Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Auditor Roundtable

26 July 2017

Registry of Credit Unions

Agenda

- Introduction/Opening remarks
- Background - Financial Conditions/Regulatory Update
- Role, Responsibilities and Expectations of the External Auditor under the Regulatory Framework
- Practice Note 27(I) – The Audit of Credit Unions in the Republic of Ireland
- Interaction of External Auditor with Internal Audit and Finance Functions
- Provisioning for Impaired Loans
- FRS102 – observations following 2016 Year End
- RCU Expectations for 2017 Year End
- AOB

Central Bank's Statutory Mandate & Vision for the Credit Union Sector

Vision:

- Strong credit unions in safe hands.

Statutory Mandate:

- The protection by each credit union of the funds of its members.
- The maintenance of the financial stability and well-being of credit unions generally.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

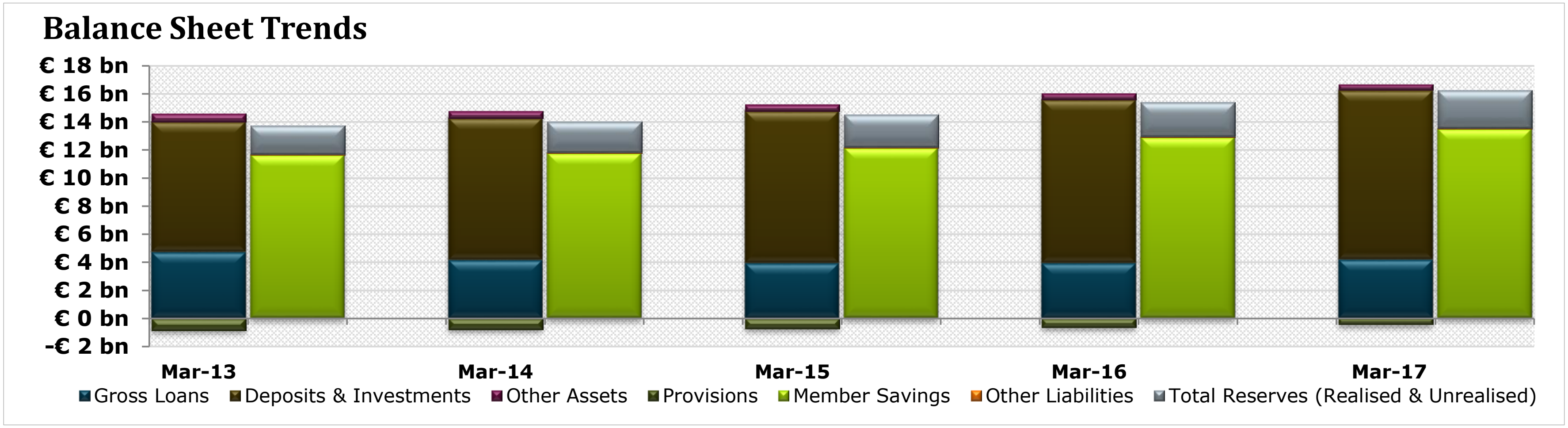
Credit Union Sector: Financial Conditions and Key Trends

