

## Statement of Dargan FitzGerald

1 May 2015

### 1. Introduction

- 1.1. I have been invited to submit a statement on a voluntary basis to the Committee. I have read Mr Smith's statement and do not propose to repeat its contents save to note my agreement. I will deal in more detail with the accounting and auditing standards applicable to the audit of banks' Financial Statements in 2008 and I will also explore some of the key changes to the regulatory, auditing and accounting rules which have been introduced since then. In addition, I will comment on the points which the Committee specifically raised in its letter to Mr Smith dated 2 April 2015.
- 1.2. I am EY Ireland's Audit Compliance Principal and an Audit Partner specialising in the audit of financial institutions. I was the audit partner for EBS for the years ending 31 December 2007 and 2008.

### 2. Financial Statements and the Integrity of Financial Reporting

- 2.1. In Ireland and internationally directors are responsible for the preparation of Financial Statements. Irish law places the responsibility for preparation of annual Financial Statements on the directors of the Irish banks. Accounting judgments are also the directors' responsibility.
- 2.2. A company's annual Financial Statements are inherently retrospective - showing a historic snapshot of its financial position at a particular balance sheet date, and also its past performance during the period covered by the Profit & Loss Accounts.
- 2.3. Financial Statements reflect information that existed at the balance sheet date and certain information that came to light after the balance sheet date but before the Financial Statements were signed that concerned the circumstances that existed at the balance sheet date.
- 2.4. In 2008 the accounting standards applicable to Irish banks were the International Financial Reporting Standards (IFRS). These required an "incurred loss" model. Essentially this meant that loan impairment provisions reflected the position at the balance sheet date. Losses expected as a result of future events, no matter how likely, were not recognised. Consequently, deteriorating economic conditions would inevitably require an increase in impairments in subsequent Financial Statements. However, banks were not permitted to anticipate this. They had to wait until the loss was incurred.
- 2.5. The incurred loss model has attracted criticism in Ireland and overseas and the standards are being changed. For example, *Nyberg* observed:  
  

***"Pro-cyclical IFRS accounting rules further limited the predictive value of the covered banks' Financial Statements. From 2005 the banks' profits, capital and lending capacity were enhanced by lower loan loss provisioning while the benign economic conditions continued. As the global crisis developed from mid-2007, the banks were constrained by these incurred-loss rules from making more prudent loan-loss provisions earlier, and the auditors were restricted from insisting on such earlier provisioning."***
- 2.6. The requirement that banks (like other companies) presented their Financial Statements on the basis of an 'incurred loss model' flowed from the Framework that underpinned the International Financial Reporting Standards at the time. An inherent feature of an incurred loss model is that, all else being equal, impairment provisions will change depending on subsequent economic developments. Sophisticated users of the Financial Statements (to whom such documents were traditionally directed) would have their own views as to the economic prognosis and would factor that into their analysis of the Financial Statements, as would prudential supervisors.
- 2.7. The relevant accounting standard, IAS39, is being replaced. The new standard (IFRS9) will require companies to adopt an expected loss model in future Financial Statements.

## Going Concern

- 2.8. Although Financial Statements report on historic financial performance, they are normally prepared on the basis of fundamental accounting assessments, including whether the enterprise will continue as a going concern for at least twelve months after the Financial Statements are approved. The EBS Financial Statements for 2008 record the directors' conclusion that it was reasonable to assume that EBS would continue as a going concern for the following twelve months. Such assessments received particular audit scrutiny in 2008/2009 and we probed this issue during the 2008 audit. The Government Guarantee was a key factor in EY Ireland's analysis of this assessment by the EBS directors.

## 3. **Audit Responsibilities**

- 3.1. Irish banks are required by law to appoint independent auditors. Irish statutory auditors' duties are defined by law. Auditors perform their duties in accordance with independently prescribed auditing standards (not to be confused with accounting standards), in this case the International Standards on Auditing (UK & Ireland) (ISAs).

- 3.2. The auditors' primary function is to carry out a statutory audit of the company's Financial Statements, and to express an independent opinion. The opinion must address matters prescribed by law - such as whether the Financial Statements show a true and fair view in accordance with the applicable accounting standards.

