?

Mr. Dargan Fitzgerald: I think the short answer is "No" and if I just explain, that's because in the course of our work, we were not ourselves coming across any of the exceptions in the way in which, I think, your comments are referring to the Financial Regulator's comments. We may not have been testing for what in testing terms we call "that attribute" in our testing. We would have been, perhaps, concerned with the set-up of the loan, the overall approval of the loan and that particular aspect may not have, as I mentioned previously, been a particular item for which we were testing at that time or in that case. And, as a general matter, and as you can see in the core documents that are before the committee, while we brought various matters to the attention of the audit committee, which we found during our audits, of a control compliance nature or of financial reporting or judgmental nature, credit exceptions were not one of those which we came across and, therefore, they did not fall to be reported.

Deputy Joe Higgins: Okay. Mr. Fitzgerald, in 2008, Ernst and Young identified a "going concern" problem with EBS in relation to an outflow of funds, a fall in share prices, and then you have the guarantee-----

Chairman: I'll just reference the document there as well, Deputy Higgins, while you're getting the ... page 25 to 28 of the core documents.

Deputy Joe Higgins: Yes. Did you consider a review of the assessment of going concern in any previous year, in 2006 or 2007, for example?

Mr. Dargan Fitzgerald: Yes, I can confirm that in each year there is a formal assessment of going concern, typically both by the directors of actually, of all entities subject to external audit and that going concern assessment is initially carried out by the directors and, in fact, it's part of the representations which auditors annually receive that the directors have satisfied themselves that the going concern basis continues to be appropriate. So, yes, to answer your question, in each year, there's a formal assessment of going concern, both by the directors and by the auditors.

Deputy Joe Higgins: But you expressed concern in the 2008 ... was there any form of concern in relation to that issue in any of the previous years?

Mr. Dargan Fitzgerald: Only as I mentioned ... well, my direct knowledge is only of 2007 and it would have been in the context of what our mandatory audit procedures to assess going concern and from my recollection of that year, there would have been a formal going concern assessment from the directors. If I could just highlight in the documents and I'm referring to document 25 and if I could just highlight that the words used in the document are, "We have identified from our market knowledge that there is a potential going concern problem for EBS and for all Irish credit institutions". So I just would like to highlight that it's "potential" and really what that is saying is we are. ... [and the note is dated 14 February, within a few weeks of the approval by the directors of the financial statements] ... we're confirming that, as a matter of ... as a matter of logic and one might say common-sense in the circumstances of their time, there would fall to be a greater focus on going concern for all banks, given that they were then, in the case of domestic institutions, availing of the Government guarantee scheme. So by definition, there was a potential going concern issue for all banks which all auditors, I'm sure, considered very carefully at the time.

Deputy Joe Higgins: Mr. Smith, if I could turn to yourself, just in conclusion, and in a more general way. I think you hinted yourself and certainly your counterparts in the other three major auditing firms are adamant that no one, as it was put today, could have foreseen the collapse in the banking system and the crisis and the crash that resulted from the bubble, but could I just put it to you: Ernst and Young is a massive international organisation, you are in 150 countries, you have 190,000 employees, your income gross in 2014 was €27.4 billion, I guess ... or dollars ... so you're a huge organisation with huge resources and expertise. Now, Mr. Smith, considering, for example, the history of your company in the United States, which would have seen the loans and savings debacle in the '80s and the '90s and the huge crash that happened there and then in the Scandinavian countries in the late '80s and the '90s, Sweden for example, a modern capitalist, industrialised society with a huge bank ... banking crisis, all as a result of speculative lending and of excessive rates of growth, would it be reasonable or not to say to a company like yourselves, you should have seen that what was happening in Ireland was really a replica of what caused all these previous bubbles and disasters? And, indeed, others did see in advance. I just put it to you for comment, if you like.

Mr. Paul Smith: Thank you for your question. Undoubtedly, these cycles of boom and bust come all the time and in many, many jurisdictions, but I have to say, as a matter of fact, we, notwithstanding our large international network, did not feel any different from, I would say, almost the unanimous view of the commentators in Ireland on the economic situation in Ireland that the two events which occurred, the liquidity crisis and the crash in property values, we did not anticipate that.

Deputy Joe Higgins: Yet we had a witness in front of this, an economic commentator, David McWilliams, who said: "I think the Irish property crash and the banking crash were both

incredibly predictable and absolutely preventable.” And then he made reference to statements he made in 2003 in relation to the bubble and the banks and the huge extension of loans we had. Another witness, Alan Ahearne, referred to a 2005 report that was published by the US Fed, a study of dozens of booms and busts. And, finally, we had Professor Morgan Kelly in late 2006 and again in 2007 similarly, studies of international boom and bust, and drawing the conclusions that it was inevitable. We had all the same features in Ireland. It was, therefore, inevitable that it would end in a disaster. Why ... that was their conclusion. Why did an organisation like yours, as I said, with resources and expertise not draw the same conclusion?

Mr. Paul Smith: Well, Deputy, those were individual points of view, but I have to say they wouldn't correspond in my recollection ... and remember, it's six years ago now and further. In my recollection, that didn't correspond with the widely held view by the vast majority of commentators that what Ireland was experiencing - the growth that Ireland was experiencing - would slow down and that there would be a soft landing. That was by far the most widely-held view. So, I agree that there were individual people who spoke out at various times, but if you look over the whole broad level of commentary around the financial crisis, those were very few views in the overall crowd.

Deputy Joe Higgins: Could I ask you, finally perhaps, Mr. Smith, would you see any ... would you agree in any way with some assertions that have been made in evidence here that, in the course of the bubble, you had institutions making inordinate, or massive by any scale, profits? You had senior executives in financial institutions and perhaps in related professions reaping extensive bonuses and huge material rewards linked to the rapid expansion. Would you say in any sense that that might have blinded people or not to the dangers and left people carry on even if they had some inkling that perhaps this could end in tears?

Mr. Paul Smith: Well, I can't speak for people in other institutions, but I can say that the auditors in Ernst and Young were not blinded by those circumstances and carried out their duties as sceptical auditors independently and I believe arrived at the correct conclusions in terms of providing an audit opinion on the accounts of EBS.

Deputy Joe Higgins: Thank you.

Chairman: Thank you very much. Next questioner is Deputy Kieran O'Donnell. Deputy, you've 25 minutes.

Deputy Kieran O'Donnell: Thanks, Chairman. I want to welcome Mr. Smith and Mr. Fitzgerald.

Mr. Paul Smith: Thank you.

Deputy Kieran O'Donnell: Can you recall any issue, which may have warranted qualified report, which was discussed with the bank but did not feature in a management letter?

Mr. Dargan Fitzgerald: No, I cannot, Deputy.

Deputy Kieran O'Donnell: Did the adoption of IAS 39 mean that the audited financial statements no longer had to comply with true and fair standard, the previously ... that was previously accepted?

Mr. Dargan Fitzgerald: I might just make some comments on that. I'm aware that that topic has come up, both in this room and elsewhere, and the short answer is, no, I don't feel

that there is any conflict between international financial reporting standards and the true and fair view. And in particular in relation to the EBS audit in 2008, I'm quite satisfied that the appropriate accounting framework was employed and therefore that, as auditors, we were entitled to report in true and fair terms, as it's called.

Deputy Kieran O'Donnell: If IAS 39 came into being from accounting years from 1 January 2005 onwards, if IAS ... which appears to, you know, by way of fair comment, have coincided with the massive growth in loans - development loans - in the banks. If IAS 39 had not been introduced, would there've been a difference in the way you reported and would there've been a difference in the way losses were reported in the accounts of EBS?

Mr. Dargan Fitzgerald: Well, I must say that's a difficult question to answer because one would have to rework the historical fact patterns to arrive at a conclusion. I must say my sense of it is I doubt if there would've been much difference, but that would have to be tested by a very rigorous analysis. In ... conceptually, the regime prior to IFRS was not fundamentally different and it ... while I can't speak for any of the EBS report results-----

Deputy Kieran O'Donnell: But you would've provided expected losses, as well as incurred losses, under the old regime prior to ... IAS 39 purely restricted it to incurred losses, but you would've been ... effectively, as an auditor, you would've looked to have losses provided on an expected losses basis prior to IAS 39. Correct?

Mr. Dargan Fitzgerald: I'm not sure that the position is quite as simple as that and quite as clear cut as that. And as I wasn't the auditor to any particular bank, actually, at the transition date to IFRS, I can't comment in a sort of live environment, so I'm not sure I could really speculate as to that. My overall sense is that, as a general matter, that the statement is ... needs to be qualified by careful analysis of any differences between pre-existing GAAP, as it's called - generally accepted accounting practice - and IFRS. I think the key point ... I mean, I can only speak for the audits that I was involved in, 2007 and 2008. You're absolutely correct and, as I referred to in my opening comments, they employ ... in applying IFRS and particularly international accounting standards relating to loan loss provisions, they employ the incurred loss model. I think, and I think it's now been widely debated ... I think it's clear that that does comply with reporting requirements requiring a true and fair view as the applicable reporting requirement of the time.

Deputy Kieran O'Donnell: Did ye have an issue with the introduction of ISA 39 as an accountancy organisation? Did you make your views known to various bodies, your own institute and so forth? How did you feel about IAS 39 being introduced?

Mr. Dargan Fitzgerald: Well, actually, I can't speak for the generality of the firm or the management of the firm that time. My feeling is that there was no particular issue, inasmuch as accounting standards do constantly evolve. In all GAAP frameworks, generally accepted accounting practice, and in all IFRS, international financial reporting standards, governed by the International Accounting Standards Board's frameworks, there are, as I'm sure you know, annual improvements projects. These often involve significant updating or rewriting of standards. This is typically in response to consultation with stakeholders and they typically involve very large groups which give expert opinion and the opinion of stakeholders as to how standards should best evolve.

Deputy Kieran O'Donnell: Can I go to EY - Vol. 1, page 31, which is basically your reporting requirements to the regulator in respect of 31 December 2008 accounts? And I want

to reference this document back to your own internal memo, page 25 of the same document ... on page 27, paragraph 3. And you reference in it that - the paragraph I'm doing is paragraph 4 on page 31, "EBS internal reports indicate that it ha[s] not been compliant with this requirement on certain dates during March, November and December 2008". And you said, "Under Requirement 6.3, certain limits [as] prescribed for two separate time bands. In the second time band prescribed, cash [flows] are required to equal at least 90% of [the] cash outflows." And in your own internal memo on page 27, you say that "In a Big 4 meeting with the Central Bank on Friday 21 November ['08] the Central Bank representative twice stressed that [the] non-compliance with these tests did not mean a bank was insolvent." So, first of all, were you surprised with that comment from - or not from - the regulator and how did that feed into your review in terms of going concern for EBS for the 31 December '08 accounts?

Mr. Dargan Fitzgerald: Thank you. First of all, in relation to any concern or reaction to the regulator's comment as reported, I am not surprised reading that account. I feel that the regulator was likely anxious to emphasise that, in times of liquidity stress in the financial system, there would from time to time be breaches of what may have been quite stringent regulatory requirements around future expected cash flows. And in essence, I feel the Financial Regulator was emphasising that these might be catered for by, as it turned out, Government support in terms of the Government guarantee, or, indeed, other measures that the banks might be able to take. Then in terms of your reference to ... and I hope I have the same reference ... 31 ... our letter of 6 March and you referred to the ... to our making of a report of these items. There was no latitude for us to fail to report these, as they were required under those regulatory instruments.

I think the last part of your question was whether they were ... these were factored into the question of going concern. And I can confirm, absolutely, liquidity was one of the key aspects of going concern considered, of course, by the directors initially in their papers and consideration, and, secondly, by us as external auditors. We ... we would have been aware of matters of this nature. In fact, it's exactly as you highlighted in your comments. I don't think they were particularly serious, but they were absolutely required to be reported to the regulator when we were aware of them, which we duly did.