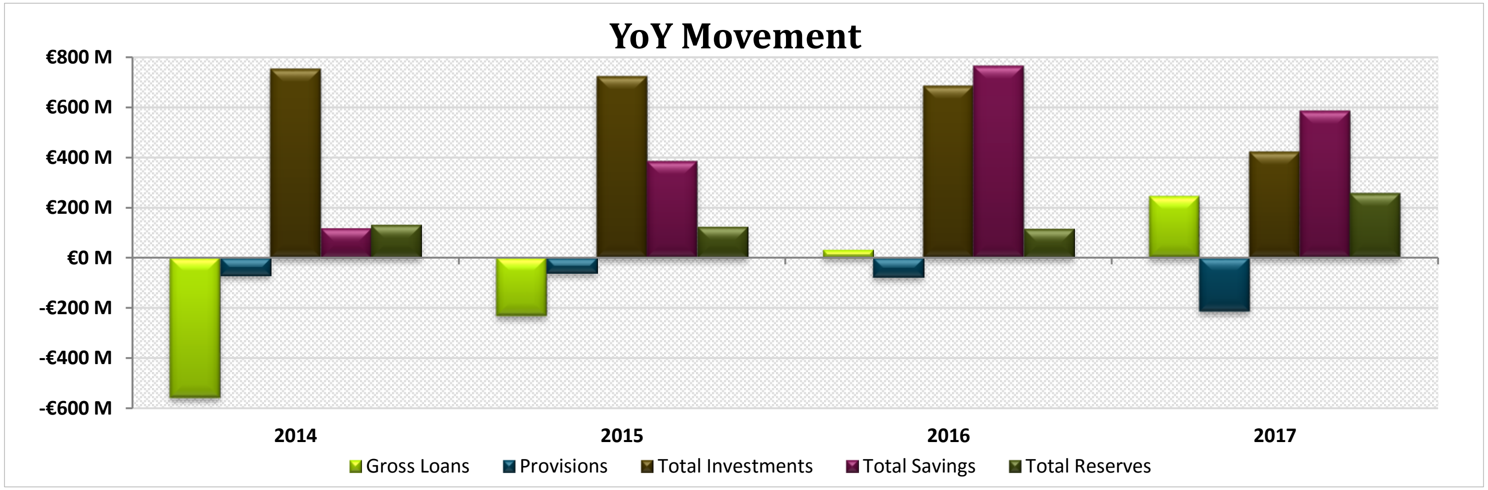
Background / Context

- Credit unions have weathered the recent financial crisis and economic downturn.
- However, the sector has been impacted by a number of factors including:
  - Pressure on members' repayment capacity;
  - Cases of poor credit underwriting – leading to need for significant bad debt provisions in many cases;
  - Overall decline in demand for consumer lending.
- Nonetheless, a number of positive factors have helped the sector, including:
  - Confidence and loyalty of members;
  - Commitment by Board, Management and staff of credit unions;
  - Management of arrears and defaults;
  - Regulatory and supervisory actions;
  - Voluntary restructuring;
  - Resolution.