- 3.3. The importance of an audit was acknowledged in the 2010 European Commission Green Paper "*Audit Policies: Lessons from the Crisis*", (the EU Green Paper):

***"The Commission recognises that continuity in the provision of audit services to large companies is critical to financial stability."***

- 3.4. As Nyberg observed:

***"The purpose of the external audit as set out in Irish company law was to enable the covered banks' auditors to express opinions to the shareholders on whether the Financial Statements prepared by the directors gave a "true and fair view" of the banks' financial results and positions for the financial periods just ended. In broad practical terms, "true and fair" means in this context compliance with applicable accounting standards and applicable laws and regulations."***

- 3.5. The Chartered Accountants Ireland 2011 Report "*Statutory Audit – What the Future Holds*" was to similar effect:

***"The primary purpose of statutory audit has remained unchanged for many decades. This is, as enshrined in company law, to enable the statutory auditor to express an opinion on whether the Financial Statements of an entity give a "true and fair view". Counsel's opinion to the Accounting Standards Board on the meaning of "true and fair" concludes that, in the context of financial reporting, compliance with a relevant accounting framework (Accounting Standards) and the relevant company law provisions is prima facie evidence of a "true and fair view"."***

- 3.6. The responsibilities of statutory auditors are similar throughout the European Union. The objective is to obtain reasonable assurance as to whether a company's Financial Statements are free from material misstatement. The *EU Green Paper* observes:

***"The annual accounts of limited liability companies are required to be audited by law. The fact that companies' Financial Statements are audited does not mean that there is an obligation on the auditor to ensure that audited accounts are entirely free from misstatements. When reporting that Financial Statements give a true and fair view in accordance with the relevant financial reporting framework, auditors provide "reasonable assurance" that the Financial Statements as a whole are free from material***

***misstatement, whether due to fraud or error. Auditors thus seek to minimise the risk that historical financial information, presented in compliance with a given accounting framework, is "materially" misstated. The Commission notes that the statutory audit has evolved from substantive verification of income, expenditure, assets and liabilities to a risk based approach."***

- 3.7. Auditors are not responsible for the company's commercial strategy or decision-making. To the contrary, independence from management and decision-making is an essential feature of the audit process. Statutory auditors must be independent by law.
- 3.8. Although directors are responsible for corporate governance, as auditors we consider the company's governance and structures during our review of its Financial Statements. Also, obligations to report to the Financial Regulator may arise in some circumstances, for example where we become aware of a regulatory breach. We also inform those charged with governance if we became aware of significant governance concerns or issues with the company's internal controls during the audit. We also consider aspects of governance compliance under Irish Stock Exchange listing requirements when applicable. However, it is not our function as auditors to undertake a forensic analysis of governance or regulatory compliance.
- 3.9. Our statutory audit report is published as part of the Financial Statements. Amongst other things, it expresses our independent professional opinion as to whether the Financial Statements show a true and fair view of the company's state of affairs as at the balance sheet date and of its profit or loss for the period covered by the accounts.
- 3.10. We approach our audit responsibilities professionally and ethically and on the basis of the principles laid down in the auditing standards, including a strong sense of professional scepticism. EY Ireland has confidence in our professionals and their audit work and approach (as do I). Testing, probing and challenging management accounting and financial reporting judgments in its Financial Statements is an essential part of our audit role, and it consistently happens in practice. We challenge management assertions and accounting positions where necessary, even if this has significant implications for the company's financial reporting.
- 3.11. The work involved in a bank audit may not be fully appreciated by those who have not participated in such a process. Our audits are designed, in accordance with auditing standards and our own global procedures, to identify matters which present a significant risk of material misstatement of the Financial Statements. Our work is particularly focussed on such significant risks.

#### **4. International Financial Reporting Standards and International Auditing Standards**

- 4.1. The development of International Financial Reporting and Auditing Standards was intended to foster international trade and investment by ensuring greater transparency and consistency in financial reporting. Accounting standards do this by requiring a common international approach to the presentation of Financial Statements. Likewise the auditing standards are intended to ensure a consistent international approach to auditing. These standards are part of a framework of assurance that includes prudential regulation, central banking and regulation on capital requirements. All these areas have changed since the crisis.