Deputy Kieran O'Donnell: And were ... were you ... did ... were you aware at any stage in the '06 and '07 audits that there was liquidity issues?

Mr. Dargan Fitzgerald: I don't believe we were required in either of those years to make any similar reports.

Deputy Kieran O'Donnell: Okay. And what would have been your interaction with the Financial Regulator between '03 and '08? And how do you feel their role ... how did you feel their role, I suppose, was? And I can take it ... because KPMG were here before us and they confirmed that a meeting took place on 10 January 2008 with the Financial Regulator involving the big four-----

Mr. Dargan Fitzgerald: Yes-----

Deputy Kieran O'Donnell: -----practices, including yourselves.

Mr. Dargan Fitzgerald: Yes.

Deputy Kieran O'Donnell: So you might just give us a general overview of your general dealings with the regulator.

Mr. Dargan Fitzgerald: Certainly. Well, as I say, I was involved in 2007 and 2008. There may have been dealings with the regulator in previous years but I actually can't speak to that. I would be happy to check that and come back to the committee, if that was required. In 2007 and in 2008, I think ... my recollection is that the dealings with the regulator were exactly as you mentioned and as, I think, other testimony confirmed. In terms of a joint meeting between the regulator and meeting or meetings between the regulator between representatives of the big four firm, possibly in one case under the aegis of the Institute of Chartered Accountants in Ireland. I feel those meetings were very fruitful, in a broad sense, very informative. From the account of those meetings - I don't think I was at either of those meetings personally, but colleagues reported to me in writing and verbally about them, of course, as they were very important matters - and I feel that the regulator was anxious to listen to any of the commentaries on the ... what, even in the earlier of those dates, was an involving credit crisis - it was called a credit crunch at that time - and was also able to give the firms some high level briefing without, of course, dealing with matters relating to any individual institution, to give a high level briefing, in terms of the stance of the regulator in relation to any aspects, and in any ... in later meetings to confirm the effect and intention of the Government guarantee, in other words, to stand behind the Irish domestic banks. That was a very important matter for the later consideration of going concern, as my previous comments mentioned.

Deputy Kieran O'Donnell: And in terms of what you quoted in your own internal report on going concern, page 27, and also your reference to the regulator, do you feel that it was in order to take the evidence or to take the assurance of the regulator in terms of that there wasn't an issue with solvency with the bank in terms of the breaches of the zero to eight days category?

Mr. Dargan Fitzgerald: Well ... well, I'd comment in relation to that that the views of the ... of the directors at the time ... I should start by saying the going concern assessment would have considered a number of different factors. And the consideration of those was made formally by the directors in a separate paper, which I don't think is a part of the core papers but would have been available to us at during our audit, and it would have formally considered aspects such as solvency and in that particular ... in relation to that in the case of EBS, the particular aspect for consideration was the extent of loan losses, as the loan losses directly reduced solvency, if you like, on a one-for-one basis, notwithstanding that a significant impairment was proposed and eventually adopted by the society in its books. And that caused the first ever loss of the building society in its history, if I recall.

Deputy Kieran O'Donnell: That was ... that was 31 December 2008.

Mr. Dargan Fitzgerald: 2008. And in relation to ... in relation to your question around solvency-----

Deputy Kieran O'Donnell: And did you adjust their accounts ... the provision they made, that based on post-year audit, did you look for a higher impairment provision?

Mr. Dargan Fitzgerald: Well, to answer that question ... just to make a couple of comments. The work we carry out in relation to impairments, sort of, starts with planning as I mentioned, selection of a sample of files to see if loans have been appropriately recorded. These are called systems tests, tests of internal control and they are ... they then are the basis upon which we ... we take those ... the results of those tests into account in our year-end work. When we come to our year-end work, we look at a variety of indicators of potential impairment of the loans. We discuss these with management. These may be documentary matters; they may be background environmental or macroeconomic matters; they may be the condition of the bor-

rower; they might be collateral values ... that collateral values of themselves might not cause impairment-----

Deputy Kieran O'Donnell: Well, I suppose, two things then might feed into that. Would you have carried out, independently, stress tests on the loans for EBS? And, secondly, what did you set the level of materiality ... which is obviously the benchmark at which you look at making adjustments ... if it's below a certain figure, an adjustment isn't required ... what was the level of materiality for the EBS audit and did you adjust it, we'll say, from '07, '08 on to take account of the increased risks in the ... both the domestic and the financial markets and the international markets?

Mr. Dargan Fitzgerald: Yes, well as a matter of fact, and I just brought the figures with me, as a matter of fact, in the 2007 year, our materiality was calculated at €7.3 million. And, in 2008, we reduced it very explicitly and deliberately to €2.7 million.

Deputy Kieran O'Donnell: And can I ask ... you might just explain to people looking in how you ... because that means that you dropped it by not too far off €5 million. That's a significant drop of €7.3 to €2.7 million. Will you explain how that would operate in practice in terms of carrying out the audit and how it was dealt with loans?

Mr. Dargan Fitzgerald: Yes, certainly. So the effect of the lower materiality is, I mean, in very simple terms: the lower the materiality, the more significant will be any individual error that is present in the financial statements. So if an error were greater ... a single error were greater than that materiality amount, we would propose adjustment as a matter of course.

Deputy Kieran O'Donnell: Why did you feel it necessary to drop your materiality level from €7.3 million to €2.7 million in one year?

Mr. Dargan Fitzgerald: Because we ... and I think you ... I think your previous question actually referred to this. We took into account the macroeconomic factors, the stress in the system generally, the potential decline in collateral values and our clear desire was to carry out an increased scope of audit testing. And this materiality amount is linked to another amount we call a testing threshold and that means that the sample sizes is in simple terms would have been considerably bigger in the 2008 year.

Deputy Kieran O'Donnell: And did it give rise to you requesting that EBS make a larger provision in terms of an impairment provision ... in terms of loans ... than they had provided based on the accounts that were provided to you to be audited?

Mr. Dargan Fitzgerald: Well, I wouldn't put it in terms of our requesting a provision-----

Deputy Kieran O'Donnell: What did it result in?

Mr. Dargan Fitzgerald: Understood. But again, the materiality that the auditors choose does not of itself, in principle, effect the provision. The provisioning is entirely carried out in the first instance by the society. And I must say in EBS case, there was a very structured methodology and a very structured approach to calculating all the relevant provisions.

Deputy Kieran O'Donnell: I suppose, in simple terms, Mr. Fitzgerald, did your audit result in an increased impairment charge or not?

Mr. Dargan Fitzgerald: Well, I don't think I could answer the question quite in those terms because I ... thank you-----

Chairman: Continue.

Mr. Dargan Fitzgerald: Just, I don't think I can answer the question in quite those terms. There's a degree of iteration between a company being audited and its auditors in terms of whether the auditors are satisfied with the provision. I must say, in times of increasing uncertainty, there's an element of ... an increasing element of judgment in terms of settling on the final provision amount. I mean, we would have, as management was, encouraging of ... of taking a particularly careful review of all the provisioning inputs in arriving at the final figure.

Deputy Kieran O'Donnell: Okay. Is it in order, Chairman, for me to quote from the Nyberg report?

Chairman: Yes, if ... Are you familiar with the Nyberg report, Mr. Fitzgerald?

Mr. Dargan Fitzgerald: As a general matter.

Deputy Kieran O'Donnell: You're familiar with it, okay. Can I ... I want to quote from page 51 and, I suppose, it's the question that people ask. It says, and I quote:

All of the covered banks received unqualified audit reports throughout the Period. An obvious question is: why did the banks require State support in 2008 so soon after all of them had received unqualified audit reports from various auditing firms?

How would you both comment on that statement from Nyberg?

Mr. Dargan Fitzgerald: Well, I'd make a couple of comments. The first comment I'd make is I do think the statement valuably highlights that at the time audit reports were what's sometimes called "binary" in nature. They either qualified and said there was a major problem or they were unqualified and suggested, perhaps, to a reader unfamiliar with financial reporting, that there was no problem. And, in that regard, I think that developments since then have been very helpful in terms of allowing audit reports ... or, I should say, requiring audit reports of certain public interest entities to now contain a detailed commentary on the nature of financial reporting risks encountered by the auditor during the audit and the nature of key judgments made by audit committees, directors and management. And, those items were not present in audit reports of the time so-----

Deputy Kieran O'Donnell: But emphasis of matter was always available, Mr. Fitzgerald.

Mr. Dargan Fitzgerald: Understood. And an emphasis of matter arises when a matter so serious as to be necessary for the reader to be aware of it to, in simple terms, make sense of the accounts has, as you say, always been available. It does, under auditing standards, only arise in a particular set of circumstances and so I think it ... in reality, in terms of the critique of financial reporting in the crisis, I think emphasis of matter has probably had a limited application and, indeed, factually has had very limited use. I think that's because of the constraints around its use and the intention for which it was designed.

Deputy Kieran O'Donnell: And, I suppose, the final question I have is that Nyberg, in his report ... he basically headed up the issue on external auditing. He said: "The Silent Observers: External Auditors". How would you ... what would be your reaction to that statement?

Mr. Dargan Fitzgerald: Well, I'm not sure I should make any particular reaction. It's a ... it's a ... it's essentially a personal observation and it's ... it's ... it's ... it's-----

Deputy Kieran O'Donnell: Well, I suppose, let me put the question another way.

Mr. Dargan Fitzgerald: Thank you.

Deputy Kieran O'Donnell: Do you believe that the role of the auditor is too limited in terms of dealing with the audit of organisations in terms of expressing a true and fair view? Do you think it was too limited?

Mr. Dargan Fitzgerald: Well, I'm not sure it was too limited in terms of the ... in terms of the requirements on audit at the time. However, I mean, I do understand that ... that ... that the crisis has caused a re-evaluation of the benefits of external auditing and I do feel that external auditing, as an activity - and that the profession of those who are involved with it - has responded, at least to some extent, since the crisis, particularly in terms, as I just mentioned, of ... of ... through new auditing standards for audit reports for public interest entities making qualitative commentary on the risks and judgments that are included and involved in the financial reporting of public interest entities. So, I think that ... I think that the commentary in relation to possible shortcomings of both financial reporting and auditing need to be very carefully taken on board and I think many of those have already been acted on in terms of the financial reporting and auditing profession.

Deputy Kieran O'Donnell: Thank you, Chairman.

Chairman: Thank you very much, Deputy O'Donnell. Just a couple of matters before I move on to Senator MacSharry. In regard to the Financial Regulator, do you believe that the reports issued to the Financial Regulator provided them with enough information to enable them to discern the full regulatory position of the society?

Mr. Dargan Fitzgerald: Chairman, could I just clarify the reports that you mentioned. What reports have you in mind?

Chairman: They ... in going back to Deputy ... earlier, when Deputy O'Donnell was talking to you, he was talking to you briefly about the firm's interaction with the Financial Regulator-----

Mr. Dargan Fitzgerald: Yes.

Chairman: -----during the 2003 to 2004 period and the role that the Financial Regulator played during that period as well. So, I'm just asking you do you feel that the reports issued to the Financial Regulator provided them with enough information to enable them to discern the full regulatory position of the building society?

Mr. Dargan Fitzgerald: Thank you. Well, I'll just comment ... I think the question is in relation to reports that we may have made and, as I think I've mentioned, we made one - and only one - report of a regulatory breach which we discussed and which forms part of our papers, our letter of 6 March 2009. Just to highlight that the building society, as a regulated banking entity, made its own quarterly unaudited annual returns to the Financial Regulator and those are very key components of the regulatory supervision, as I understand it, and so the vast majority of the information relevant to the regulator would be contained in those documents, which are not subject to external involvement.

