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BANKING INQUIRY

Statement of Pat Cullen
Partner, Deloitte & Touche Ireland

Introduction

1. I am a Fellow of the Institute of Chartered Accountants in Ireland and a past president of the Irish Taxation Institute. I am a partner in Deloitte & Touche ('Deloitte' or the 'Firm') specialising in taxation with over 30 years' experience advising on both domestic and international transactions. My fellow partners elected me as managing partner of Deloitte in the Republic of Ireland for a four year term, from 1 June 2007 to 31 May 2011.

2. As managing partner of Deloitte I was responsible to the partners and the Firm's Executive Committee for the management and operation of all aspects of the Firm's affairs. In my role as managing partner I oversaw the management of the Firm including the provision of professional services to our clients, the skills and resources of our people and the financial management of the firm.

3. The delivery of our services is led by our partners. Where the professional services provided by Deloitte are subject to external regulation, they are led by persons who are individually authorised by the appropriate regulatory body. All partners who act as audit engagement partners for statutory audits have been granted Responsible Individual status by the Chartered Accountants Regulatory Board and are registered statutory auditors. I am not and never have been a registered statutory auditor.

4. A summary of our firm structure and governance, together with audit quality processes is set out in the Appendix to this statement.

5. This statement is made by me in response to the Direction issued by the Joint Committee on 2 April 2015 which identifies five lines of inquiry, as follows:-

   B1 Effectiveness of banks' board governance, client relationships and business models

   (b) Integrity of financial reporting [Paragraphs 8 to 14]

   B2 Effectiveness of banks' credit strategies and risk management

   (a) Appropriateness of property related lending strategies and risk appetite [Paragraphs 15 to 17]

   B3 Effectiveness of banks' funding, liquidity strategies and risk management

   (e): Capital structure and loss absorption capacity [Paragraphs 18 to 22]

C2 Role and effectiveness of the policy appraisal regime before and during the crisis

(c): The liquidity versus the solvency debate [Paragraphs 23 to 28]

R2 Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

(c): Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector [Paragraphs 23 to 28]

I have cross referenced each of these to the paragraphs in my statement where I have commented on them. It should be borne in mind that my comments are in the context of Deloitte being auditors to Ulster Bank Ireland Limited (UBIL).

6. Mr Gerry Fitzpatrick who was the audit partner of UBIL from 2004 to 2008 is separately making a statement to the Banking Inquiry. Mr Fitzpatrick heads our audit function.

7. My professional expertise lies primarily in the area of taxation while the Lines of Inquiry in the Direction to me deal with highly technical accounting and auditing matters. Therefore, Mr Fitzpatrick, who is a registered auditor, and a specialist in the banking sector has kindly advised me on my responses set out below to the five lines of inquiry in the context of our role and responsibilities as statutory auditors to UBIL. My responses are set out in paragraphs [8] to [25]. Mr Fitzpatrick comments on these matters with regard to the audit of UBIL, with which he was involved for a number of years.

Effectiveness of Banks' Board Governance, Client Relationships and Business Models: Integrity of Financial Reporting

The Role of the Auditor

It is in the context of our role as auditors, that we would have considered matters related to the Line of Inquiry – B1(b) – Effectiveness of Banks' Board Governance, Client Relationships and Business Models: Integrity of Financial Reporting. I have taken this to refer to the truth and fairness of the financial statements.

8. I would like to address the following issues to provide some background to the Joint Committee having regard to the role and function of an auditor:

- the purpose of financial statements;
- the Firm's role and responsibilities as auditors; and
- some of the key aspects of the matters under review from our perspective as auditors.

9. The statutory financial statements of UBIL are prepared by the directors of UBIL in accordance with the requirements of International Financial Reporting Standards and the relevant requirements of the Irish Companies Acts. The Firm's audits of the financial statements of UBIL were carried out in accordance with International Standards on Auditing (UK and Ireland).

10. International standards describe the purpose of financial statements as being a structured representation of the financial position and financial performance of an entity with the objective being to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of management's stewardship of the resources entrusted to it.

11. In considering the integrity of financial reporting it is important to consider the nature, extent and adequacy of the financial statements taken as a whole. The financial statements provide the shareholder and other users such as the Regulator with extensive analysis of the performance and financial condition of an entity.

12. Under the Irish Companies Acts every company must at each Annual General Meeting, appoint an auditor and that auditor must make a report to the members on the accounts examined by them, with the primary purpose being to state whether, in their opinion, the company's balance sheet and profit and loss account have been properly prepared in accordance with the provisions of the Companies Acts and give a true and fair view of the state of the company's affairs as at the end of its financial year and of the company's profit and loss for the financial year.