#### **5. EY Audit methodology**

- 5.1. Our Audit Methodology provides a global framework for delivering high-quality audit services through the consistent application of thought processes, judgements and procedures in audit engagements. Making risk assessments, reconsidering and modifying them as appropriate, and using these assessments to determine the nature, timing and extent of audit procedures underpin our approach. Our approach reflects International Standards on Auditing (ISAs) supplemented to comply with the local Irish legal requirements. Our procedure requires compliance with ethical requirements, including independence. We regularly review and update our methodology in the light of changes to auditing standards or other relevant developments.

- 5.2. Our structures are also designed to ensure compliance with our procedures and the auditing standards. They provide for the review of the work of more junior members of the audit team, and the appointment of an independent partner on certain audits (in addition to the engagement partner).

## 6. The Presentation (and Audit) of Financial Statements and the Banking Crisis

- 6.1. While it may be appropriate to consider changing responsibilities and standards, the actions of earlier years must be judged by then applicable requirements.
- 6.2. The banking collapse was not caused by issues with regard to the Banks' presentation of their statutory Financial Statements but by a series of unprecedented events in the financial markets. The global economic crisis was caused by a series of factors including governance failings, supervisory weaknesses and capital upheaval, made worse in Ireland by the massive losses resulting from the collapse of the property markets.
- 6.3. With the benefit of hindsight, observers have criticised the banks' business models and approach to risk. However, these are issues for the board and management and for regulators. Key factors (such as lending and liquidity strategies) were the responsibility of those charged with commercial decision-making within banks.
- 6.4. The EBS Financial Statements for the year ending 31 December 2009 included comparative figures for the previous year, 2008 (in accordance with normal practice). These comparative figures came from its 2008 Financial Statements. This demonstrates that, when the 2009 Financial Statements were prepared (in early 2010), the directors of EBS remained satisfied that the 2008 Financial Statements had been properly presented in accordance with the applicable accounting standards. If at that stage the directors had considered that the 2008 comparative figures did not give a true and fair view of the position for the year ending 31 December 2008 then EBS would have been obliged to restate the 2008 comparative figures in its 2009 Financial Statements.
- 6.5. It would also be wrong to assume that Irish banks' liquidity problems or increased impairment provisions implied that previous Financial Statements had been misstated, far less than that there had been any audit deficiency. The Financial Statements presented the bank's financial position at the balance sheet date, rather than anticipating future profit or loss. Likewise, audit reports confirmed that the auditors agreed that the Financial Statements gave a true and fair view in accordance with the applicable accounting standards.
- 6.6. While conditions had been deteriorating previously, the downturn greatly worsened from 2009. Further massive losses occurred due to the collapse of the property markets. Such losses and increased impairment provisions were duly reflected in subsequent Financial Statements. Banks worldwide increased impairment provisions. This necessarily impacted on their Financial Statements. These changes did not imply that previous Financial Statements had been misstated by virtue of their failure to anticipate future losses.

## 7. The Need for Change

- 7.1. Although I do not believe that the crisis was caused by any failure to properly audit Financial Statements, this does not mean that auditors, audit standard setters and policymakers should be complacent. The question arises, what is the relevance of historical audited financial information? It is also necessary to consider changes to financial reporting requirements and whether the auditors' role should be extended beyond reporting on whether the Financial Statements give a true and fair view.
- 7.2. The *EU Green Paper* observes:

***"For other stakeholders it may be difficult to understand that an institution's Financial Statements may suggest "reasonableness" and "material soundness" even if the same institution was, in fact, distressed financially. Given that these stakeholders may be unaware of the limitations of an audit (materiality, sampling techniques, role of the auditor in the detection of fraud and the responsibility of management), this engenders***

***an expectation gap. The Commission therefore advocates the need for a comprehensive debate on what needs to be done to ensure that both audits of Financial Statements and auditor reports are "fit for purpose".***

7.3. I believe the current reporting and auditing model delivers significant value to users. I also note that significant changes have already been made since 2008. However, I accept that the profession should always be open to positive changes that enhance stakeholder confidence and improve audit quality.

7.4. Current audit practice is part of an international framework of assurance that includes prudential regulation, central banking and regulation on capital requirements. These areas have seen significant reform since the crisis and Ireland's approach to these issues should remain aligned with its international partners.