Chairman: Okay, thank you. During Ernst and Young's interaction with the society, did either party express concerns rather than just talk about the issues ... but specific concerns in

regards to the adaptation of IAS 39?

Mr. Dargan Fitzgerald: Not to my knowledge.

Chairman: There was no concerns, either at Ernst and Young's side or at EBS's side?

Mr. Dargan Fitzgerald: Not to my knowledge.

Chairman: Okay, thank you. Senator Marc MacSharry.

Senator Marc MacSharry: Thanks very much and welcome, gentlemen.

Mr. Dargan Fitzgerald: Thank you.

Senator Marc MacSharry: Can I ask, with regards to the preparation of the firm's annual audit plan and the risk assessment underpinning it, did the risk assessment approach adopt a change to meet the prevailing environment?

Mr. Dargan Fitzgerald: Yes. Thank you. As I mentioned, the risk assessment starts with an updating of our understanding of the circumstances of the entity being audited. So, in this case, the building society. This is carried out through meetings and discussions with management and review of relevant papers, such as board reports. As a result of our assessment of the ... what are called "entity level controls", controls within the company ... or within the building society and consideration of external factors, such as stress within the financial system and other macroeconomic factors. As I previously referred to, one of the planning tools is to select what's called planning materiality ... and, these are the comments I made earlier. That materiality is set at a level which results in a particular set of sample sizes, which govern the extent of detailed testing we carry out, both of internal controls and of balance sheet amounts. So, if I put that in, sort of, more plain English, we update our understanding through discussion with management of the state of play within the building society. We set out a plan of testing of internal procedures and controls - called internal control testing - and then at the year end we select a sample, which in the case of 2008 was statistically quite a large sample, of loan files and other items to test substantively. And, in simple terms, that substantive testing means discussing with management the circumstances of each individual loan, as I previously mentioned.

Senator Marc MacSharry: Is that process gone through every year or just, say, in the context of '07-'08?

Mr. Dargan Fitzgerald: It's an ... it's an annual process of assessing the financial reporting risks and annually we update our understanding of the business and the internal control environment and we plan our various tests, both of internal controls and of balance sheet and income statement transactions and balances, accordingly.

Senator Marc MacSharry: And for 2008, I mean, was there a marked difference in the preparation and planning for that because of the environment?

Mr. Dargan Fitzgerald: I must say there was. The planning for the 2008, 31 December year-end audit would have begun ... it's really part of a year-end ... all-year process but, in practical terms, it would have taken place in August, September, October of 2008. And you'll appreciate that, particularly in September and October of 2008 the ... actually the global financial system was showing enormous stress and strain and so we had to consider whether financial reporting risks were likely to arise and be heightened in our audit of EBS and we responded accordingly.

Senator Marc MacSharry: Can I ask did the firm conduct their own independent assessment of EBS's credit risk methodology to satisfy themselves that the principles-based process adopted by the society were appropriate?

Mr. Dargan Fitzgerald: In simple terms, yes. We reviewed the various methodologies for setting loan impairment provisions. Just for clarity, some of those would be methodologies relating to the calculation of what is called individual provisions - where it's on a loan-by-loan basis - and then some of the methodologies, and I think this may be the thrust of your question, relate to the calculation of what's called collective provisions. And this is where, for a portfolio of loans as a whole, an additional provision is made for what's sometimes called the latent incurred losses in the portfolio - on the basis that these losses may not always be evident from examination of individual loan files.

So the methodology adopted by the society, in common with other banks, was to model the incidence of incurred but not reported losses as they're called and the subsequent derivation of the collective impairment provision. So we reviewed that and we reviewed, therefore, the methodology itself, the inputs, the outputs for sense check and carry out overall analytical review procedures. And in that way we satisfy ourselves that the methodology adopted and the results appear reasonable.

Senator Marc MacSharry: In 2005 Ernst and Young sent a management letter, it's on page ten of the evidence book, to EBS and it looked at the maintenance of credit quality and the appropriateness of loan provisioning. It said there should be-----

Chairman: What page?

Senator Marc MacSharry: Ten. It is only a short reference and I'll be quoting it directly but I'm just mentioning it for you. "Should there be a default on a loan, there is an additional risk that the collateral securing the loan is insufficient." It later says in the same letter, "Our controls testing focused on the credit review process and the role of the Credit Risk Committee in assessing asset quality and approving impairment provision." Further, it later says, "We concluded that the credit review process is robust and that there are suitable controls around the processes."

Chairman: I just need a small bit of clarity on that, Senator, I'll give you a bit of time. I just need a bit of clarity in finding it. The reference page may not be the actual page in the core booklet.

Senator Marc MacSharry: Page ten is blank so it's the one beside it.

Chairman: Okay, it's page 11.

Senator Marc MacSharry: But it starts on the page before that again, so sorry. But I've quoted the relevant points precisely so it's only for the Chairman's benefit. How significant did Ernst and Young at the time believe that the risk of insufficient collateral to EBS?

Mr. Dargan Fitzgerald: To answer that question, just to highlight that for each loan selected in our sample we discuss with management the situation of the borrower, the extent to which the loans are fully paid up to date. We also examine the question of whether there is any objective evidence of impairment of the loan. In technical terms that starts with the question of default. Also, if there has been a default there may be a requirement for management to carry out a discounted cash flow analysis and part of the consideration of the residual value of the

loan will involve consideration of collateral value. So collateral value is absolutely assessed as part of that set of procedures which assess each loan individually, to assess whether it is impaired or not.

Senator Marc MacSharry: So I mean if ... in that management letter, if you believe there was insufficient collateral potentially, why would the firm state that the credit review process is robust and there are suitable controls around the process?

Mr. Dargan Fitzgerald: Because the latter conclusion is of a more general nature whereas some of the specific items that we have highlighted are for the benefit of management to understand items that we may have come across during our testing work. So for clarity, the second conclusion that you read is of a more general nature and rests on the body of work that we have carried out, of which we may find some individual instances, as I think I previously referred to, where we need to report to management that we have come across those matters but they typically will not prevent us from making the overall conclusion in a satisfactory way.

Senator Marc MacSharry: Can you confirm that CARB and IAASA regulate your firm?

Mr. Dargan Fitzgerald: Yes I can.

Senator Marc MacSharry: Has your audit activity of financial institutions been reviewed by them?

Mr. Dargan Fitzgerald: Absolutely, from time to time, and if I just ... explain your reference to CARB and IAASA. So CARB is the Chartered Accountants Regulatory Board and it carries out the on-site routine inspections-----

Senator Marc MacSharry: We know. With respect, it's just that I have a minute left.

Chairman: I can afford a bit of time.

Mr. Dargan Fitzgerald: I beg your pardon.

Senator Marc MacSharry: No bother, it's just we have gone through this with all of the others. No disrespect but we know the organisations.

Mr. Dargan Fitzgerald: Not at all, I understand.

Senator Marc MacSharry: So if ... you've had reviews of your audit work in that regard. Has there been any adverse findings?

Mr. Dargan Fitzgerald: Not to my knowledge although, I'd have to go through individual findings and I don't believe that any findings were what would be described as adverse in the context of your question.

Senator Marc MacSharry: Ever asked by a client that you're auditing, from a financial services perspective, to alter or remove a member of the audit team?

Chairman: Okay, just tell me where you are within the terms of reference here now Senator and then I'll bring Mr. Fitzgerald in?

Senator Marc MacSharry: It's consistent with questioning of the other auditors from the other ... a very specific line was dealt with, with other auditing firms.

NEXUS PHASE

Chairman: Okay, I'll give a bit of space there but just be mindful of any reputational damage of people that are not inside the room here.

Senator Marc MacSharry: But I'm not mentioning any names and I presume you won't.

Mr. Dargan Fitzgerald: Could I ask you to repeat the question?

Senator Marc MacSharry: Were you ever asked by a client firm to alter or remove the auditor or member of an audit team?

Chairman: If I go back to that now, when we were dealing with that last week ... the firm itself - I didn't allow that question and they didn't respond to it.

Senator Marc MacSharry: No, they did, and what you didn't allow, Chairman, with respect, and you can check the record, was the naming of the institution. The question was answered. Where there was a delay in a question was very specifically to do with me asking was it a particular company and at that point you intervened.

Chairman: Okay, give us the specific issue, coming back to Mr. Fitzgerald.

Senator Marc MacSharry: I am not mentioning any financial institution, I'm asking were there ever financial institutions who may, in the course of your work, have made an approach to you to say, "Could you remove part of the team for being over enthusiastic in their questioning or efforts"?

Mr. Dargan Fitzgerald: My reply is firstly to say I can only confidently speak in relation to the work I have carried as auditor of EBS in 2007 and 2008. In relation to EBS as audit partner I can confirm to my knowledge the question is "No". I have no other knowledge of any such thing but I could not be definitive.

Senator Marc MacSharry: Just very finally then, there's ... I think it's the very first page in the evidence book, would it be page 3, it's a note ... a file note by Kieran Kelly following a meeting with the CEO of the society and it mentions a number of things. One of the things it mentions, as a concern, is a credit shock. Obviously, this would have been a lot earlier than the ... it would have been 7 February 2007. I'm just interested to know ... an external market shock such as a credit shock was identified clearly by Mr. McGovern in discussions with Kieran Kelly and that is certainly his note on it, as we can see there from page 3. Can you give us any other information on that? Was it articulated as a result of fears that the society had at the time or indeed Kieran Kelly your own personnel, and what if any actions were determined as a result?

Mr. Dargan Fitzgerald: Well, I'm sorry to say that my knowledge is limited as I wasn't at that meeting, and that was in relation to the year preceding the year in which I took up the position as audit partner for the society. So I actually just can't make any additional comment that might help you in that regard.

Senator Marc MacSharry: It certainly didn't form the basis of any discussion, or did it, from that date to your knowledge, up until the credit crisis with the collapse of Lehman's in September 2008?

Mr. Dargan Fitzgerald: Well, I think I can comment because shortly after this time I would have become involved, as you would expect, in the planning for the following year. I can say that as soon as the evidence of shortage of liquidity in the banking markets began to present itself, which, from memory, was towards the latter half of 2007 ... I can confirm that the audit

team was aware of that and factored into its assessments for year-end 2007, an appropriate audit response.

Chairman: Okay, thank you very much. With that now said, I propose that we take a break. The witnesses are reminded that once they begin giving evidence that they should not confer with any person other than their legal team in relation to their evidence on matters that are being discussed before this committee. With that in mind, I now suspend the meeting until 4.35 p.m. and remind the witnesses that they're still under oath until we resume. So I now propose we suspend until then. Is that agreed?

Sitting suspended at 4.21 p.m and resumed at 4.40 p.m.

Chairman: Mr. Smith and Mr. Fitzgerald, are you okay? So we go back into public session to continue this afternoon's proceedings, is that agreed? I now invite Deputy Michael McGrath to question.

Deputy Michael McGrath: Thank you very much. I would like to welcome Mr. Smith and Mr. Fitzgerald here today. Can I just start by asking Mr. Fitzgerald to outline the structure of a typical audit team that you would have led in respect of EBS, and to give us some insight into the level of skill and experience within this group ... and to state your opinion, whether you believe that there was sufficient banking and property experience, and people with the right balance of qualifications, in the teams that you would have managed for the two years that you led the audit?

Mr. Dargan Fitzgerald: Certainly, thank you. So, as a general matter, the teams are - which carry out the audits - are, we call them multidisciplinary teams. The key disciplines involved are core auditors, but also tax specialists and information technology specialists, being the two other specialisms that are typically brought in, and I'll come back to the matter of property valuations in just a moment. So, the two years that I was involved in, I think I mentioned previously that, the team was considerably larger in the 2008 year than in the 2007 year. The reason for that is the increased focus and increased ... we had on the lending portfolio and the question of impairment, based on our risk assessment. In that context, we expanded the team, as I say, from the 2007 team.

