Opening Submission to the Banking Inquiry

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Introduction

I was invited to appear before the Committee in my capacity as the Senior (or Managing)Partner of PricewaterhouseCoopers in Ireland ("PwC"). I have held the position of Senior Partner of the Irish firm since July 2007. Prior to that, I was an auditor, mainly in our Technology practice for 15 years. I joined the firm in 1980, became a partner in 1992 and am a Fellow of Chartered Accountants Ireland.

PwC is one of the largest of the Statutory Audit firms in Ireland, with 96 partners and over 2,100 staff, nearly 40% of whom specialise in Financial Services.

During the period 2001-2010, PwC was engaged as statutory auditor of Bank of Ireland. We were also the statutory auditor for Bank of Scotland (Ireland) for the year ended December 2009 and for AIB for the year ended December 2001.

In preparation for my appearance today, my colleagues and I have provided the Inquiry with in excess of 5,300 pages of materials relating to our role as Statutory Auditor pursuant to the information request received on 15th January 2015. These materials (along with an explanation of how they were compiled) were delivered to the evidence manager on February 19th and February 27th, 2015.

The top priority of PricewaterhouseCoopers and our partners continues to be consistently performing high-quality audits which are relevant, unbiased and objective. To deliver on this responsibility, we continue to respond to the evolving needs of our stakeholders while meeting the expectations of regulators and other interested parties.

Context of my appearance

In advance of my appearance, the committee provided me with a direction to address aspects of the remit of the Inquiry as they impact the statutory audit process. The direction set out the themes which it wishes me to cover. These are

- Integrity of financial reporting
- Appropriateness of property-related lending strategies and risk appetite
- The liquidity versus solvency debate
- Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector
- Capital structure and loss absorption capacity

My evidence on these themes relate to the work performed by PwC in our role as statutory auditor.

Integrity of Financial Reporting

Objective reporting of the financial performance of a company is one of the pillars of modern commerce. When considering a Bank, one of the matters of fundamental importance to the integrity of these statements is an ***acknowledgement*** that there are judgements required in the preparation of any set of financial statements and an ***understanding*** of the context of the judgements in any year.

The integrity of financial reporting has two aspects; the measurement of performance and the disclosures within the financial statements.

Measurement of performance

The ultimate amounts likely to be repaid by borrowers and hence the value of a bank's loan book is a key judgement.

From summer 2008 onwards, the speed and scale of the deterioration in the global and local market environment (as well as the uncertainty regarding when the trough in the economic cycle would be reached) meant that it was very difficult for banks, investors and other commentators to quantify the impact on their business and customers. In particular, both Ireland and the UK had experienced benign credit conditions for over ten years. This meant that there was no recent reliable information on the impact of such a deterioration. Historic data from previous downturns was not particularly relevant as it related to a time when the scale and structure of these economies was very different. Property Price Indices were proving both unreliable and inconsistent. This scarcity of reliable or consistent information was a significant constraining factor on how both the management of the Banks and their auditors approached their respective responsibilities at the time.

This deterioration was triggered by an unprecedented level of global financial turmoil. Governments were working to try to stabilise the position as quickly as possible. However there were many variables at play which meant a wide range of outcomes was possible. The various reports that have been produced for the Irish Government, EU and others have established that there were multiple interconnected causes of the difficulties experienced by the Irish economy.

Translating this rapid change in economic outlook into real time financial reporting was also largely untested. The uncertainty was heightened by the accounting standards in place at the time (and which remain today). International Financial Reporting Standards (IFRS) and specifically IAS 39 adopts an "incurred loss" approach that results in provisions based only on impairment (or loss) ***incurred*** at the Balance Sheet date based on ***objective evidence*** of impairment. It is accepted that, under these rules, loan loss provisions can only be made as and when actual losses are judged to have occurred rather than when they could be foreseen. It does not allow the factoring in of future losses on currently unimpaired loans, nor increases in the provision on presently impaired loans based on forecast future events.

This gives rise to a lag effect as between the level of expected cash loss which will be experienced in the future and the booked loan impairment provisions in any given year. These specific requirements have raised questions as to the timing of booking of these provisions for loss.

This is not just an issue or concern applying only to banks based in Ireland. As a single set of International Accounting Standards, IFRS is applied globally. Subsequent reports from the troika and publications/recommendations from regulators and others have acknowledged that the interpretation of IFRS was applied in a broadly consistent manner elsewhere within the EU and further afield.