7.5. I also endorse the testimony to the Public Accounts Committee in 2010 by Mr Elderfield, then newly appointed Head of Financial Regulation - he:

***"...broadly welcomed a suggestion by the CAG [Comptroller and Auditor General] that auditors provide annual positive assurance of corporate governance regimes, including risk management. However, he cautioned that this would require careful consideration and should not impose excessive overheads or standards to be audited that are vague or too extensive." (Committee of Public Accounts Report)***

7.6. The possibility of extending the audit role from the independent review of the historic Financial Statements to the provision of prospective information about the company has given rise to international debate - the *EU Green Paper* gives a guarded response.

***"The focus of the audits so far to a large extent has been based on historic information. It is important to consider the extent to which auditors should be assessing forward looking information provided by the company, and given their privileged access to key information, the extent to which auditors should themselves provide an economic and financial outlook of the company.***

***Forward looking analysis, at least for large listed companies has so far been covered by equity analysts and credit rating agencies. The role of the auditor should thus be extended in this direction only if there is real value added to the stakeholders."***

7.7. Risk is inherently linked with commercial decision-making, the responsibility of those charged with the management of a company's affairs. There may be a case for additional requirements to ensure greater disclosure either to regulators or shareholders, supported by audit reports. However, these requirements should be clear and focussed.

7.8. There have been significant legal, accounting and auditing changes since the banking crisis. For example, apart from the Companies Act 2014, Central Bank reforms include rigorous fitness and probity requirements for control functions in banks, a new Auditor Protocol and a new Corporate Governance Code.

7.9. The Protocol enhances information sharing between the Central Bank and auditors requiring the auditing firm to share information which may assist the Central Bank in its supervisory function and requiring the auditors to include such arrangements in letters of engagement.

7.10. The (revised) Corporate Governance Code applies to all banks licensed by the Central Bank. It increases Boards' responsibilities and requires contingency plans to address identified risks. These plans must be regularly reviewed, updated and tested. It also contains detailed provisions concerning governance, independence of directors, separation of roles and powers, composition and structure of Boards and key committees and other issues to ensure best practice in governance, including provisions relating to the time directors must be able to dedicate to their role.

- 7.11. Further, the Central Bank (Supervision and Enforcement) Act 2013 strengthened the enforcement and supervisory powers of the Central Bank.
- 7.12. In addition, the regulatory, capital and liquidity regime under CRD IV goes further than the previous regulatory regime in that it requires banks to maintain more and higher quality capital reserves and minimum levels of liquidity coverage.
- 7.13. Other measures instituted by the CBI include requirements as to:
- (i) Disclosure of Loans to Persons Connected to Directors;
  - (ii) Management of Liquidity Risk; and
  - (iii) Impairment Provisions.
- 7.14. In addition, SI 450/2009 and SI 83/2010 require Irish companies (including banks), whose shares are listed on regulated markets to include a Corporate Governance Statement in their annual report. The auditors must express an opinion on aspects of the report.
- 7.15. International Standards on Auditing have also changed. ISA 700 (revised in 2013) requires greater disclosure in the audit report in respect of Financial Statements of companies with their listing in Ireland or UK primary markets (like the Main Securities Market (MSM) of the Irish Stock Exchange or the FTSE). The audit report must now disclose information about the approach to the audit of the Financial Statements.
- 7.16. For example, a recent expanded audit report on a leading Irish bank's financial statements, confirms that the Financial Statements give a true and fair view and:
- specifies the Financial Statements and other documents which have been subject to audit;
  - confirms the audit scope in terms of materiality and the areas of focus;
  - identifies areas of focus which were identified as posing a potential risk of misstatement to the Financial Statements, namely:
    - impairment;
    - recoverability of deferred tax assets;
    - valuation of insurance contract liabilities;
    - retirement benefit obligations; and
    - going concern.
  - the audit report explains how the audit approach addressed each focus area.

Hitherto this information would typically have been shared with Management, the Audit Committee, or the Board but would not have been made publicly available. I welcome the greater transparency.

- 7.17. Further, the revision of ISA 260 reflects developments in several jurisdictions. The new standard imposes additional explicit communication requirements on auditors in respect of significant difficulties encountered and significant matters that were discussed with management during the audit.
- 7.18. In addition, ISA 265 was issued in 2009 to enhance the quality of the auditors' communication of deficiencies in internal control. It requires the auditors to determine whether any deficiencies identified in internal controls merit the attention of those charged with governance and, if so, to communicate in writing all deficiencies to those charged with governance.