Just to give you some contextual background to that, the total numbers involved in the audit team would have been in the region of 30, from memory, in 2007, and 40 in 2008, with a corresponding increase in the audit hours. I should also mention that in 2008 the ... because of our general understanding of the presence of risk within the financial system, we made a designation of the audit which we call "close monitoring", which means we heighten its risk in terms of our register of the risk of the potential misstatement in relation to the audit. So I was assisted by what's called an independent partner, who acts as a sounding board and a peer reviewer of any key decisions that I make. There are other partners involved in the team, such as a tax partner and an information technology partner, and then, as you can imagine, the balance of the team of some 40, from memory in 2008, is made up of directors, managers, senior managers and core staff, coming from those various disciplines.

Deputy Michael McGrath: Thank you. Can I ask, when did EY secure the audit of EBS? When was the first year?

Mr. Dargan Fitzgerald: I actually don't know. I have a feeling I read somewhere that we were in place as auditors for some considerable period and I certainly don't remember a time

when we weren't, but then I joined EY in 1999.

Deputy Michael McGrath: Mr. Smith, are you aware?

Mr. Paul Smith: I think we have been auditors right since the very beginning of the foundation of the society.

Deputy Michael McGrath: And when was that?

Mr. Dargan Fitzgerald: So probably 50 or 60 years, possibly longer.

Deputy Michael McGrath: Okay. Right up to and including 2008?

Mr. Paul Smith: Yes.

Deputy Michael McGrath: And given that EY had the audit for that length of time, do you think it creates any difficulty in terms of the closeness of relationships, the knowledge that you would have and the fact that working so closely with the same people over a long period of time would have an impact on your independence for example or on the quality of the work being carried out?

Mr. Dargan Fitzgerald: No I don't feel so, Deputy. You, I am sure, are aware from other testimony that there is a very formal system of audit partner rotation. And there is also a system of rotation of what is called "key audit personnel", which means that the senior personnel with extended periods of tenure on the audit team are also rotated. So, I feel that the audit partner rotation, which is precisely the reason I took up as audit partner in 2007, rotating in, as we call it, for the preceding audit partner after his five-year period in place. There is, actually, a balance to be struck between familiarity and closeness to the client. And it is precisely for that reason that our ethical standards require the mandatory partner rotation.

Deputy Michael McGrath: Okay. The final taxpayer bill, as such, for EBS was in the region of €1 billion. Given your knowledge of the accounts of EBS and the business model pursued, can you give us your view on how those losses arose? Were they substantially related to the property and development loan book which was grown considerably since 2005 or how much of it do you believe was mortgage related? Can you give us your sense of why the bill was about €1 billion for EBS?

Mr. Dargan Fitzgerald: I'll do my best, Deputy. Since I didn't have an involvement with any of the financial reporting of the society in 2009, 2010, 2011 or subsequently, I must say I am not qualified to comment on those years specifically. And I must say, as a matter of fact, you will be aware that the vast majority of the loan losses were recognised in those later periods. I feel that the work that I did have connection with in 2007, and particularly 2008, probably gives me some insight and I think it's probably a matter of fact, although I could be corrected, that a large proportion of the ultimate loan losses arose from commercial property, including development property and buy-to-lets. My understanding of that is purely from brief review of the NAMA documentation that forms part of the core packs. So, I do feel that the facts of which I am aware show that commercial property and, as one would expect, buy-to-let property and of course development finance, which was the first to show evidence of stress and strain, as I mentioned, were probably the prime reasons for the losses.

Deputy Michael McGrath: Okay. The 2008 financial statements, in note 11, do break down the loans and advances to customers and as far as I am aware, that was the first time that

there was such a breakdown. For example, the figures that are provided for commercial development finance, home loans, retail, buy-to-let, commercial buy-to-let. I don't see a corresponding breakdown in the 2007 accounts. Would that be correct?

Mr. Dargan Fitzgerald: I'd have to check, but I think you are correct. And I think I recall that in view of the loan losses which were being recognised in 2008, and as I previously mentioned, I think this caused the first ever loss in ... overall loss for the building society, which was regarded as a very major matter. I believe that the categories and detail of the loan note disclosures in 2008 were expanded to include that additional detail, so that there could be, for the user and reader, a clear relationship between the provisions and the loan portfolios.

Deputy Michael McGrath: So, just to clarify that, additional disclosure in the 2008 financial statements didn't arise from any change in accounting standards, for example. It was a decision made by the directors and supported by the auditors. It wasn't as a result of any change in accounting practice.

Mr. Dargan Fitzgerald: I'm actually not sure. I'd have to check those facts but I'm happy to do so and revert to the committee.

Deputy Michael McGrath: If you could, please-----

Mr. Dargan Fitzgerald: Absolutely.

Deputy Michael McGrath: -----that would be helpful.

Just to look at the issue of the losses that did arise. There is a breakdown, as I say. The total loans and advances to customers was about €17 billion across the group at the end of 2008. Home loans, €13 billion. Retail buy-to-let, €1.5 billion. Commercial buy-to-let, €600 million. What's the difference, just to clarify, between retail buy-to-let and commercial buy-to-let?

Mr. Dargan Fitzgerald: Two things. Firstly, commercial may relate to non-residential and will be designated commercial. And I think within the accounting policies, buy-to-let over a certain size - I think from memory it was €1.5 million - was classified as commercial.

Deputy Michael McGrath: Okay. And then under, let's say, property development, commercial is listed at about €1.2 billion and development finance at about €500 million. So, at the peak, EBS's loan exposure to commercial and development finance was in the region of €1.7 billion to €1.8 billion.

Mr. Dargan Fitzgerald: Those figures are correct.

Deputy Michael McGrath: Is it of that order, as you understand it. And so, then the overall bill for recapitalising EBS is accounted for by heavy losses on the commercial and development finance book but also buy-to-let mortgages, both retail and commercial.

Mr. Dargan Fitzgerald: I'd have to emphasise I don't have granular connection with any of the later years' figures. So, I'm afraid I cannot assist with specifying exactly where the losses arose, as they were in subsequent periods.

Deputy Michael McGrath: Okay. And were you involved in the decision to make additional disclosure in the 2008 financial statements as regards the exposure of EBS to development and property for example? There is disclosure there, significantly above and beyond what was there in 2007. Was that a decision of the directors? Or, was it a decision that you encour-

aged or advised would be made in the course of the audit in 2008?

Mr. Dargan Fitzgerald: Again, you will have to forgive me. I'd have to check the facts. I'd have to compare the 2007 and 2008 disclosures to give you a definitive answer and I'd have to check our files. My overall recollection is that, as I mentioned, the disclosures in 2008, which may in the case of certain components of the loan book have been expanded, were to give additional information given that the loan losses were being recognised into a very significant degree. It may, subject to checking, have been because of ... practice was then dictating that additional disclosure, although I must say I don't remember that. It would in any event, just to conclude, it would in any event have been the case that in 2007, we as auditors would've checked that full disclosure was made in accordance with whatever the disclosure rules were at that time. And similarly for 2008. There is a certain latitude that management teams may give additional helpful disclosures over and above specific required disclosures if they feel that it gives a fuller picture and we, of course, encourage that from time to time.

Deputy Michael McGrath: Okay. Just a final area I'd like to touch on, Mr. Fitzgerald, is IAS 39, which has come up time and time again in terms of impairment provisioning. It is to tease out the wriggle room, if any, that you would have as an auditor in advising directors how to make provisions in accordance with IAS 39. My question for you is whether the application of IAS 39 is absolutist as such or whether, if you believe in the interests of making a true and fair view override as such and if you have the evidence to back it up, that a departure from IAS 39 would be warranted and could result in additional provisioning, provided you could stand over it and have the evidence? Can you explain the absolutist nature of IAS 39? And to what extent an auditor has discretion to depart from IAS 39 in making provisions for potential bad debts where he or she believes the evidence points in that direction.

Mr. Dargan Fitzgerald: Certainly, I'll do my best. First of all, I would say I'd ... I probably wouldn't describe any of the accounting requirements of IAS 39 as absolutist. I would say that in terms of the way in which they prescribe the recognition of loan losses, they are certainly relatively tightly defined.

Deputy Michael McGrath: Yes.

Mr. Dargan Fitzgerald: And I feel that the accounting profession and then, by extension, the auditing profession, was rightly very careful to interpret appropriately the precise wordings within international accounting standard 39 and the relevant guidance notes and ... and I think it touches on some of the points in your question. It is ... it is absolutely the case, in my professional opinion, that there ... there was not very great latitude in terms of recognition of loan losses and when I say not great latitude, I mean that ... that tests of the existence of objective evidence of impairment of the loans had to be passed before impairments could be made. And my ... my clear understanding from the work of ... of our own audit teams in this case is that we very carefully assessed whether ... whether management had appropriately implemented those specific definitional requirements of objective evidence of impairment. And where judgments were made, that for example, additional provisions were required, that those were justified in all the circumstances. There were some elements of a judgment, particularly in larger loans, and particularly in cases where there was perhaps some repayment capacity but repayments had perhaps slowed and perhaps where collateral values had declined but were still substantial. And all of those things had to be taken into ... in the round in making an individual assessment of impairment.

Deputy Michael McGrath: Okay. What the regulations state, as I read them, is "In the

extremely rare circumstances in which management concludes that compliance with a requirement in a standard or an interpretation would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity shall depart from that requirement in the manner set out in paragraph 18 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.” So it is narrow, but the question is, are there some circumstances in which the strict application of IAS 39 was not required ... where there are some circumstances in which an auditor could depart from IAS 39 and seek additional provisioning and still remain within accounting standards and the regulations that underpin them?

Mr. Dargan Fitzgerald: I must say that ... in relation to the 2006, ‘7 and ‘8 audits of EBS, I don’t believe there was any question of any such circumstances arising and I’m not sure if, conceptually, I can actually imagine such circumstances. I mean ... perhaps, conceptually, as a ... in a hypothetical way, that could be argued and I am aware there is testimony-----

Deputy Michael McGrath: It is provided for in the regulations.

Mr. Dargan Fitzgerald: Well-----

Deputy Michael McGrath: It does say “extremely rare circumstances”. My question is ... is really asking you to confirm ... it isn’t necessarily specific to the audits you did, but that, and you mentioned it earlier on, the IAS 39, no more than any other accounting standard, is not absolutist in nature and that, while the discretion is extremely narrow, the auditor does have some discretion to depart from a standard in the event that rigidly sticking to it would be misleading in that it would conflict with the objective of the financial statements set out in the framework. So I am just asking you to confirm that ... that that is correct. Is that the case?

Mr. Dargan Fitzgerald: Well, absolutely. I can certainly confirm that, in the case of the audits that I was involved in, there was no question of any conflict arising between the true and fair view and the implementation of the accounting standard, absolutely.

Deputy Michael McGrath: But in certain circumstances, an auditor could interpret that requirement as giving him or her scope to depart from the strict interpretation of an accounting standard, if they felt that was necessary for the financial statements to give a true and fair view.

Mr. Dargan Fitzgerald: Well, you’re absolutely correct that the concept of true and fair override involves exactly such a thing. There can always be that potential. I just would stress that ... that, in terms of the specifics of the audits I was involved in, I don’t feel that that was-----

Deputy Michael McGrath: Didn’t arise.

Mr. Dargan Fitzgerald: -----a relevant consideration.

Deputy Michael McGrath: Thank you, Mr. Fitzgerald.

Chairman: Okay, thank you very much. Just two matters, I just want to ... before I bring in the next questioner ... in earlier questioning there with Deputy McGrath, Mr. Fitzgerald, you said you would return to the issue of the property experience and we didn’t get around to it, so maybe if you could now.