13. The 'true and fair' concept has been a part of English and Irish law and central to accounting and auditing practice in the UK and Ireland for many decades. There has been no statutory definition of 'true and fair'. The most authoritative statements as to the meaning of 'true and fair' have been set out in legal opinions. In overall terms, true and fair is not something that is merely a separate add-on to accounting standards. The whole essence of standards is to provide for recognition, measurement, presentation and disclosure for specific aspects of financial reporting in a way that reflects economic reality and hence that provides a true and fair view. The preparation of financial statements cannot be reduced to a mechanistic following of the relevant accounting standards. Objective professional judgement must be applied by the Directors to ensure that financial statements give a true and fair view.

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14. International standards state that in virtually all circumstances an entity achieves a fair presentation by compliance with International Standards. International standards which are of particular relevance to the circumstances under review and therefore of particular significance as to whether the financial statements showed a true and fair view are as follows:

14.1 IAS 1: Presentation of Financial Statements – Going Concern

14.2 IAS 39: Financial Instruments: Recognition and Measurement – Impairment and Incurred Loss Model.

Effectiveness of Bank' Credit Strategy and Risk Management: Appropriateness of Property-Related Lending Strategies and Risk Appetite

Impairment of Loan Assets

It is in this context that we, as auditors, would have considered matters related to the Line of Inquiry – B2(a) - Effectiveness of Bank' Credit Strategy and Risk Management: Appropriateness of Property-Related Lending Strategies and Risk Appetite. I have taken this to refer to the impairment of loan assets in the financial statements.

15. Accounting Standards (IAS 39) require an assessment by the directors (in this instance of UBIL) at the end of each reporting period as to whether there is any objective evidence that loans are impaired because of events that occurred after the initial recognition of the asset (a 'loss event'). An asset is impaired, and an impairment loss recognised, if and only if, such evidence exists.

16. In carrying out this assessment, the following points are of relevance to the Directors:

- Such loss events must have an impact on the estimated future cash flow of the asset, or group of assets, that can be reliably measured.
- An impairment loss may occur as the result of the combined effect of several events – it is not always possible to identify a single, discrete event that caused the impairment.
- Losses expected as a result of future events are not recognised (no matter how likely those events might be).

17. Auditing standards address the question of how auditors consider the estimation of impairment losses made by the directors. This is perhaps most clearly described in International Auditing Standard ISA 545 *Auditing Fair Value Measurements and Disclosures*. Paragraph 5 states:

> *'Many measurements based on estimates are inherently imprecise. The auditor's consideration of assumptions is based on information available to the auditor at the time of the audit and the auditor is not responsible for predicting future conditions, transactions or events which, had they been known at the time of the audit may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures'.*

Effectiveness of Banks' Funding, Liquidity Strategies and Risk Management: Capital Structure and Loss Absorption Capacity

Going Concern

It is in this context that we, as auditors, would have considered matters related to the Line of Inquiry – B3(c) – Effectiveness of Banks' Funding, Liquidity Strategies and Risk Management: Capital Structure and Loss Absorption Capacity. I have taken this to refer to the going concern basis of accounting.

18. With regard to going concern, accounting standards (IAS 1 – paragraph 25) state:

> *'Management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties relating to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties'.*

Paragraph 26 goes on:

> *'In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case'.*

19. It is important to note that when an entity prepares financial statements on a going concern basis, this does not imply an absolute level of confidence that the entity will be able to continue as a going concern, as IAS 1.25 requires the going concern basis of accounting to be used except in very limited circumstances.

20. The auditor's responsibility in relation to the audit of the going concern basis of accounting is set out in ISA (UK and Ireland) 570. Paragraphs 9 & 10 of that Auditing Standard state that it is the auditor's responsibility to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. The auditor also considers whether there are adequate disclosures regarding the going concern basis in the financial statements in order that they give a true and fair view.