## 8. Communications with Regulators

8.1. I believe that prudential supervisors and auditors should work more closely together. This would help auditors serve the public interest and would reinforce the role and effectiveness of both parties.

8.2. For example, perhaps banks should be required to obtain an independent audit of their regulatory returns. This would be a cost for the banks but would give the Financial Regulator the assurance that these returns had been independently reviewed. The auditors' knowledge of the bank would be greatly reinforced if, as well as focussing on the annual audit of the Financial Statements, they reviewed the regulatory returns during the year. Inconsistencies between the annual audited Financial Statements and the regulatory returns during the year could be identified if the latter were subject to independent audit. Such requirements are imposed in respect of insurance companies' regulatory filings but not in respect of those of banks.

8.3. A further reform concerns the information sharing between auditors and regulators. While supporting the Auditor Protocol, I would welcome further changes to facilitate information sharing. The *Committee of Public Accounts Report* observed:

***"Bank external auditors are obliged to return various types of information to the Financial Regulator but had no right to report other matters (Nyberg 3.6.1). This information includes audit findings reports, management letters, and Miscellaneous Technical Statements (M46 letters). This was done in all cases and the returns contained sufficient information to deduce the banks' business models and lending practices, including those of Anglo and INBS. They did not, however, contain any discussion or comment on the implications of the returned information; nor did auditors and the Financial Regulator engage in dialogue regarding audit finding reports. Such comment or dialogue could have highlighted emerging problems before they became acute."***

8.4. The *Committee of Public Accounts Report* noted the limitations on auditors' ability to disclose information to the Financial Regulator:

***"Bank auditors communicate in varying levels of formality with the Financial Regulator. While they are required to report certain matters to the Financial Regulator, client confidentiality prevents them (unlike their UK counterparts) from reporting other concerns (such as concerns about the risks associated with the business models used)."***

8.5. This need has also been recognised internationally. The *EU Green Paper* observes:

***"The knowledge gathered by external auditors through their work may be useful to supervisors and the Commission recognises the need to strengthen cooperation between the auditors and the supervisory authorities."***

8.6. Auditors must report to the Central Bank (and other authorities) in specified circumstances, but it would be more appropriate for the law to allow auditors a broader discretion to raise matters with the Central Bank (or other regulators). This would be *in addition to* existing requirements to report specified matters (such as breaches). This is merely a general observation in relation to reform – I do not believe that I was constrained in my communications with the Financial Regulator in 2008 in relation to the audit of EBS but I believe that closer dialogue in future between the Financial Regulator and auditors would assist both parties in discharging their respective roles.

8.7. Furthermore, because it receives regulatory returns from all participants in the market and from information with regulators in other jurisdictions, the regulator has greater access to information and market wide data than is available to any one institution or its auditors. The regulator is itself understandably subject to duties of confidentiality, and it would be inappropriate for it to disclose to one institution (or its auditors) information in respect of another. However, it is difficult to see any policy objection to greater dialogue between the regulator and the auditors in respect of a particular institution, with both parties sharing with each other any concerns about regulatory compliance, risks, exposures,

or accounting or reporting issues. A proactive two way dialogue would enhance both parties' discharge of their respective roles.

- 8.8. I believe that is worth exploring whether the measures undertaken since 2008 go far enough, including whether the Central Bank's recent Auditor Protocol should be placed on a formal statutory footing.

## 9. Audit Committees

- 9.1. Boards are responsible for determining the membership of audit committees but I support greater shareholder and investor engagement on this issue. I welcome the requirements in relation to audit committee composition and responsibilities in the Corporate Governance Code. High quality reporting requires audit committees to be strong, dedicated and engaged as representatives of shareholders. Otherwise investors will not have confidence that the company's strategy and reporting is robustly challenged.

## 10. Specific Issues Raised by the Committee

- 10.1. For completeness, I will summarise my perspective on specific issues which the Committee has raised:

### Issue B1:b Integrity of financial reporting

- 10.2. I agree with Paul Smith that the global crisis was not caused by financial reporting issues. The economic crisis was caused by a series of factors including governance failings, supervisory weaknesses and capital upheaval. It was made worse in Ireland by the collapse of the property markets and the overall economic downturn.
- 10.3. The recession has led to concerns about the Incurred Loss Model. I support the proposed adoption of IFRS9 which responds to such concerns.