Mr. Dargan Fitzgerald: Yes, by all means.

Chairman: And that’s in regard to the firm’s audit team and the sufficient property experience that you might have.

Mr. Dargan Fitzgerald: Yes, thank you, Chairman, and happy to do so. And, as I think other testimony to the ... from other auditing firms may have confirmed, it is not the typical practice among the auditing firms to employ within their own teams estate agents or valuers. And so the ... in accordance with auditing ... international auditing standards, the appropriate approach is for the entity being audited to obtain and to arrange to be carried out the appropriate valuations of properties where they are needed or where they are appropriate and the auditor carries out tests, referred to as reliance on the work of an external expert, where they assess the qualifications and the experience of the valuer and they may then, for their audit purposes, rely appropriately on the valuations obtained.

Chairman: Okay, and, I suppose, a general question then following on from that, Mr. Fitzgerald: were you satisfied or were there sufficient qualified staff in Ireland in that regard?

Mr. Dargan Fitzgerald: Well, absolutely, in the context that I've just outlined, absolutely, I feel that our staff were appropriately qualified.

Chairman: Okay, thank you very much. Deputy John Paul Phelan.

Deputy John Paul Phelan: Thank you, Chairman. Good afternoon, gentlemen. First of all, I want to start with the core documents, pages 4 and 9. First, on page 4 - it's a minute of a meeting between a Mr. Kieran Kelly from Ernst and Young and the chief executive of EBS, Mr. McGovern, and it's from February 2007 - on page 4 in the third paragraph, I want to reference a quote, the second half of the third paragraph beginning with "He" ... "He also commented [he being Mr. McGovern] that whilst his confidence in the financial reporting function is improving he is still finding that there is imprecision in figures and that people are being forced into taking actions which are in turn imprecise and slightly unfocused." And again, on page 9, it's the management letter of 2005 under the heading "Risk", I want to reference it also:

There is a risk that the Society may fail to identify errors or [misposition] mispostings arising from uncontrolled changes to formulae or data in key spreadsheets. As a consequence, the financial statements of the Society may be misstated.

Mr. Fitzgerald, were you satisfied that you and the audit team from Ernst and Young had access to complete and accurate information from EBS in order to conduct your audit properly?

Mr. Dargan Fitzgerald: Thank you. Well, first of all, for the 2007 and '8 audits that I supervised and, ultimately, signed as auditor, yes, I am so satisfied. Looking back and to your question in relation to both of those comments and if I could take the management letter from 2005 and without necessarily ... this was wasn't my own audit team, rather I wasn't supervising the audit team that carried this out and subject to that, nonetheless, if I just explain the purpose of this communication. So, as auditing standards require, that's auditing standard 260, reporting to those charged with governance, as I previously mentioned, where we come across an issue or an improvement point that needs to be brought to the attention of management of the audit committee, our management letter typically contains it and it typically contains it in the sort of format that one sees there. So the topic, in other words, what, sort of, part of the financial reporting is involved, the observation, what we found, and then the risk and the comment that you quoted from the two comments under the heading, "Risk", their purpose is to illustrate - we sometimes call them "what could go wrong", they illustrate, if you like, the worst case, if this control point is not acted on, of what could happen. So, where we write appropriately, "As a consequence, monthly management finance reports may be inaccurate", just to highlight that those would not necessarily mean that there would be pervasive error in management accounts

but that arising from, and in the context of euro bank account reconciliations, there might be misreporting. The key point is that is highlighting the risk of what might go wrong and then our recommendation and the response of management ... we highlight in our recommendation what we feel should be done to, if you like, fix the problem and then management under the column "EBS response" identifies how they intend to resolve the issue, assuming they agree with it. It would typically be our practice, just for your additional understanding, then in the following year to follow up to see that such items had been cleared and then they may be replaced, of course, with new comments but that that item would be closed in the following year-----

Deputy John Paul Phelan: Was it cleared in the following ... was it resolved in the following year, do you know?

Mr. Dargan Fitzgerald: I'm actually not sure because I think it's not in the 2006 management letter.

Deputy John Paul Phelan: Yes, it's not there either.

Mr. Dargan Fitzgerald: It may be in the papers ... it may not be in the papers. My understanding is it would typically be closed, and I think even the comment in the EBS response reads: "This recommendation was implemented in November 2005". And on that basis, assuming that is factual, I assume the point would be closed.

Deputy John Paul Phelan: Okay. In reference to the first quote from the meeting with Mr. Kelly and Mr. McGovern and the reporting function and the statement that's included in that minute where Mr. Kelly spoke about imprecision in figures again ... this is 2007. It's a kind of a repetition, although it might not be directly related to the quote off of page 9. But do you feel that that matter was addressed subsequently or have you any comment on it?

Mr. Dargan Fitzgerald: Well, you'll forgive me saying, not being present at the meeting, I'm not sure in quite what context it was made, and it feels like a very high-level comment where the chief executive is commenting to the audit partner to give the audit partner a flavour for his level of confidence in using the financial information generated internally to make management decisions, in other words, an operational and business focus. not strictly the domain of the audit in terms of the external auditor's assessment of risk of financial reporting misstatement. But, having said that, one which, as I think you can probably take from the fact that the note is reproduced so, if I may say so, comprehensively and included on our audit files, one that I'm sure would've been taken into account in the subsequent audit work.

Deputy John Paul Phelan: Okay. Can I briefly ... I want to put a couple of questions to you in relation to some matters that I raised with other audit firms. In particular, I want to address the issue of necessary professional scepticism, which I've raised with all the others. And Mr. Nyberg in his report ... and it's a quote that I put to other ... your colleagues from other audit firms and I want to put it to you in relation to your auditing of EBS. And I quote from page 56 of the Nyberg report, paragraph 3.6.2: "The Commission would have expected a bank auditor, exercising necessary professional scepticism, to have concerns where there were growing property and funding exposures, combined with material governance failings." Do you feel that that applies to your auditing of EBS, that finding of the Nyberg report?

Mr. Dargan Fitzgerald: Well, I have a couple of reactions to the commentary. First of all, I suppose it is very much a summarised reaction and, I might say, a personal reaction in terms of the quality of the comment, and I think, in terms of the role of external auditor, it's probably

not something I would immediately move to agree or disagree with. I kind of feel it's that person's opinion, and, you know, they're absolutely entitled to have that. I do know that the role of professional scepticism has come into some particular focus since the financial crisis and, in the context of the work of this committee and of similar work groups across the world reacting to the financial crisis, there has been a very explicit move to increase both the exercise of scepticism, which has always been an important and, you might say, necessary attitude of mind of external auditors and of auditing firms, but to improve both the rigour of challenge to management and management's judgment. And in that context, I would mention a project in the external auditing world called clarified ISAs, international standards on auditing. They were, after the financial crisis, updated to improve the level of specificity of some of their required audit procedures, and some of those related to exactly that point - scepticism. So I feel the general matter of challenge and scepticism is integral to external auditing and always has been, and I do feel there have been improvements in enabling those challenges to management judgment and the exercise of scepticism being deployed more fully.

Deputy John Paul Phelan: I understand. Briefly, though, to return to my initial question, his comment from the Nyberg report ... does it apply to Ernst and Young's auditing of EBS, yes or no?

Mr. Dargan Fitzgerald: Well, I'm-----

Deputy John Paul Phelan: It's a criticism, if you like, and it's not my words.

Mr. Dargan Fitzgerald: Understood.

Deputy John Paul Phelan: I'm not making any value judgment on it, but he said that he would've expected a bank auditor exercising that scepticism to have had some ... identified some of these failings. That's basically what he's saying.

Mr. Dargan Fitzgerald: I understand that, and I just would ask you to appreciate that it's, I think, a generalised comment about the sector as a whole. In terms of the audits that I was personally responsible for on behalf of Ernst and Young, I don't feel that scepticism was lacking, far from it. In fact, I feel it was robustly exercised. I hope that answers your question.

Deputy John Paul Phelan: That's fair enough. Finally, Mr. Smith, I just want to ... at the ... in your opening statement you referred to three proposals, if you like, for the auditing profession I suppose really, going forward ... recommendations I think you did call them. Can you outline briefly in the, in the minute or so that is left, the nature of the changes that would be required to bring them about? You know, would it require legislation, regulation, European regulation, is it something that can be instituted from the audit community themselves, from auditors internally or is it something that the Oireachtas would have to act upon?

Mr. Paul Smith: Yes. I am happy, I am happy to respond to that, albeit with a big caveat, which is that I am no expert. You know, I am out of the business six years and before that I wasn't an auditor, *per se*. But the three recommendations were, one: that there would be more effective two-way communication between the regulator and the audit firms. I think I would have to refer to Dargan on this in terms on what the technicalities are around that because there's obviously a framework, a legislative framework around that. And since it involves issues of client confidentiality or at least, potential client confidentiality issues, I could see how some legislation might be required there. The second was in the strengthening the role of audit committees and the role of internal audit. I think that's not really a legislative matter. I suppose

legislators will always want to participate but I think that that's more an internal matter, probably falling more within the codes of governance for companies generally. The third is around the audit of the returns that are made by financial institutions other than insurance companies and these are the quarterly returns to the Financial Regulator. I simply don't know whether that would require a legislative adjustment or not.

Chairman: Thank you very much. Deputy Doherty.

Deputy Pearse Doherty: Thank you very much agus fáilte roimh an beirt. In the EBS building society 2008 audited reports under the heading: "Significant Accounting and Auditing Issues", Ernst and Young states and I quote:

Given [the] current market conditions, there is an increased likelihood that borrowers will be unable to repay loans. Should there be a default on a loan, there is an additional risk that the collateral securing the loan is insufficient. Provisioning [in this area - sorry provisioning] is an area of judgement and estimation ...

And it goes on. So, with that in mind, did Ernst and Young ever perform a review of the valuations received for assets offered as security? And were E and Y satisfied with the valuation policy?

Mr. Dargan Fitzgerald: Thank you. So my first point to mention is that the work we carried out is both at an overall level, and as I think as I previously mentioned, is in relation to individual loans. And where we are carrying out audit work in relation to individual loans, we are considering the collateral values if it is appropriate in considering the carrying value of the loan and any relevant impairment. As I previously mentioned, typically the society would have engaged external valuers to value the collateral. At the time of carrying out the audit from ... in some circumstances, updated valuations were obtained. Perhaps for the more significant loan collateral values and in other cases, they were proving difficult to obtain and management made its own estimates and we evaluated the estimates that management had made. So in summary, I must say that collateral values were a focus of audit attention and in terms of external valuers, as I mentioned, those valuations were commissioned by the entity, as was normal and appropriate and reviewed by us where appropriate.

Deputy Pearse Doherty: So, when appropriate. So, the question was: did you review the valuations received for assets offered as securities? Is that a yes, where appropriate?

Mr. Dargan Fitzgerald: It's in relation to the samples in which we chose, some of those may have been cases where collateral was important to the evaluation of the loan and in some of those we would have reviewed and inspected the actual third party valuations.

Deputy Pearse Doherty: And the second part of my question: were you satisfied with the valuation policy within EBS?

Mr. Dargan Fitzgerald: Yes, absolutely. All of the-----

Deputy Pearse Doherty: You've given comment on it but the ... if you are satisfied with it that's fine because you've mentioned earlier on-----

Mr. Dargan Fitzgerald: Yes. Overall, we were satisfied.

Deputy Pearse Doherty: Did Ernst and Young ever review EBS's process of registration of mortgage security and, if so, what was your opinion on the process and controls the bank

adopted?