21. The auditor's procedures necessarily involve a consideration of the entity's ability to continue in operational existence for the foreseeable future. In turn, that necessitates consideration both of the current and the possible future circumstances of the business and the environment in which it operates at the time the audit opinion is being formed each year

22. ISA 570 states that the auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Role and Effectiveness of the Policy Appraisal Regime before and during the Crisis: The Liquidity vs Solvency Debate

Effectiveness of the Supervisory Practice (Central Bank, Financial Regulator and Department of Finance: Adequacy of the Assessment and Communication of Liquidity and Solvency Risks

The Financial Regulator

23. It is important to emphasise that our primary role and responsibility in relation to UBIL was as statutory auditor reporting to the members of the company expressing our opinion on whether the financial statements gave a true and fair view. It is in this context that we, as auditors, would have been concerned with the going concern assumption underlying the bank's financial statements. As auditors we did not examine and we did not form any opinion on the matters referred to in the following Lines of Inquiry in your Direction:

    C2(c) Role and Effectiveness of the Policy Appraisal Regime before and during the Crisis: the Liquidity versus Solvency debate

R2(c) Effectiveness of the Supervisory Practice (Central Bank, Financial Regulator and Department of Finance: Adequacy of the Assessment and Communication of both Solvency and Liquidity Risks in the Banking Institutions and Sector.

24. Practice Note (PN) 19 (I) '*The Audit of Banks in the Republic of Ireland*' published by the Auditing Practices Board is significant. It contains guidance on the application of auditing standards to the audit of financial statements of banks in the Republic of Ireland. PN 19 (I) comments in paragraph 10 on the relationship between the objectives of the Financial Regulator and the objectives of the Auditor, as follows:

> '*In many respects the Financial Regulator, as the banking supervisor and bank auditors have complementary concerns although the focus of their concerns may be different. In particular, the Financial Regulator is primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks in order to protect the interests of the depositors. The Financial Regulator monitors the present and future viability of banks and may use their financial statements in assessing their condition and performance. The auditor's primary responsibility is to report to the shareholders his opinion as to whether the financial statements present a true and fair view, in the course of which they consider the appropriateness of the use of the going concern concept as a basis for the preparation of financial statements*'.

25. PN 19(I) includes ISA 250: Section B which deals with 'The Auditor's Right and Duty to Report to Regulators in the Financial Sector'. It requires that where an apparent breach of statutory or regulatory requirements comes to the auditor's attention, the auditor should:

- Obtain such evidence as is available to assess its implications for the auditor's reporting responsibilities; and

- Determine whether, in the auditor's opinion, there is reasonable cause to believe that the breach is of material significance to the Regulator.

26. Legislation pertaining to banks and in particular the duty of a bank's auditor to report to the Financial Regulator without delay in certain circumstances is set out in Central Bank legislation. Section 47 of the Central Bank Act 1989 and Regulation 7 of the Post BCCI Regulations place a duty on auditors to report to the Financial Regulator without undue delay in certain circumstances including where the auditor has reason to believe that the continuous functioning of the bank may be affected; in particular, that there exists circumstances which are likely to affect materially its obligation to depositors or where there are issues relating to its ability to meet its financial obligations.

27. Following the publication of the Central Bank and Financial Services Authority in Ireland Act 2004, the Accountancy Bodies published Miscellaneous Technical Statement M46 to assist auditors in meeting certain obligations under the Act. M46 provides guidance to auditors in meeting the requirement to provide the Financial Regulator with a Statutory Duty Confirmation.

28. The Act requires that if the auditor of a regulated entity makes a report to the entity, or those concerned with management, on any matter that has come to the auditor's notice during the course of the financial statements audit, the auditor must provide the Financial Regulator with a copy of that report. Where no such report is to be sent, a 'nil return' must be sent to the Financial Regulator. The Financial Regulator has indicated that it would expect to receive copies of post audit reports prepared in accordance with ISA 260 'Communications with those charged with governance' and that particular areas of interest include any concerns relating to solvency/capital adequacy or the entity's conduct of business with its clients.

Lessons Learned

29. It is clear that the banking crisis has had an enormously disruptive impact on a wide range of stakeholders. Deloitte recognises the need to learn from the crisis and we support inclusion in such reviews of the role of auditing. Across the globe and in Ireland the auditing profession has reflected on their role and considered how financial reporting and auditing could be enhanced. We have engaged with many of such reviews.

30. Examples of enhancements explored in such reviews have included:

- The development of a new expected loss accounting standard (IFRS 9) which is due to be implemented in 2018.
- The development with the Regulator in Ireland of an Expanded Auditor Assurance protocol which involves the auditor reporting on aspects of governance processes at financial institutions in accordance with the European Banking Authority Guidelines on Internal Governance (GL44). This process has commenced in Ireland from 2014.
- Changes in auditor reporting to Audit Committees and shareholders: this is now in place.
- Enhanced dialogue around the audit process with regulators: this has been a feature for banks in Ireland since 2009.
- Augmented auditing practices including wider IT systems testing, use of data analytics, enhanced benchmarking and increased use of specialists.