The genesis of IAS 39 was a reaction to a time where there was more scope for reserves for future costs or operating losses to be used to "smooth" or flatten the reported financial results of banks between economic cycles. Commentators at the time were concerned that the creating and release of "unallocated" reserves made it very challenging to compare companies over time or across a sector. The standards we have today were put in place to address this. However, in tackling this perceived abuse, the present accounting rules have been criticised as being both pro-cyclical and counter intuitive.

Specifically, since provision cannot be made for future losses no matter how likely they are to arise, this leads to ***an expectation gap*** between the reported losses at a point in time and a user's expectation of the ultimate cash loss to be incurred.

It is for this reason that IAS 39 is acknowledged by many as not "fit for purpose". This is a fundamental weakness of IFRS and is the primary catalyst surrounding the proposed changes in the accounting currently being debated. The fact that this work started in 2008 and is not yet implemented is in itself evidence that this is a very complex and contentious issue.

It is also relevant that traditional accounting would often use prudence as a justification for booking of provisions. IFRS is very much focused on fair presentation and the fact that accounts should be neutral and unbiased. It does not contain an assumption of prudence.

Disclosure

A further criticism often made relevant to the integrity of financial reporting is that financial statements did not provide the clarity of reporting required by users. We would accept that there is a considerable volume of information in the annual reports for banks. However, as many contributors to the Inquiry have already postulated, an exposure to an overheating property sector and rapidly increasing loan books without corresponding increases in domestically sourced retail deposits were contributors to the crisis. The extent of these factors varies significantly between banks. ***This information was required to be included in the financial statements***.

Specifically, in the period from 2006-2008, BOI's level of wholesale funding exposure was disclosed in the Bank's annual report and investor presentations and referenced by analysts and rating agencies. It was not an issue of concern raised until the financial crisis emerged.

We would like to return to the topic of the integrity of reporting later in our remarks when we deal with some of the subsequent improvements and enhancements to the financial reporting regime.

Appropriateness of property related lending strategies and risk appetite

In addressing this topic from the perspective of the statutory audit, I should begin by clarifying the role and responsibilities of the statutory auditor.

In respect of any set of financial statements, there is a clear delineation of responsibilities between the Directors and management as the preparers and approvers of financial statements and of the Statutory Auditor in their capacity as auditor of these statements.

It is for the Directors and management to devise and approve the bank's strategies and risk appetite and monitor their implementation. Specifically in the case of a set of financial statements for a bank, the Directors and management are solely responsible for the description of its strategies, targets and controls as well as reporting its performance in achieving these strategies.

One measure of this performance is the level of lending growth and the quantum of provisions for loss on this lending. Applying their judgement around the setting of appropriate loan loss provisions in the financial statements is a key part of the assessment of their stewardship.

In contrast, our responsibility (as defined in the Companies Acts and set out in the body of International Standards on Auditing to which we operate) is to assess whether the financial statements give a true and fair view as a whole and within the confines of the rules and guidelines used in their preparation. Our conclusion following our audit is set out in our audit opinion. While the mandated wording of this conclusion from the audit (in the form of the audit opinion) may vary somewhat from jurisdiction to jurisdiction, the overall premise of the output of an audit is consistent.

The loan loss provisions are clearly ***a material estimate*** in the overall financial statements on which we express an audit opinion. Management are responsible for setting the loan loss provisions and we are responsible for auditing management's provisions. We are not responsible for setting such provisions, nor are we responsible for choosing the regulations and how they should be applied.

With any estimate, there is a high degree of judgement involved. Our Firm's approach to auditing lending is set out in our network's auditing guide. It involves testing the process used by the Bank's management and staff in the first instance. Given the large number of loans, it is impractical (and in some cases impossible) to re-perform what the Bank has done. This is both in the context of the time it would take and the fact that the Bank will inevitably have greater insight and knowledge on their operations than we, as independent third parties, could ever have. It is also relevant that our clients were large publicly quoted groups (or in the case of Bank of Scotland, the subsidiary of such a group) and were subject to independent regulation and oversight, extensive formal governance processes and the demanding requirements of US rules on their internal controls (Sarbanes-Oxley).

In testing the process used by management, a key risk area is the use of appropriate assumptions due to the inherent subjectivity involved. The focus of our work is very much on whether the assumptions being employed are reasonable.

Auditing standards and guidance confirms that any adverse audit findings by the auditor in relation to individual assumptions or loan loss provisions must be based on a clear conclusion that they are unacceptable. We may have our own view as to whether a particular assumption could be different or is on the optimistic side. However, any such view is only relevant for the purpose of assessing whether management's provision is acceptable. It is only if an auditor considers that management's estimate is unreasonable to a material extent that there is a basis for potential disagreement by the auditor.