Mr. Dargan Fitzgerald: Yes, again as part of controls testing in various years, to my knowledge, and particularly in the two years in which I was audit partner, one of the aspects which was tested in our testing of procedures and controls related to either safe keeping of deeds or the registration of title of ... in deeds. While, as a general matter, we were satisfied with the ... with the procedures that the society employed, I'm sure you'll be aware that there was a pervasive issue throughout the conveyancing industry with the length of time that deeds were sometimes held with solicitors and, as I think you can see in the papers in the core documents, we did, on occasion, draw to the attention of management the importance of following up with tracking letters and phone calls and so on, the location of deeds and the perfection of the security. So, yes, it was something that we took note of and communicated, as required, to management.

Deputy Pearse Doherty: Okay. Mr. Smith, I'd like to refer to core booklet, page No. 4 ... this is a minute of a meeting between Kieran Kelly of Ernst and Young and Ted McGovern, chief executive of the EBS, which took place on 7 February 2007 and which was written and signed by Kieran Kelly. He says, and I quote, He goes:

I asked [Ted McGovern] how their focus on commercial lending fits into the ethos of the society as a retail ... service provider. [It goes on to say] He sees the business as having the potential to generate returns which can be fed back into the rest of the business and the possibility that they may be creating a franchise that is attractive for the future.

Can I ask you, first of all, why would the auditor be questioning the chief executive on the business model of the bank, if that, we're led to believe, isn't the role of an auditing firm in relation to questioning the business model of a bank?

Mr. Paul Smith: I'll answer briefly. Remember, I'm not an expert on auditing. But my understanding is that it would be normal for the auditor to have a conversation with, not only the chief executive but other members of the management team in the client, to try and understand what was going on in the business. And the reason for trying to understand what was going on in the business is so that the audit approach which is then taken by the auditor in examining the financial statements for the year fully understands the nature of the risks that are inherent in the business. That's the purpose. The purpose is not to advise or to criticise or to critique the business practice of the client.

Deputy Pearse Doherty: You need to help me on this one here because like ... is an auditor's role not just to look at the figures and statements and, regardless of what the institution are doing, just to look at the figures? If it is - and correct me if I'm wrong in that ... if it is, then why would you be asking the chief executive why they're going into commercial lending and how it fits in with the ethos of the building society? Maybe, Mr. Fitzgerald, if you-----

Mr. Dargan Fitzgerald: Perhaps I might have more connection with this item and I hope these comments will be helpful. You're quite right in your comment that it's not the domain of the auditor to question management on their commercial strategy and I think I mentioned that in my opening comment ... in my opening remarks. However, to be an effective auditor, an understanding of the financial reporting risks involves understanding the business risks. So, an understanding of the business risks can be obtained, typically, through a conversation with senior management and other procedures such as reviewing board minutes, which is also carried out. I think, in practical terms ... I can understand the thrust of your question ... in practical terms, an audit partner is often dealing with a finance director in terms of understanding the

financial reporting details. However, it's absolutely appropriate that in terms of understanding the commercial strategy that the audit partner would have a conversation with the chief executive and, as you can see from this note, it touches on a number of background factors. I'd more characterise it as a background briefing rather than one central to the actual conduct of the audit.

Deputy Pearse Doherty: Okay. There was mention earlier on to the evidence in the core booklet ... it's on page 21 and it's a letter from the Financial Regulator to the EBS dated 3 March 2008 and it relates to the inspection of EBS's commercial property loan book that was carried out by the regulator's office in January 2008 in relation to exceptions to policy. The letter states the level of exceptions to the credit policy for the 11 months to the 30 November 2007 was 29.2%, for 2006 it was 42.1%. I believe that you gave evidence saying that the credit ... the exceptions wasn't something you audited. Would that be correct?

Mr. Dargan Fitzgerald: Well, I just, I suppose, want to just nuance my answer slightly. We may have ... as we picked individual transactions or balances on a sample basis, we may have come across exceptions to credit policy if we were looking to see the approval history of a particular loan. However, it may not have been central to our audit assessment of whether it was reported financially correctly as to whether the ... it had been an exception or not. That would be more internal to the society and would be less relevant for the external financial reporting.

Deputy Pearse Doherty: Okay. Would it be relevant to an auditor and financial reporting, if an institution gave out loans and 100% of the loans were outside the credit policy?

Mr. Dargan Fitzgerald: Well, I think, if the auditor became so aware, and that awareness would typically be in exactly this way by reviewing regulatory correspondence, because it would be the domain of internal audit or the regulator to highlight such a thing ... I think that would probably highlight that the actual limit of approval for the policy needed to be revised. And sometimes the presence of exceptions to policies simply indicated that the throughput and the value, and the value of the loans being approved, was higher than originally intended and I think that actually runs through the Financial Regulator's letter - that they recommend that the limits be revised to cater for the throughput.

Deputy Pearse Doherty: We understand that the regulator had picked up on this because we see it from the letter. My ... what I'm trying to figure out with the 200 - I think - staff that went in ... or I'm not sure how many staff went in to this institution ... but the staff that went in to this institution and the samples ... on average, if you were taking any sample in 2006, 42% of them would show that there was exceptions to the credit policy. Does the audit team look at not just the financial accounting but also the controls and processes? And for a financial institution isn't the lending policy a core area, or not, of the institution? And if you have four out of every ten loans being issued that is outside of the lending policy of the institution, is it or is it not an issue that an auditing team should be picking up that there is so much lending taking place that is outside of the credit policy of the institution?

Mr. Dargan Fitzgerald: Understood. And so ... it might be. I must say in EBS's case it was not an issue that particularly manifest itself in the samples we selected and in the approach that we took. So, for example, if we were seeing that a loan had been appropriately approved it could well be that these ... that either it happened in periods when these exceptions did not take place, or the exceptions - as they are described by the Financial Regulator and highlighted appropriately by the Financial Regulator - they may not have been relevant to the financial reporting. They may not have actually influenced the amount that was recorded as a loan and our audit procedures would have been designed to ensure that the financial reporting of the loan

was appropriate.

Deputy Pearse Doherty: The final question I have here is in relation to IAS 39, which this committee has heard a lot of over the last number of days. I want to deal with IAS 39, paragraph 43, which allows for the ... I'll just quote it just for the reference: "When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability." That paragraph states that when you recognise a loan that was issued by a financial institution that you would have to recognise it at market value on the first recognition of the loan. Am I correct so far in my interpretation of that? I take your nodding as ... that I'm reading this properly because I'll just go on to the next bit then if that's the case.

Mr. Dargan Fitzgerald: Certainly.

Deputy Pearse Doherty: So, on that basis, was there many loans that you audited, or your firm audited, in relation to EBS, that were written down to market value and was ... when they were originally audited by ... recognised by your firm, when they were originally audited?

Mr. Dargan Fitzgerald: Certainly. I'll probably have to come back to the first part of that question. I'll have to ask to refer to the specific accounting policy - the ... the loans under international financial reporting standards are not, in some sense, reported at a market value in the sense that you mention. The sequence is, they're recorded at cost, there's an ... a derivation of an effective interest rate but, crucially, the impairment provision is what does exactly what you refer to. If an impairment provision is required, it reduces the carrying value of the loan, which, in simple terms, is typically close to its nominal value ... the amount that was loaned to the borrower. It's the operation of the impairment provision, if any, that brings, in simple terms, that to the realisable value of the loan, which you may have referred to as market value.

Deputy Pearse Doherty: Maybe to just clarify where I'm trying to get-----

Mr. Dargan Fitzgerald: Please.

Deputy Pearse Doherty: -----and I'll use a ... just an example from my own head. If an institution provided a loan for €500 million to an individual to do X, Y or Z, and on the day that you went into the audit you believed that that lending was, maybe, inappropriate, the assets weren't there to secure it, so on and so forth, and the market value - the fair value, which is the value to be reached with ... between two parties that aren't connected in the free open market - was half of that, is the accounting standard that I mentioned, IAS 39, paragraph 43 - which requires you not to recognise that loan in an incurred loss basis but actually on a fair market basis, which means that you would have to have that loan written down to €250 million instead of what was the book value of €500 million - would that be a fair assessment of what you would be required to do?

Mr. Dargan Fitzgerald: Well, I think, again, I'd have to play it back. I think you'd have to refer to the specific accounting policy which is absolutely in compliance with the standard for valuing the loans in the books of the society and because of the different types of loans, it can be a little bit more complicated than the outline description. There are two stages to assessing the value for reporting in the financial statements. One is whether there is objective evidence of impairment, that is, typically, if there is evidence of, in simple terms, stress and strain in the borrower's repayment of the loans. That absolutely depends on whether the borrower is up to date

in those payments or not in similar analysis. And then, as a second stage, if there is objective evidence of impairment, the institution - the bank or building society - will typically carry out a discounted cash-flow analysis. That fulfils the requirements of the standard. The discounted cash-flow analysis will produce a value, which will be the value that would be booked if, but only if, there is the first factor present ... the objective evidence of impairment. And in that way, and using the principle of incurred losses, which simply means that only losses which have actually occurred up to the balance sheet date, are to be recognised, then the resulting provision and write-down that you referred to is incorporated in the financial statements.

Chairman: Okay. Thank you very much, Deputy. Just on a related matter, before I bring in Senator O’Keeffe, I just want to ... when we spoke about the property experience in the audit team ... moving beyond estate agents and others that you indicated as being part of the audit team, Mr. Fitzgerald, did a team at any stage include a person who understood the concepts of commercial loan underwriting?

Mr. Dargan Fitzgerald: Oh, absolutely. I feel that the team had several senior personnel, myself included, who fully ... were fully experienced and very briefed in all of those relevant factors.

Chairman: Okay, thank you. Senator O’Keeffe.

Senator Susan O’Keeffe: Thank you, Chair.

Chairman: Your phone.

Senator Susan O’Keeffe: I am so sorry.

Chairman: Please turn off the phones. Like, it’s not possible-----

Senator Susan O’Keeffe: Guilty, as charged.

Chairman: Okay.

Senator Susan O’Keeffe: I think this ... this is probably best directed at you, Mr. Fitzgerald, but I may be wrong. I’m just trying to find out whether the society’s management and board structure ... did it impede the provision of good governance within the society at all or what impact might it have had?

Mr. Dargan Fitzgerald: Well, I don’t feel that the ... that the structure of the society impeded good governance. I never reached any such conclusion as a result of our work. I must say I was impressed in the society by the rigour of the operation of the various sub-committees of the board. I personally spoke, of course, with many senior members of the management of the society but I also reviewed the minutes of the meetings of those board sub-committees, and I’m referring, for example, not only to audit committees but to asset and liability management committees, risk committees and investment committees. And I felt, given that the society was in ... in relative terms not a giant organisation - it was one of the smallest of the Irish-covered institutions in the end of course - I actually felt its ... it had a very elaborate system of governance and control generally and I was very impressed by it.

Senator Susan O’Keeffe: In 2011, the corporate watchdog, Paul Appleby, was ... and, again, you may not be familiar with this quote, so if you’re not, of course, you may not have to comment on it. He said that there were grounds for questioning the consistency and quality of audit work within the profession, and he said that, “auditors report surprisingly few types of

company law [offices] offences to us”, with the so-called big four auditing firms reporting the least often to his office, at just 5% of all reports. So I’m just wondering if that’s a quote that you’re familiar with and if you have any view. If you’re not, of course you don’t have to.

Mr. Dargan Fitzgerald: I’m afraid I’m not familiar with the quote.

Chairman: Okay, thank you very much.

Senator Susan O’Keeffe: Were you at all aware in any of the auditing that you did of any ... whether EBS itself invested equity in any of the property transactions for which it also provided debt financing?

Mr. Dargan Fitzgerald: I’d have to check the files and check my understanding. My recollection is either no or little, but I could be corrected. I’d have to check the detail of the files, but I don’t feel that was a feature of their arrangements.