31. Deloitte member firms across the globe have actively contributed to the debates on changing accounting and auditing standards. Our member firms have produced reviews of Bank Annual Reports "*Looking beyond the numbers*" and Global IFRS Banking Surveys. We chaired the ICAEW Audit Quality Forum "*Does Bank Accounting meet Investor's needs?*". We contribute to the Enhanced Disclosure Task Force ('EDTF'), a group established by the international Financial Stability Board ('FSB') and have undertaken research on Culture in Banking.

We actively share our views with regulators including:

- Central Bank of Ireland
- European Securities and Markets Authority
- European Banking Authority
- European Central Bank
- US Securities and Exchange Commission
- The International Forum of Independent Audit Regulators

One industry review entitled *Audit of Banks: Lessons from the Crises* issued in June 2010 by the Financial Reporting Faculty of the ICAEW provides a helpful set of proposals which we, at Deloitte, support. These cover Bank Reporting, Audit Reporting, and Dialogue with Supervisors and Support for Supervision.

32. Such initiatives can help mitigate some of the risks associated with historic financial reporting. However, the preparation and audit of financial statements will continue to require significant judgment in areas of risk and estimation. The information provided in financial statements enables users including shareholders and regulators to read, analyse and consider the contents before making investment and regulatory decisions. The financial statements are an important historic report but as a point in time measure can only attempt to present measures based on a point in time judgment.

33. To assist the reader of financial statements, we support enhanced financial statements disclosures which explain the nature and extent of uncertainties and provide greater sensitivity analysis on key assumptions. For example, for impairment of loans, the disclosure of the sensitivity of impairment to changes in the value of property as collateral on impaired loans might be helpful to users of financial statements.

34. Finally, we strongly support the implementation of IFRS 9 because of the changed approach to recognising impairment losses and any other appropriate and progressive measures that underpin stakeholder confidence in financial statements and in those who audit them.

Pat Cullen

Pat Cullen
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APPENDIX – FIRM STRUCTURE/GOVERNANCE AND AUDIT QUALITY PROCESSES

Structure/Governance

The Firm is the Irish member firm of the "Deloitte network". The Deloitte network is an association of firms that are members of Deloitte Touche Tohmatsu Limited ('DTTL').

DTTL has adopted certain resolutions, policies and protocols regarding the governance of the Deloitte network, professional standards and methodologies and systems of quality control and risk management.

Member firms provide services to clients and in doing so are responsible for applying DTTL policies, as well as for setting their own policies and exercising professional judgement, to ensure compliance with applicable professional standards and local laws and regulations. The Firm has implemented an Enterprise Risk Framework to identify the principal risks and uncertainties facing the Firm, both from a quality and a business perspective, including financial and internal controls.

The Firm is structured into four functional areas each led by a partner who is head of function. Each of the functions, Audit, Tax, Consulting and Corporate Finance operate a common set of policies and procedures, where this is possible and appropriate. Each area has developed additional policies and guidance specific to its own services.

Audit Quality

Quality was and continues to be the number one priority of the Deloitte network and the Firm. The Firm's quality processes are designed to meet stakeholder expectations, internal standards and external requirements.

The Firm is committed to continuous quality improvement, through the internal quality control systems, our engagement quality control reviews and annual practice reviews of a selection of completed engagements. The Firm's audit regulator (Chartered Accountants' Regulatory Board – 'CARB') also carries out regular practice reviews which include reviews of engagements. We give careful consideration to all of the comments, recommendations and findings arising from these reviews and develop quality improvement action plans around them. Implementation of those plans is monitored regularly by the Executive Committee of the Firm.

Supporting our client-serving professionals are the Firm's risk management partners, who are responsible for the oversight of the Firm's ethics, compliance, anti-money laundering, information security and risk management processes. The risk management partners include the Risk and Reputation Leader and the Audit Risk Leader.

An audit partner termed the National Professional Practice Director is responsible for technical accounting and auditing support and managing the Firm's audit and accounting consultation processes.

The Head of Audit has an ongoing communications programme with audit partners covering current topics, including feedback from practice reviews.

Our audit practice is structured into specialist industry groups, led by partners with a depth of experience and expertise. These groups collaborate in order to share their understanding of market developments, risk assessments and emerging trends. Bank audits are led by audit partners with expertise and experience of providing audit and other professional services to the sector.

Our quality governance processes require engagement partners to be fully responsible for the services they provide and for understanding our clients' businesses. Their involvement in the audit process is required from the very outset of any engagement with partner-led audit planning key to our audit approach.