### Issue B2: a Appropriateness of property-related lending strategies and risk appetite

- 10.4. Many Irish banks which were widely acclaimed prior to the crisis have subsequently been criticised for their lending practices. The management of each bank, its property-lending strategies and its risk acceptance, were all responsibilities of the Board of each bank. The Financial Regulator was also responsible from a prudential supervisory perspective.
- 10.5. Explanations advanced for the catastrophic effect of the credit crunch and global recession on Irish and UK banks include poor lending decisions and an over exposure to property. *Nyberg* observes:

***"The willingness of banks to accept higher risks by providing more and shockingly larger loans primarily for commercial property deals was an important reason for the gradual increase in financial fragility in Ireland. This willingness occurred because of the emergence of strong foreign and domestic competitors within both the residential and commercial property lending markets."***

### Issue B3: e – Capital Structure and Loss Absorption Capacity

- 10.6. Once again, the auditors' responsibility was to express an opinion on the Financial Statements. Capital structure and loss absorption capacity were the responsibility of the banks and the Financial Regulator. Within the banks, responsibility ultimately rested with the directors. The auditors were not required to report on loss absorption capacity and only reported on capital structure to the extent it impacted on the presentation and contents of the Financial Statements.
- 10.7. In recent years, the rigour of bank stress testing has been greatly increased, and is applied on a consistent basis across the EU. I welcome these developments and any further reforms to ensure greater transparency.



Issue R2: c - Adequacy of the Assessment and Communication of solvency and liquidity risks in the banking institutions and sector and Issue C2: c - the Liquidity versus Solvency debate

- 10.8. Risks that threaten the viability of a company go beyond financial solvency and liquidity risks e.g. emerging market risks, drying up of mortgage lending market, or risks related to M&A activity. Risk is inherent in many companies' business models, and investors and regulators should appreciate and consider the risks associated with any particular company's business model, strategy or sector. Funding and liquidity risk covers a broad spectrum. Companies assess cash flows and liquidity on an ongoing basis in accordance with regulatory requirements and the policy of the institution. The level of focus and detail will also vary in line with the perceived liquidity risk.
- 10.9. Once again, these are issues for directors, management and regulators. The auditors' role was limited to the audit of the Company's Financial Statements for previous accounting periods. Given the pace of developments during the international crisis, stakeholders (including regulators and Government) were less concerned with the audited Financial Statements which gave a snapshot of the historic position and more concerned with subsequent developments, for example, the collapse of Lehman Brothers, the Government Guarantee, and the ongoing collapse of property values. Stakeholders were thus necessarily making real time decisions in the light of unfolding developments prior to having access to audited Financial Statements which would reflect the impact of such developments.
11. **Summary**
- 11.1. I believe that the banking crisis was triggered by the international economic crisis and deterioration rather than by any failure by Irish banks to comply with the accounting standards in the presentation of their accounts or by any failure in the statutory audit of such accounts. Irish banks' exposure was likely to have been increased by their lending strategies and practices. These were commercial issues and the responsibility of individual banks, their directors and management. At a prudential supervisory level they were also the responsibility of the Financial Regulator.
- 11.2. I support measures to protect the public interest. Measures already implemented include: (i) changes to accounting standards to replace the "incurred loss model"; (ii) Legal changes including the Companies Act 2014; and (iii) Regulatory changes, including the Central Bank's Issuance of the Auditor Protocol, the Corporate Governance Code, the Central Bank (Supervision and Enforcement) Act 2013, and rigorous Fitness & Probity requirements.
- 11.3. I believe further measures merit consideration. For example, should banks be subject to the same obligations as insurance companies - should regulatory returns be the subject of audit reports?
- 11.4. I would welcome the amendment of CBI duties of confidentiality to allow it to brief auditors in respect of concerns or regulatory issues arising in respect of a particular institution and to allow regulatory concerns to be a greater input into the audit planning process.
12. I look forward to appearing before the Committee and answering any further questions it may have in respect of these issues.



Dargan FitzGerald

1 May 2015