Senator Susan O’Keeffe: When Professor Ed Kane was here ... and, again, this testimony, you may not have seen. On page 233, he said, “One may know that the firm is in grave trouble but the auditors may not have sufficient information to allow them to determine that.” Would you have a view on that? And, again, that’s obviously a broad statement. He was referring broadly, not specifically.

Mr. Dargan Fitzgerald: Well, I don’t know the background or the context of that statement particularly, I’m afraid, so I probably shouldn’t comment. I don’t really know where that statement is coming from in terms of its context.

Senator Susan O’Keeffe: He was just talking generally about the practice of auditing, but I respect that. In 2011, the Revenue Commissioners - and, again, Minister Fitzgerald, you may not be familiar with this - said that audits said little about the business model of firms or their liquidity position, and:

Audit reports are primarily addressed to shareholders. However, as recent events have shown, others, including the general public, have an interest in the results of some large companies. There is a need to better set out the societal role of the audit.

Would you have a view on that?

Mr. Dargan Fitzgerald: Yes. I must say I agree with those comments, and I just might say that, as it happens, I’m a member of the council of the Institute of Chartered Accountants in Ireland, and one of the initiatives that the institute undertook in the wake of the financial crisis was to convene a working group which considered and reported with a publication called “Statutory Audit: What the Future Holds”, and in that we discussed exactly some of those challenges to the usefulness of auditing in terms of external financial reporting. And the ... some of the themes that we considered and reported on were in relation to the quality of communication that is included in the external audit report. And I think it has become clear that an external audit report in the hands of a reader, particularly a reader not particularly versed in financial matters ... in its ... in previous eras at the time that I was carrying out these audits, those audit reports restricted themselves to talking about the accounting framework and the law and certain other statements that nothing had come to their attention in relation to statutory disclosures that had not been made. Now, for public interest entities, the audit report is much longer, much more rich in content in terms of commentary on key judgment issues that have been the concern of the auditor and, by extension, the concern of management and the audit committee. And I think

that these ... this has been a significant improvement, I'm sure not perfect. I'm sure there'll always be what's sometimes called "an expectation gap" between the users, particularly non-financial users of financial statements, and the current state, but I do feel that the advances that have been made potentially improve the usefulness for society as a whole.

Senator Susan O'Keeffe: Others who've given evidence, and I mean this in the broadest sense, have referred to that period of time, I suppose, between the beginning ... probably 2008 and specifically obviously around the time of the guarantee, as being unprecedented and as being very difficult. So I just wonder what your observation might be of that time, if, indeed, you have one.

Mr. Dargan Fitzgerald: Of the time of the financial crisis?

Senator Susan O'Keeffe: Yes, of that particular time. Do you have an observation to make? Either of you.

Mr. Dargan Fitzgerald: Well, just, I'll make the general observation that I'm quite certain that in my own professional career, spanning over 30 years, they were unprecedented conditions. And I think, as ... between Paul Smith and I, we mentioned in our opening statements ... I mean, one cannot underestimate the adverse financial effects throughout all of society, and that was one of the reasons that in the institute working group that I mentioned, we were so concerned to make some public statements that would, hopefully, contribute to an improved environment for external auditing, because of some of the issues that you raise in terms of the usefulness of the external audit. But in summary, and to answer your question, I absolutely feel that the financial crisis was almost overwhelming.

Senator Susan O'Keeffe: Mr. Smith, do you ... would you care to make an observation?

Mr. Paul Smith: Only to echo what Dargan has already said and to say that in my own experience of 36 years in the profession, but not in auditing, this was absolutely unprecedented. I might just add one further comment was ... which is that, notwithstanding that it was unprecedented, I felt that the response of my colleagues in terms of carrying out their audits in a very difficult and constantly changing environment ... I thought the response was excellent and they produced very good audit reports.

Senator Susan O'Keeffe: Can I just finish by going back, perhaps, to the letter that my colleague, Deputy Doherty, referred to ... the letter between ... the Kieran Kelly file note in relation to Ted McGovern ... I beg your pardon, that's the core document, page 3 ... page 3 and 47, actually, on page 4. So, he goes on to say that Mr. McGovern raised various things like the reliance on a few numbers of very key people is a risk - he was talking about in the institution - that there is imprecision in figures and that people are being forced into taking actions which are, in turn, imprecise and slightly unfocused. In respect of control breakdowns in the year, he said that there would appear to be fewer than in previous years, which he took as being a positive outcome from some changes and actions which had been taken. He said that there were, and I quote, "a couple of fraud instances and behavioural instances" which caused him concern. So ... and then he goes on to say, "I asked [him about the] focus on commercial lending [as a fit in] the ethos of the society as a retail financial services provider", and he said "this is a business line that they feel they can make return commensurate with their risk and for which they have skills and opportunities to capitalize on". So again, largely, those comments feel again to people not familiar ... and we've listened a lot to auditors saying that it is a faithful statement and that it looks at the figures in a time and that you don't have anything to do with the running or the in-

fluence of the management. I appreciate you've observed that it is a ... that it was a background briefing, but it does seem as if there were very specific observations being made about problems at the society, albeit it's in, you know, in this context, so I'm just wondering how ... there was clearly an exchange here. How ... I don't know how that fits into the audit process.

Mr. Dargan Fitzgerald: Yes, thank you. I think I appreciate the thrust of your question. I would just say that, while it is a high-level and a background briefing note, it does inform the conduct of the audit and, I mean, I actually can't say this without checking, but if I had been in the room and was carrying out the audit based upon this as a high-level briefing, absolutely we would circle back to check matters reported as frauds. There would be a process inside the society to record frauds that have been identified and we would look to see whether they had any impact on the financial reporting. Typically, they don't, or they have already been reported and they're more internal control issues, but, nonetheless, we do take into account ... and a typical way of dealing with it on an audit would be to take a file note such as this and tick off each of the points and cross-reference them to another piece of our work where we had satisfied ourselves exactly to your question that there was nothing that was being referred to which should give us concern in carrying out our work. So I would say, yes, it was a background briefing, but we would not ignore any of the comments if we thought they would affect the financial reporting. I hope that helps.

Senator Susan O'Keeffe: Just to-----

Chairman: Quickly.

Senator Susan O'Keeffe: Just to clarify, he ... Mr. Kelly does ask about how commercial lending fits into the ethos of the society.

Mr. Dargan Fitzgerald: Yes.

Senator Susan O'Keeffe: Is that not a direct question about management style or an approach or an adopting of a, you know, maybe concentrating more on commercial lending than had hitherto been the case?

Mr. Dargan Fitzgerald: Well ... it's ... I feel it just evidences a dialogue in terms of understanding the business risks and the business motivation and, again, I feel that's quite appropriate and it doesn't stray into advising management or any of those things. I think that's obtaining and understanding appropriately by asking as to the rationale.

Senator Susan O'Keeffe: Thank you, Chair.

Chairman: Thank you very much. Senator Barrett, ten minutes.

Senator Sean D. Barrett: Thank you, Chairman, and welcome along this afternoon. Could I ask did you perform stress testing as part of the external audit of the society?

Mr. Dargan Fitzgerald: Well, if by stress testing you mean did we analyse different scenarios in which the reported results might fall, given different scenarios of loan losses, and I'm not sure that is your question, but certainly, in terms of what's commonly called stress testing, we evaluated different scenarios which the society produced in terms of the loan loss provisions, to ensure that the scenario and judgments ultimately made, in relation to the impairment provisions adopted and incorporated in the financial statements, were reasonable.

Senator Sean D. Barrett: Because, if I may, page 17 of the core document, Chairman, the

regulator is concerned at the “high level of approvals that exceeded the affordability guidelines, particularly as this criterion is the one which incorporates stress testing of loan repayments”, and it says “see also finding M1”, which we don’t have. So, was it the wrong kind of stress-testing or why did the regulator bring up the issue in relation to the EBS in his letter, which is dated 10 June 2007?

Mr. Dargan Fitzgerald: Thank you. Well, first of all, to understand that the purpose of the regulator in bringing up such items is, as I previously mentioned, quite different from the external auditor’s role and they very much approach their work from different angles. The regulator, as I understand it, carries out a very detailed body of work to check that the detailed operation of procedures, which they, as regulator, feel are important in relation to the functioning of the regulated entity, that those are carried out appropriately, and these recommendations are, therefore, very very detailed in that regard. When you mention stress testing, I think now that I see your reference, I imagine that’s in relation to the stress testing of the repayment capacity of an individual borrower, I think that’s probably what’s referred to. The answer I gave was at a level of the totality of loans and please excuse me if I misunderstood your question. So I would think in relation to that comment on stress testing, that will not have a direct correspondence with any external audit tests as such, except to the following extent: that as I previously mentioned, we always, investigating ... in reviewing a loan and discussing it with management, we look to see whether there is evidence of impairment of the loan, including any financial distress of the borrower, and so that may have been relevant.

Senator Sean D. Barrett: But would it have come to the auditor’s notice that there was a high level of approvals not within normal guidelines and a quarter, virtually, of the home loans exceeded affordability guidelines? Having in mind what Mr. Smith was saying earlier about a new dialogue between the regulator and the auditors, would these not be things that, going forward, we should actually be discussing to say, “these are the warning signals we see here”, and here is more that the regulator has brought in? Otherwise, we could lose another €100 billion, if we take into account the losses to two sets of taxpayers and the shareholders being wiped out.

Mr. Dargan Fitzgerald: Understood. Well, I would comment as follows: I think that the comments you’ve made do highlight the benefits of one initiative that I feel is very important that I mentioned in my opening remarks, which is the introduction of an auditor protocol, between the then Financial Regulator, and now the Central Bank of Ireland, and external auditors. And that edict was updated in 2013, and it provides explicitly for bilateral or in some cases trilateral meetings - bilateral meaning the entity being audited ... that meaning the Financial Regulator, on the one hand, and the auditor to an institution, on the other, and those meetings specifically allow the Financial Regulator, if they so wish, to communicate a concern around an item just like the one you mentioned. It also means that the auditor can communicate to the regulator items that the auditor may feel the regulator should have knowledge of, and, frankly, it allows for an informal discussion of such matters. And in my own experience, and I have sat in on many dozens of such meetings under this protocol, it is very helpful in a mutual understanding in the regulator’s department and in the auditor as to what the significance of such matters really is.

Senator Sean D. Barrett: I liked your earlier point about improvement points, control points and this kind of dialogue and Mr. Smith’s points, but we better move on or our mutual admiration will use up too much of the time.

You say on page 11, it’s in the fourth paragraph on the right hand side: “We noted that there is a strong risk consciousness in general throughout the Society”. But does that not contrast

with the 57% discount? I was thinking that, you know, our new man in drapery buys really good suits, but we can only sell them at 57% discount, so that he hasn't got a great cost consciousness.

Mr. Dargan Fitzgerald: Well, I would just repeat that the ... and the comment we've made that you refer to is at the, I might say, the highest possible level. It looks at and comments on our general understanding of whether processes of internal control are operating effectively. In the work that we carried out, we found that internal control environment to be relatively strong. And when I say that, we would be comparing to the experience we had had of other similar institutions and to other institutions generally. I do feel there was a strong control consciousness.

Now, notwithstanding that, banking involves dealings with an enormous number of individual customers and the Financial Regulator's brief, I believe, in carrying out reviews like this is to highlight procedural matters that would not have the same significance for us as for the regulator.

Senator Sean D. Barrett: How do the groups of accountants operate? Again, the dreaded word, does EY Ireland operate as a "silo" or would you have contacts with the other EYs around the world?

Mr. Dargan Fitzgerald: Well, we certainly don't operate as a silo. We describe ourselves as a global firm and we are integrated in a number of ways with other practices. We would work, as you might expect, closely with the practice in the United Kingdom, but also with other financial services centres overseas, such as New York and----

Senator Sean D. Barrett: So it's more than a franchise, is it?