We will return to the topic of the adequacy of communications later in this submission.

The liquidity vs solvency debate

and

Adequacy of the assessment and communication of solvency and liquidity risks in the banking institutions and sector

and

Capital Structure and loss absorption capacity

We will address these topics together as, in our view, much of their relevance to our role as statutory auditor is complementary.

Solvency and Liquidity are fundamental to the management and sustainability of any Bank. Confidence in a bank sustains its business model. Solvency and Liquidity impact the statutory auditor in that we are required to form a view on, inter alia, the Bank's overall measurement of its financial performance in the financial year and its own assessment of its ability to continue as a going concern.

Our key focus is the design and execution of risk based audit procedures to assess whether the banks own views on the measurement of its financial performance (specifically as it impacts the Inquiry, the recoverability of its loan books) and its assessment of going concern were reasonable in the circumstances.

Assessment of recoverability of loan books

In assessing the adequacy of loan loss provisions, our audit approach involved a combination of testing of management's controls in respect of loan loss provisioning along with specific tests at the loan and portfolio level. This approach is in accordance with local and international guidance provided in relation to the audit of loan loss provisions, both then and now.

We employed dedicated banking specialists in carrying out the testing. These specialists benefited from specific training on the risks within the lending portfolios. We invited third parties from the industry (including auctioneers and building contractors) to address our teams on the challenges for the market and to provide their perspective on the possible outcomes. We also arranged for the circulation of relevant material from the industry setting out latest trends and projections for the Irish property market.

From mid 2008 onwards, there was a pronounced lack of reliable information on the market in general. There were few if any reported transactions in the market. The National Asset Management Agency (NAMA) had been announced but there was no guidance on how it was to operate, the price it was to pay for loans etc,. Commentary has suggested that there were reliable property values and market transaction information which would inform on how the economy would unfold broadly available during the period from mid 2008 to late 2009. We do not believe that this was the case.

Assessment of Going Concern

A consideration of Solvency and Liquidity impact the financial statements when the Directors are considering the matter of whether it is appropriate to adopt the Going Concern basis of preparation in their financial statements.

Financial Reporting Standards, Listing Rules and the Companies Acts require Directors to satisfy themselves that it is appropriate to prepare financial statements on a going concern basis and to provide certain disclosures in the annual report. It is the auditor's responsibility to evaluate the Director's and management's assessment. It is not the auditor's responsibility to prepare the assessment itself.

The objective of the auditor's assessment is to conclude on the appropriateness of the Directors conclusion in adopting the going concern basis in the preparation of the financial statements and form a view as to whether there are material uncertainties about a bank's ability to continue as a going concern which need to be disclosed in the financial statements by the Directors (and referred to in our audit report). In discharging our responsibilities, we considered relevant technical reference materials published by local and global regulators.

The Directors typically document in detail their considerations and conclusions in this regard. Our audit approach is to undertake a detailed review and assessment of relevant and available internal and external evidence. This includes;

- A review and assessment of managements' judgement as to the key risks and uncertainties, their assessment of the impact of these uncertainties (under a range of scenarios including a stress case) and their plans and available actions to address these uncertainties together with their overall conclusion;
- Discussions with those Directors involved in direct correspondence with other stakeholders, including the Central Bank and the Department of Finance;
- An independent consideration of the factors impacting going concern relevant to the Irish banking system in general;

- Statements regarding support for individual banks and the Irish Banking System as a whole made by the Central Bank, Department of Finance, Government and the Financial Regulator.

The materials supplied to the Inquiry outline the key factors for consideration and our independent assessment of those matters. In accordance with our procedures, our conclusions were reviewed and signed off by senior and experienced partners in our firm including the Engagement Leader and Engagement Quality Review Partner as well as a number of other partners with positions of responsibility within our Assurance practice.

Our communication of risks within the Banks

In relation to communication of our findings and perspectives, a central theme running through subsequent public comment on the results of the statutory audit is that the auditors did not exercise sufficient scepticism.

Our reporting in public is limited by statute to our audit report. The wording of this two page opinion is set out in regulation and is binary in nature, either a clean review or a qualified report. In other words, we either agree that, in our opinion, the financial statements give a true and fair view, or we do not.

We believe it important to note that since we did not conclude a bank's booked loan loss provision lay outside of an acceptable range, it was not appropriate to qualify the financial statements or otherwise. There was no capacity for the auditor to make comment on the quality of the judgements within the financial statements.

