RESERVE BANK OF VANUATU

INTERNATIONAL BANK

PRUDENTIAL GUIDELINE No. 5

AUDIT ARRANGEMENTS

BACKGROUND

1. The Reserve Bank's supervisory process depends on information[1] provided by banks. The Reserve Bank needs to be assured of the accuracy and integrity of the information provided to be confident that its judgements about the bank's management practices and compliance with prudential requirements are well informed and soundly based. Arrangements with a bank's external auditors operate to enhance the credibility of the information provided.

2. Liaison with a bank's external auditor will generally be conducted under tripartite arrangements involving the Reserve Bank, the bank and its external auditor. In the normal course, regular tripartite meetings will be held to discuss the external auditor's reports and any matters, which arise from the external auditor's review. Any one of the three parties can initiate meetings/discussions at any time. Notwithstanding the tripartite relationship, the Reserve Bank may engage with external auditors on a bilateral basis should either party consider it necessary.

3. A bank should keep its external auditor fully informed of the Reserve Bank's requirements as outlined in the various Prudential Guidelines and any other relevant communication from the Reserve Bank.

RISK MANAGEMENT SYSTEMS

4. It is the responsibility of a bank's board and management to ensure that the bank meets prudential and statutory requirements and has management practices to limit risks to prudent levels. The risk management practices must be detailed in management systems descriptions, which should be regularly reviewed and updated (at least annually) to take account of changing circumstances.

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[1] Information includes statutory and prudential returns, financial statements and risk management system descriptions.

5. A bank is required to provide the Reserve Bank with high level descriptions of its key risk management systems covering all major areas of risks and keep the Reserve Bank informed of all material changes to their risk management systems descriptions as they are made.

6. Within 3 months of its annual balance date, a bank should provide the Reserve Bank with a "declaration" from the chief executive, endorsed by the board.

7. The "declaration" should attest that, for the financial year past:

   (a) the board and management have identified the key risks facing the bank;

   (b) the board and management have established systems to monitor and manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits, and by adequate and timely reporting processes;

   (c) these risk management systems are operating effectively and are adequate having regard to the risks they are designed to control; and

   (d) the risk management systems descriptions held by the Reserve Bank are accurate and current.

8. If a bank feels it needs to qualify the declaration prescribed in paragraph 7, it would need to explain the reasons for the qualifications, as well as provide plans for corrective action.

AUDIT COMMITTEE

9. The board of a bank should establish an Audit Committee to oversee the bank's financial and management reporting, audit (both internal and external), as well as risk management processes, including the formulation and periodic review of the exempted financial institutions business continuity plan. The Audit Committee should review the external auditor's engagement every year, and in the process, remind auditors of their statutory obligations.

10. The Audit Committee should have a majority of non-executive directors. The Chairman of the board would not normally chair the Audit Committee.

INTERNAL AUDIT

11. Banks should have a comprehensive and independent internal audit process for reviewing and testing their internal controls and risk management systems. Where the scale of a bank's operations does not justify maintaining a full time internal audit function, the bank should agree alternative review arrangements with the Reserve Bank.

12. The internal audit scope should include a review of compliance with laws, regulations and the Reserve Bank's prudential guidelines.

13. Internal auditors should be represented in tripartite meetings with the Reserve Bank, the bank and its external auditor.

ROLE OF EXTERNAL AUDITORS

14. Section 36 of the International Banking Act No. 4 of 2002 (the "Act") provides for the Reserve Bank to require an institution's external auditor to prepare a report on such matters as the Reserve Bank may determine.

15. External auditors should, within 4 months of the annual balance date of a bank, provide simultaneously to the Reserve Bank and the Audit Committee, a report up to the latest balance date detailing the external auditor's opinions as to whether:

    (a) the bank has observed all prudential standards ;

    (b) the statistical and financial data provided by the bank to the Reserve Bank are reliable;

    (c) the bank has complied with all statutory requirements, any conditions on the banking license, and any other conditions imposed by the Reserve Bank in relation to the bank's operations; and

    (d) there are any matters which, in the auditor's opinion, may have the potential to prejudice materially the interests of depositors of the bank.

16. Management Letters relating to work undertaken by the auditor which have a bearing on the auditor's opinions as required in paragraph 14 should accompany the report.

17. Consistent with Section 36 of the Act, the Reserve Bank may request an external auditor to undertake a specific review of a particular aspect of a

bank's operations or risk management system. The cost of specific reviews is to be born by the bank.

18. The specific reviews will be conducted along the lines of an "Engagement to Perform Agreed-Upon Procedures". The review will result in a report submitted to the Reserve Bank, which should cover the strengths and weaknesses of the risk management system in the designated area(s). The report of such reviews should be submitted to the Reserve Bank and the bank simultaneously, within 6 months after the review is commissioned.

19. In addition to the requirements of this Guideline, the Act requires an auditor of a bank to inform the Reserve Bank if the auditor has reasonable grounds for believing that:

    (a) the bank is insolvent, or is likely to become insolvent; or

    (b) the bank is likely to be unable to meet its obligations or is in serious financial difficulties; or

    (c) a criminal offence involving fraud or dishonestly has been committed; or

    (d) serious irregularities have occurred, including irregularities that jeopardise the interests of depositors and creditors of the bank; or

    (e) losses have been incurred which substantially reduce the capital funds of the bank.

20. Under the Act, the Reserve Bank may, require an auditor of a bank to provide information about the bank if the Reserve Bank considers that the provision of the information will assist the Reserve Bank in performing its functions under the Act.

21. This guideline does not limit the scope or nature of a report that the Reserve Bank may require to be prepared in terms of Section 36 of the Act.