Mr. Dargan Fitzgerald: Yes, but I wouldn't have described it as a franchise.

Senator Sean D. Barrett: When Lehman Brothers collapsed, would you have been speaking with your opposite numbers in New York about what did they feel went wrong in the audit? Because it's been crucial throughout these hearings, the collapse of Lehman Brothers. I'm just wondering if you had any insights into ... from your colleagues in EY New York?

Mr. Dargan Fitzgerald: Well, I'd say two things. First, no, I personally had no such conversations, but I wouldn't have expected to particularly and ... but I would also say that both internal EY commentary of the risks facing financial institutions was disseminated regularly, which assisted teams like my own significantly in their understanding of the nature of the financial crisis that was then unfolding and of the financial reporting and auditing risks that resulted.

Senator Sean D. Barrett: As I understand Sarbanes-Oxley, there are two things that I might like to ask you about. Individual responsibility, I think, it's as high as 20 years imprisonment for malpractice in auditing and \$5 million fines, and separation of auditing from consultancy work. Could you tell us a little bit about those in the little time remaining, please?

Mr. Dargan Fitzgerald: Certainly ... well, certainly happy to comment on the latter. In relation to the former, I would just comment that the attitude of legislators in each jurisdiction, in each country, does vary greatly. And I'm sure there's broad consensus that in the United States there's a very great focus on that. I'm sure that lessons can be learned in other countries and territories. And I might mention that, for example, in Irish legislation, there has increasingly, and will increasingly be, certification of financial statements amounts by directors, rather than just a sort of general responsibility. So, I do think that has evolved.

In terms of the question you asked about the separation of consulting or advisory work from auditing work, in practice, it is rigidly separated, due to the operation of ethical standards. And so, I must say the profession is extremely conscious of the perils of self-audit or of conflict of interest. I know in our own firm, as I'm quite sure in the other firms, enormous lengths are gone to to ensure conflicts of interest are either not present or are handled appropriately.

Senator Sean D. Barrett: Thank you very much. Thank you, Chair.

Chairman: Senator D'Arcy.

Senator Michael D'Arcy: Thank you, Chair. Mr. Fitzgerald, what changes, if any, to the auditing process should be taken in to improve the current structures?

Mr. Dargan Fitzgerald: Well, some of them we've probably touched on in some of the discussions. I think the move to make ... to update audit reports so that in the case of public interest entities they give more detail about the judgments, are an important development. I feel that the role of audit committees in terms of the robust challenge that they can bring to board operation is an important additional improvement that is being and can continue to be made across the piece.

Senator Michael D'Arcy: And in terms of ... what's your opinion in relation to audit firms to further improve the supervisory and the regulatory process of banks and financial institutions?

Mr. Dargan Fitzgerald: Well, I'll probably confine my comments to the perspectives that deal with auditor-specific matters and the interaction with the Financial Regulator that auditors have. As I mentioned, an updated auditor protocol enables both meetings and other communication between the auditor and the Financial Regulator. I feel this is very helpful to the conduct of external auditing. I presume it is helpful to the regulator.

I had mentioned in my ... both my opening remarks and in our written statement that it possibly could be improved by being underpinned in a statutory way. At the moment, it's a protocol issued by the Central Bank of Ireland and there is some thought that if it were underpinned by a statutory basis, it might be more reliable. And there is always the possibility that external auditors should have a right to report rather than the duty to report which they currently have.

Senator Michael D'Arcy: Outside of the move to codify those protocols, those non-statutory provisions, anything else you could think of that should be incorporated that haven't been to date?

Mr. Dargan Fitzgerald: Nothing springs to mind.

Chairman: Okay. Thank you. I'll just move towards a wrap-up so, Mr. Fitzgerald and Mr. Smith, in inviting both Deputies in.

Can I just come back and deal with just one matter relating to the Financial Regulator and the matter of loan exceptions? Following the Financial Regulator's findings, did Ernst and Young alter their sampling approach when reviewing loan exceptions?

Mr. Dargan Fitzgerald: I probably would have to check the detail of the files. My recollection is that it was not felt that we needed to do so. And the reason I say that is that, as I previously mentioned, the sample sizes that we were contemplating in the and then executed in the 2008 year were significantly increased in number and scope on the 2007 year so there was

already a considerable increase in the amount that we were testing.

Chairman: Thank you. Deputy Higgins.

Deputy Joe Higgins: Gentlemen, I've just one question to sum up. We're just coming to a conclusion of just north of 14 hours of testimony and questions from the four that are considered the giant auditing firms in this State, and giants internationally as well in the auditing world, who audited in this State the giants of the financial institutions. Up to the end of 2007 and reporting in the first six months of 2008, there were no qualified reports whatsoever. A clean bill of health was given. You were happy with the loan books. You were happy with the security for the loans. You were happy with the large concentrations of loans in land and property. Happy with loans-to-deposit ratio and happy that all the banks were going concerns. Yet, just a few short months later at September's end, the self-same financial institutions were in a state of chassis, down banging on Government Buildings, desperately looking for a bailout and a guarantee, leading to a process that eventually cost our people €64 billion and years of austerity and pain and dislocation. Can you try to explain that to our aggrieved people?

Mr. Dargan Fitzgerald: Well, perhaps I can lead off and just say I think your comments, which absolutely, in me personally, provoked the reaction that as we previously mentioned, the effects of the financial crisis have been, I would say, cataclysmic and there is no attempt, Deputy, to underplay, in any of my, and I think our, testimony those effects. I mean, they are fully appreciated and I think some of ... some of the comments I've made in terms of improvements to auditing practice since the financial crisis began I hope go some way to improving the situation going forward but I am cognisant that they are only small steps and ... and that greater steps must be taken in a whole plethora of different arenas such as regulation generally, governance generally and so on.

I think your comments highlight the precipitous fall in certain markets, particularly for property assets, in a very short number of years, and I just would reflect on the fact that, in the 2007 report to the audit committee, we wrote then specifically highlighting that the credit loss provisioning represents one of the most significant challenges for banks and building societies in complying with the requirements of International Accounting Standard 39. So, I just would highlight, I think in our ... certainly in my own case, I can say, I think the audit team was alert to the possibility of financial reporting being under stress and strain but I think that it's important to remember the respective roles of the various participants in the crisis.

Deputy Joe Higgins: Mr. Smith, you were the senior person in Ernst and Young. Your comment, please.

Mr. Paul Smith: I really don't think that I've got anything specifically more to add to what my colleague has already said.

Chairman: Okay, just on that note, can I just turn to, in respect of the booklet, page 11. I now bring in Deputy O'Donnell. And this just develops on from Deputy Higgins's comment there. It's the second panel of conclusions and it's the second paragraph:

We reviewed the Society's Credit Impairment Policy to understand and consider the Society's methodology [to determine] specific and collective provisions. We are satisfied that the methodology complies with the requirements of IAS 39.

That was in 2007; in around the time that you wrote that correspondence. I just need to just kind of measure how I frame this. By satisfying the methodology compliances and require-

ments of IAS 39, was that sufficient in providing a true and fair view of the banks, in effect?

Mr. Dargan Fitzgerald: Thank you. Yes, I do feel it was and, if I can perhaps put some of my comments in a slightly different and summarised way, which I hope will be helpful, the ... those readers of the financial statements prepared in accordance with that accounting standard, assuming they had knowledge of the way in which the standard prescribed the recognition of incurred losses, in terms of impairment of loans, would have been in a position to appreciate from the financial reporting that ... that there was ... that there was weakness in the bank's situation and the ... the principle of our giving a true and fair view is that, because it references a specific reporting framework, if the reader can appreciate the, and I appreciate that's not always easy, but if the reader can appreciate the actual formal basis for the framework, well then it is important that the auditor carries out their role in reporting within that framework, and I think the true and fair view is to be understood in that context.

Chairman: Okay. Thank you very much, Mr. Fitzgerald. Deputy O'Donnell.

Deputy Kieran O'Donnell: Can I just take up the true and fair view, just to get clarity? You're required to audit obviously under company law but, in here case, it was built inside the Act 1989 for a true and fair view. The question, I suppose, I want to ask is, with the change in ISI 39 in terms of recognising losses from 1 January 2009, did it bring about a delayed recognition of losses after the horse had bolted or did IA 39 have any ... did it change in any way the provisioning of the banks?

Mr. Dargan Fitzgerald: Well, I think I can respond by just making a general comment in terms of the application of that accounting standard and the incurred loss model. The incurred loss model continues to be employed in the financial reporting of banks currently. I'm sure you're aware that under a coming accounting standard, but not yet implemented, what's known as an expected loss model will be employed. It's probably overstating it to imagine that it would be a completely different regime, it will still depend on objective evidence to some extent and it remains to be seen what differences it actually causes in financial reporting.

Deputy Kieran O'Donnell: Can I just ... the context ... am I correct in saying that ISA 39 ... from 1 January 2005 was amended in that way because it was felt that financial institutions were effectively smoothing out losses, they were making provisions up ahead and they were effectively smoothing out losses and that ISA 39 ... it still dealt with ... on a discounted cash basis. So, you were still looking at the value of a loan, day one, the market value and then you looked at what the cash flows were like and then you discounted it back to net present value. So, the question I'm asking is, how is that different ... that looks to me like that you are providing losses as well being incurred but also an element of expected losses ...so what is the significant change in ISI 39, that everyone says it's the ... and many people have stated that it's the reason why significant ... sufficient impairment provisions weren't provided?

Mr. Dargan Fitzgerald: Well, I'll just make some comments which I hope will be helpful. Firstly to say, I'm not aware of the specific motivation in standard setters for designing and promulgating IAS 39. However, as a general matter and from my knowledge - and not just in banks - there was an overall objective to make it less easy for companies, including banks, to, as you say, smooth results by incorporating what are sometimes called general provisions. So, I must say I agree with the thrust of your comment that that seems to have been a motivating factor. In terms of whether a different model would have had a ... would have brought about a different recognition pattern within the history of, perhaps the Irish banks, I mean that is speculation. One doesn't know the quantum of a difference that might have been made. I think it is

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probably very helpful to transparent financial reporting that the model has evolved and will be rolled out in an improved state-----

Deputy Kieran O'Donnell: Mr. Fitzgerald, you're at the coalface, you're the guy on the ground doing it in your daily chores, do you believe it would have made a difference if ISA 39 wasn't implemented from '05 on?

Mr. Dargan Fitzgerald: Any comments I make would just be personal and, in that context, I'm just not sure because I just don't know. I have a suspicion that the ... an instinct that we were perhaps, collectively, in discussions like this, assuming that it would have been very different in terms of the financial reporting of losses. I'm not actually not sure, given that it would have also been evidence based, whether it would have made as big a difference as one thinks but the next point is even more crucial. I don't think the financial reporting of the losses was linked to the presence of the underlying causes of the crisis. The losses reported, whether in any particular period, are a consequence of the factors that caused the crisis, they didn't cause the crisis and I think that's a very important point.

Chairman: Okay, thank you very much. Thank you very much, Deputy, and thank you, Mr. Fitzgerald. Thank you, Mr. Smith. Is there any other final comments you'd like to make before I conclude?

Mr. Dargan Fitzgerald: No, thank you.

Chairman: Okay, with that said, I'd like to thank you both, Mr. Fitzgerald and Mr. Smith, for your participation and engagement with the inquiry this afternoon and to now formally excuse you and thank you once more. Thank you. So with that said, I now propose that the meeting is adjourned until 9.30 a.m. on Thursday, 21 May at 9.30. Is that agreed?

The joint committee adjourned at 6.05 p.m. until 9.30 p.m. on Thursday, 21 May 2015.