It is also important to acknowledge that we expressed our views very clearly and in a detailed manner at the highest levels within our clients as to the relative positioning and risk attaching to the loan loss provisions. The materials supplied to the committee provide clear evidence of an attitude of professional scepticism. Our audit planning documents and audit findings documents, which were presented to and discussed with the Audit Committees of the Banks, demonstrate that

- Our audit robustly challenged the process used and the assumptions made by the Directors and management.
- We communicated our views on managements process for determining loan loss provisions and the risks and uncertainties inherent in these.
- We also communicated our recommendations to the Audit Committee and management to improve and enhance the loan loss provisioning models over a number of years.
- We debated and challenged management on the levels of overlay to be included within the loan loss provisions in order to mitigate the inherent risk that given the speed and quantum of deterioration, there would be insufficient data which was representative of the increase in loan losses experienced.

It is important to note that we did not have the benefit of hindsight in forming our views. We were obliged to give fair consideration to scenarios which were deemed reasonable at the time.

Our communication of risks to the Regulator

The Financial Regulator/Central Bank of Ireland receives, as a matter of course, both the statutory financial statements and copies of the findings reports we discussed with the Audit Committee as part of each reporting cycle.

We are also subject to certain reporting requirements to the Central Bank of Ireland. These are set out in guidance referred to as Practice Note 19 (I) which is published by our Institute.

PN 19 (I) notes that, while the scope of the statutory audit of a bank's financial statements is no different from that of the generality of companies in the Republic of Ireland, there are circumstances where the auditor has a duty to report to the regulator "*with the express purpose of making the regulator aware of matters that might jeopardize the stability of the banking and financial system or interests of depositors and others*".

PN 19 (I) recognises that the objectives of the Financial Regulator and auditor are often different.

- *"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 auditor's primary responsibility is to report to 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 the financial statements;*
- *The Financial Regulator is concerned that banks maintain a sound system of internal control, including an adequately resourced, independent internal audit function, as a basis for safe and prudent management of a bank's business. The auditor is concerned with the assessment of internal control to determine the degree of reliance to be placed on the system in planning and performing the work necessary to express an opinion on a bank's financial statements; and*
- *The Financial Regulator must be satisfied that each bank maintains adequate records prepared in accordance with consistent accounting policies and practices that enable it to appraise the financial condition of the bank. The auditor is concerned with whether adequate and sufficiently reliable records are maintained in order to enable the entity to prepare financial statements that do not contain material misstatements*".

Our obligations to report to the regulator are set out in Section 47 of the Central Bank Act 1989. The regulations provide the auditor with legal protection from a breach of confidentiality in and only in the specified scenarios listed therein. These include when we believe *"there are material inaccuracies in, or omissions from, any financial returns made by the bank to the Financial Regulator*"; or "*there is a material breach of the laws, regulations or administrative provisions which lay down the conditions* *under which the bank has been authorised*". "Material" is further defined as *"a matter or group of matters is normally of material significance to a regulator's functions when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator."*

PN 19(I) also noted that there may be circumstances where the auditor concludes that a matter does not give rise to a statutory duty to report but nevertheless feels that in the public interest it should be brought to the attention of the Financial Regulator. Before making any such 'voluntary' report the auditor needs to consider whether any duty of confidentiality or other duty will be breached by making such a report. The common law may provide protection for disclosing certain matters to a proper authority in the public interest. It notes that before making any such voluntary report the auditor may wish to take legal advice before deciding whether and in what form to make a report to the Financial Regulator when not statutorily required to do so.

PN 19 (I) also confirms that the examination by the auditor of returns made by a bank to the Financial Regulator is outside the scope of an audit of a bank's financial statements.

International Dimension and subsequent improvements

Before concluding, we would like to make some reference to subsequent responses to the financial crisis and enhancements to the audit process.

International

Previous evidence to the Inquiry has noted the many similarities between the causes of the Irish crisis and international crises. Investigations in the US, UK and by the IMF on the causes of the present crisis tend to confirm these similarities.

As we operate using both International Financial Reporting Standards and International Standards on Auditing, it may be helpful to consider the international dimension. As noted earlier in our remarks, much has been written on the causes of and contributors to the global financial crisis. Many of these reports make recommendations as to the measures which are necessary to consider within the audit profession to ensure a repeat of the crisis does not reoccur. While a full list of these reports would be extensive, some of the more influential works within the principal jurisdictions which influence the audit regime in Ireland include;

- The House of Lords Economic Affairs Committee (March 2011)
- ICAEW Audit of Banks – Lessons from the Crisis (June 2010)
- Commission of investigation into the banking sector in Ireland ("Nyberg") (March 2011)
- ACCA review of post financial crisis enquiries (May 2011)
- Institute of Chartered Accountants Australia - the changing face of audit (Dec 2011)
- EU proposals on audit reform
- The Sharman report

The findings of each of these reports are extensive and varied. However, a relevant theme is the need to divorce the questions of:

- whether audit firms complied with existing accounting and auditing standards; and
- whether accounting standards themselves were properly calibrated to the then economic circumstances.

These are two entirely different prisms for viewing the financial crisis.

An extract from the House of Lords Economic Affairs Committee reinforced this point. "*The Committee heard that International Financial Reporting Standards (IFRS), which became mandatory for EU listed companies in 2005 and are intended to pave the way towards common accounting standards around the world, had lowered audit standards. They encouraged box-ticking and reduced scope for auditors to exercise judgment to reach a true and fair view. The Committee recommends that prudence be reasserted as the guiding principle of audit*".

A number of responses have already been put in place to address these perceived shortcomings in the requirements of auditors including;

- fundamental changes and enhancements to the audit report with a view to reducing the expectation gap on what an audit is and is not;
- increased obligations on Directors to provide a commentary on the key judgements and uncertainties in the preparation of the financial statements; and
- increased disclosures from auditors as to the manner in which they conducted their audit.

We welcome these changes and endorse them as strengthening a common understanding of the audit process.

Further changes and reforms are anticipated in the medium term.

As noted earlier, the accounting standard (IAS 39) is also in the process of being replaced. The fact that this is currently anticipated for 2018 (ten years post the crisis) is a testament to the complexity inherent in arriving at an accounting model that is fit for purpose and responsive to changing circumstances.

Ireland

Throughout the time covered by the Inquiry, we have had robust policies to promote and ensure the execution of our audit quality program. Specific to our audits of the banks within the scope of the Inquiry, stringent requirements were in place in respect of the appointment, tenure and experience of the lead audit partners, independent review partners and other key audit staff. Rules around rotation of the key audit personnel were also in place and followed.

Also in relation to our audits of BOI, subsequent independent reviews (both from external regulators and peer reviews from within our global network) have concluded that our audit plan, execution of the plan and our reporting was in accordance with our responsibilities.

Each year, our global and local methodology is enhanced to meet and exceed many external recommendations for improvement. As part of our ongoing quality improvement programs, we have incorporated a significant number of enhancements. These include:

- more qualitative reporting to Audit Committees and Boards around our views on the quality of judgments within the financial statements,
- a clearer description on how we use external sources of information to challenge our clients' internal views (and why we consider this market data appropriate)
- a clearer articulation of our skepticism in how we challenge management's conclusions.
- extending the coverage of our audit to the enhanced disclosures being made on asset quality, forbearance etc.

We welcome the initiative of the Central Bank in introducing independent reviews of specific areas of control within certain banks with the first reporting due in May 2015. We consider this a positive step in improving the consistency of oversight and control within the sector and would support an expansion of its scope to other areas, including regulatory returns.

We note the consistency of these actions of the Irish firm with themes and views of other regulators and other interested stakeholders in other territories and jurisdictions. As recently as December 2014, the Financial Reporting Council in the UK published a thematic review of the audit of loan loss provisions in UK banks and building societies which noted within its key messages for audit the need to ensure audit teams apply an appropriate degree of challenge and professional skepticism in the audit of loan loss provisions rather than seeking to corroborate management views.

Similar themes and messages have emerged from reviews from other regulators including the US PCAOB through its annual inspection process.

Notwithstanding these improvements, the issue of what auditors do today and what the expectation is of what auditors do remains. There are accounting rules and auditing standards that we adhere to. Equally, there is the expectation by investors, regulators and by others involved with the financial reporting process that auditor should do more and different things. There is also an appetite to simplify the way we report on financial information and improve the communication of what we are responsible for (and by implication what we are not responsible for). One key lesson that our profession has to think about is how to give much more insight about what comes out of an audit. If investors want to know where were the critical judgments were made, we have to consider how to respond. While in some cases, it may not be possible to address, within the boundaries of the standards to which we are expected to operate, there needs to be much more transparency around that gap between what stakeholders expect and what we can deliver.

Conclusion

Audits in the period from the start of the financial crisis were clearly challenging due to the inherent uncertainty facing the Irish and global economies and the particular issues faced by Irish Banks. The loan loss provisions were clearly a material estimate in the overall set of financial statements on which we expressed an audit opinion.

We stand over the quality of the audits of the financial statements of Bank of Ireland, AIB and Bank of Scotland Ireland and the robustness of the audit opinions issued on their respective reporting dates.