Credit Union Sector – Financial Overview and Key Trends

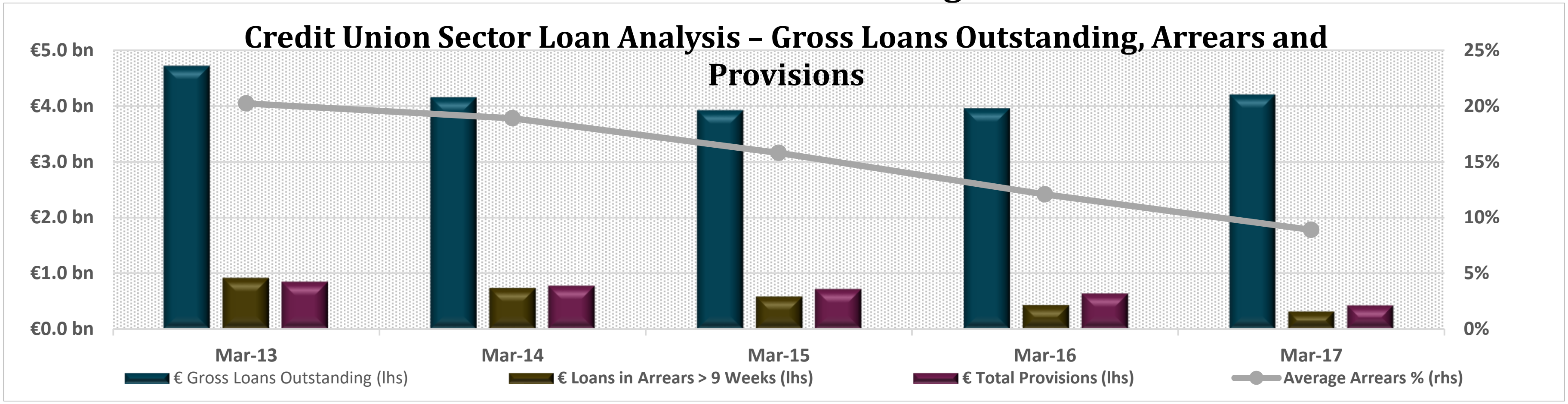
Balance Sheet Overview

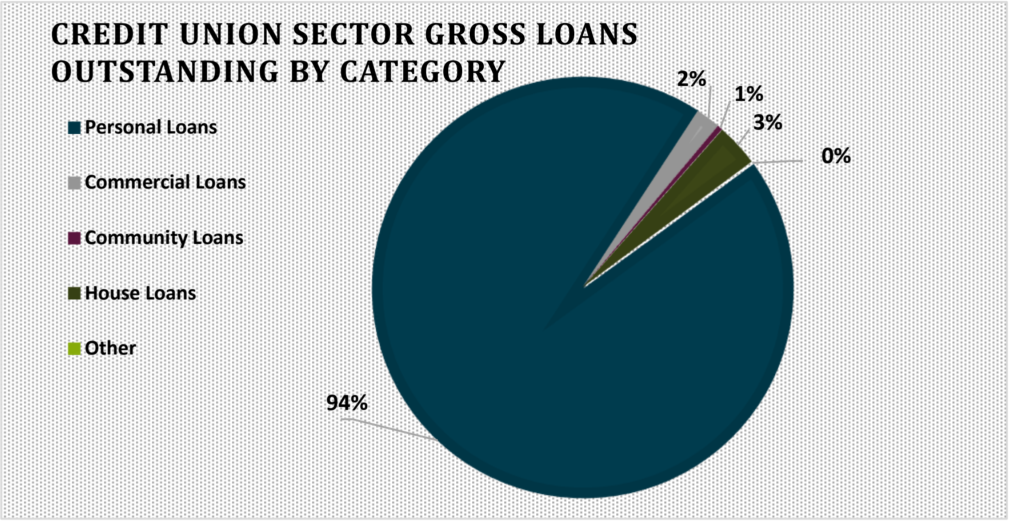




Credit Union Sector – Financial Overview and Key Trends

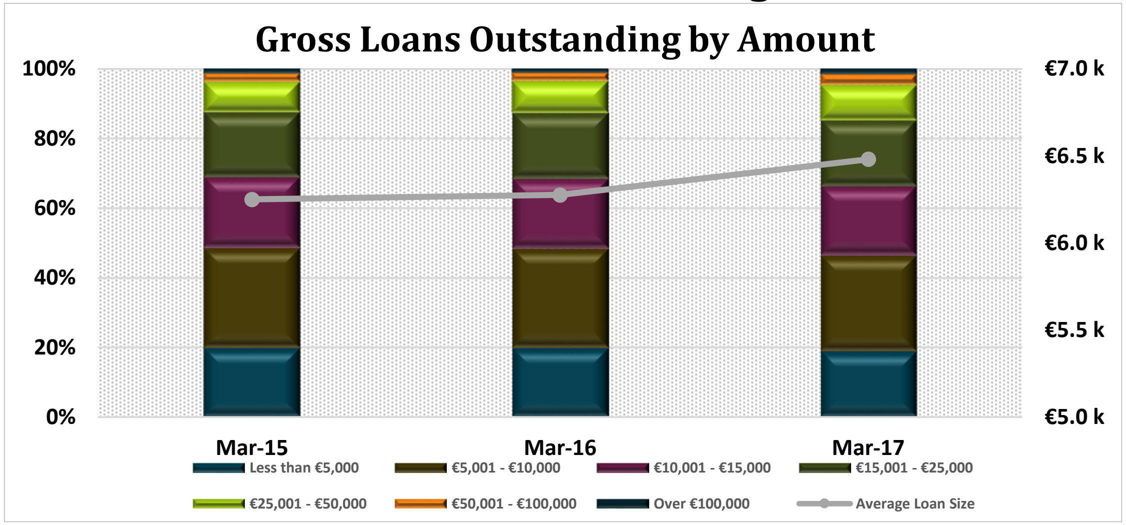
Credit Union Lending

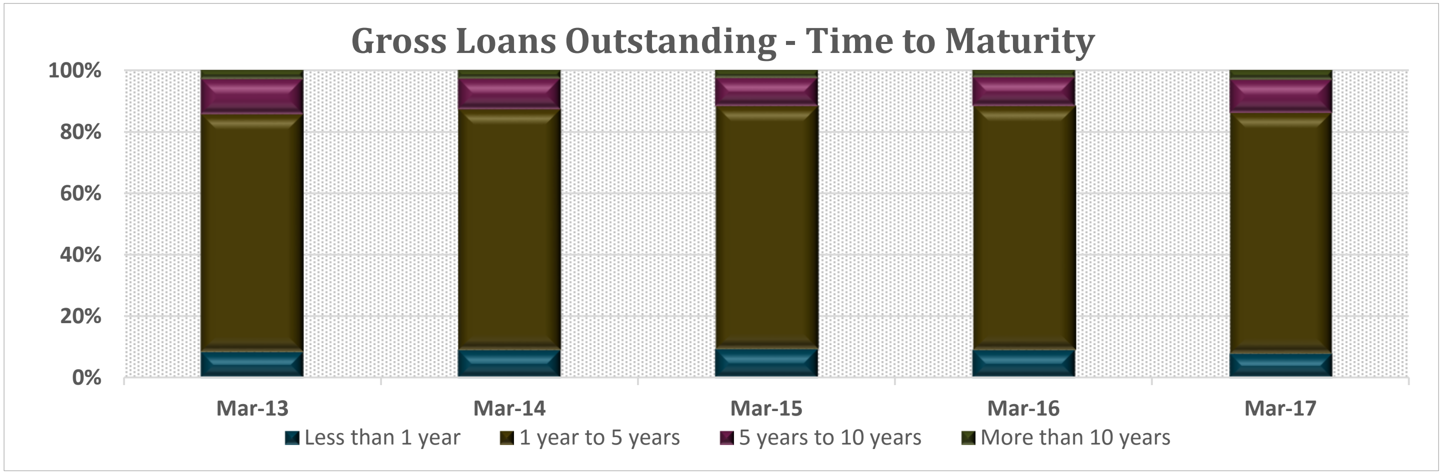




Credit Union Sector – Financial Overview and Key Trends

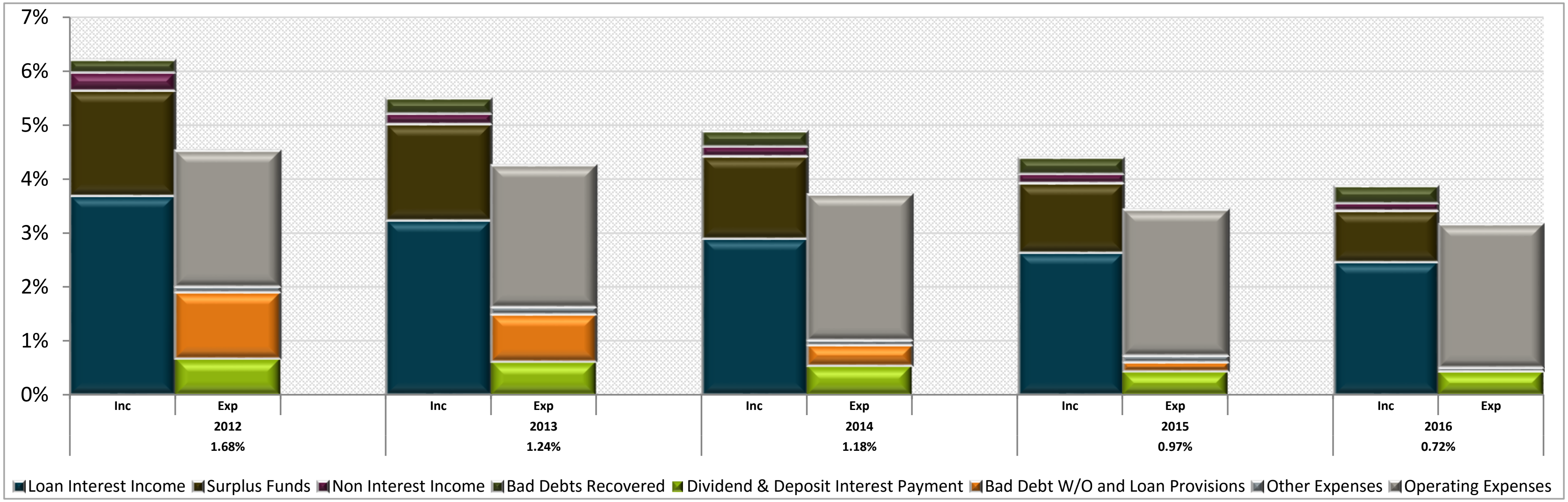
Credit Union Lending

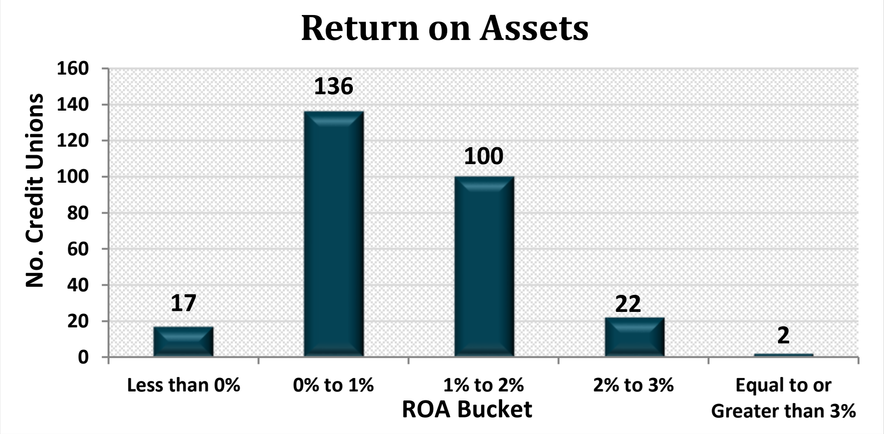


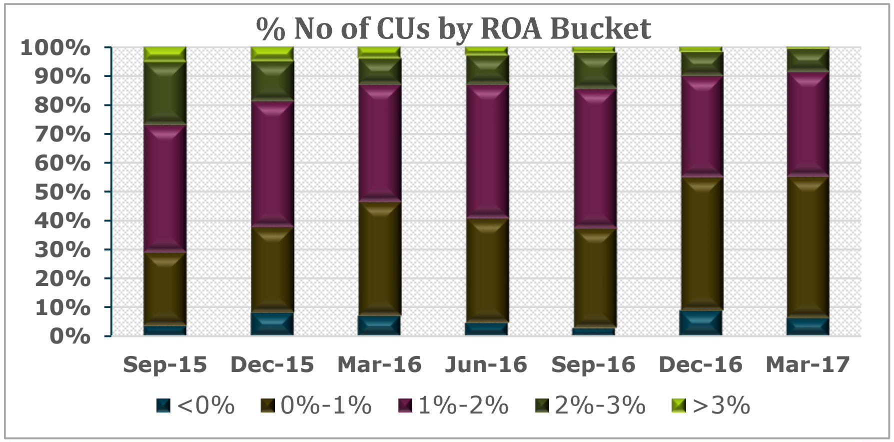


Credit Union Sector – Financial Overview and Key Trends

Return on Assets Profile





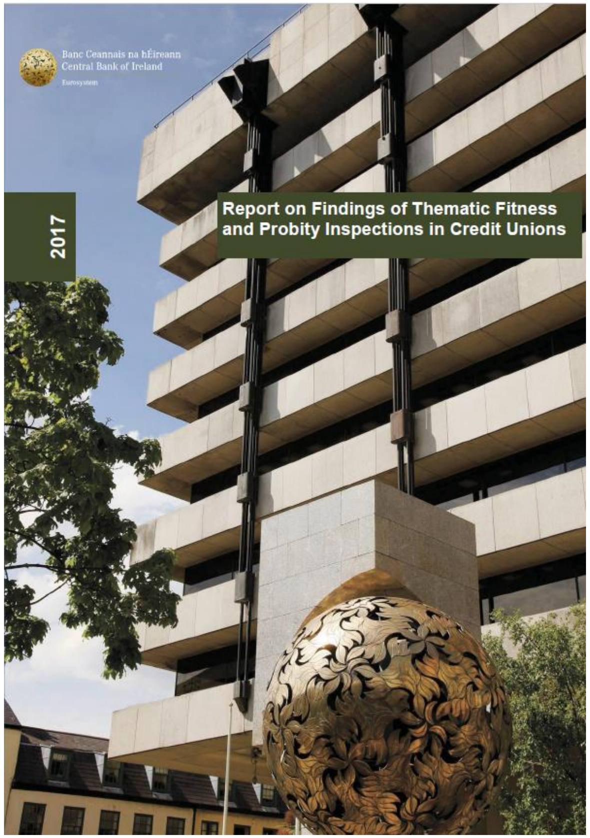


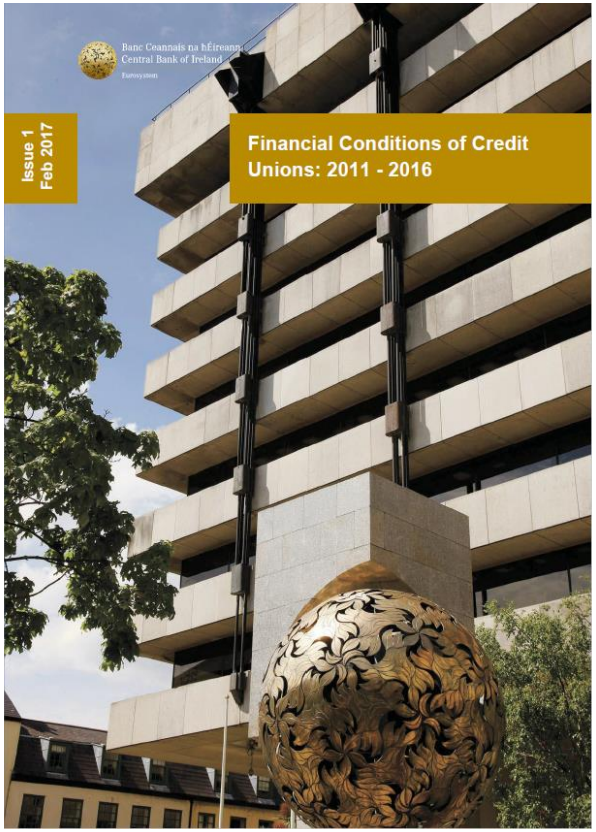
Key Challenges

- Low loan to asset ratio.
- Pressure on investment income and in turn ROA.
- Ability to pay a dividend.
- Ageing membership.
- Embedding restructuring.
- Business model development.

Background / Context

- Our Supervisory engagement with credit unions and analysis of returns highlight ongoing issues in the sector.
- Recent publications highlighting some key supervisory issues include:





Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Role, Responsibilities and Expectations of the External Auditor under the Regulatory Framework

Role, Responsibilities and Expectations of the External Auditor

- Statutory Audit
- Statutory Duty to Report to Registrar
  - Management Letters

Statutory Audit

- To audit the financial statements prepared by the directors:
  - Obtain evidence to give reasonable assurance that amounts & disclosures are free from material misstatement, whether caused by fraud or error;
  - Accounting policies – appropriate, consistently applied & adequately disclosed;
  - Accounting estimates – reasonable; &
  - Overall presentation of the financial statements.
- Identify material inconsistencies between the non-financial information (included in the Directors report) & the audited financial statements.
- To express an independent opinion on the financial statements to the members of the credit union in accordance with Credit Union Act, 1997:
  - True & Fair view.

Statutory Duty to Report to Registrar

- Section 122 of the Credit Union Act, 1997 sets out the auditor's duty to report certain matters to the Registrar.
- These duties include where the auditor has reason to believe that:
  - There exists circumstances which are likely to affect materially the credit union's ability to fulfil its obligations to its members, or meet any of its obligations under the Credit Union Act, 1997; or
  - There are material defects in the accounting records, systems of control of the business and records of the credit union; or
  - Proposes to qualify any report which is provided under the Credit Union Act, 1997.
- Where an auditor has provided a report ('management letter') to a credit union on a matter that has come to their attention during the course of the audit a copy of the letter and the response provided by the credit union must be provided to the Central Bank pursuant to section 22 of the Central Bank (Supervision and Enforcement) Act 2013.

Statutory Duty to Report to Registrar

- Section 27B of the Central Bank Act, 1997 imposes additional obligations on auditors to make reports (the Statutory Duty Confirmation) to the Registrar.
- The Statutory Duty Confirmation must be submitted within one month after the date of the auditor's report on the credit union accounts stating **whether or not** circumstances have arisen that require the auditor to report to the Registrar.
- Practice Note 27(I) provides further detail on the duties of credit union auditors to report to the Registrar – ISA (UK and Ireland) 250: Section B – The Auditor's Right and Duty to Report to the Regulators in the Financial Sector

Management Letters

- The management letter from an auditor to a credit union is one source of key information used to inform our supervisory process.
- Content of management letters generally is variable in highlighting areas of significant concern about **systems**, **control** and **related governance** issues in credit unions.
- Our concerns about the quality and content of management letters have been reinforced by our onsite PRISM engagements with credit unions.
- Quality of response from credit unions- evidence that a number of points raised are not adequately addressed by credit unions.

Discussion

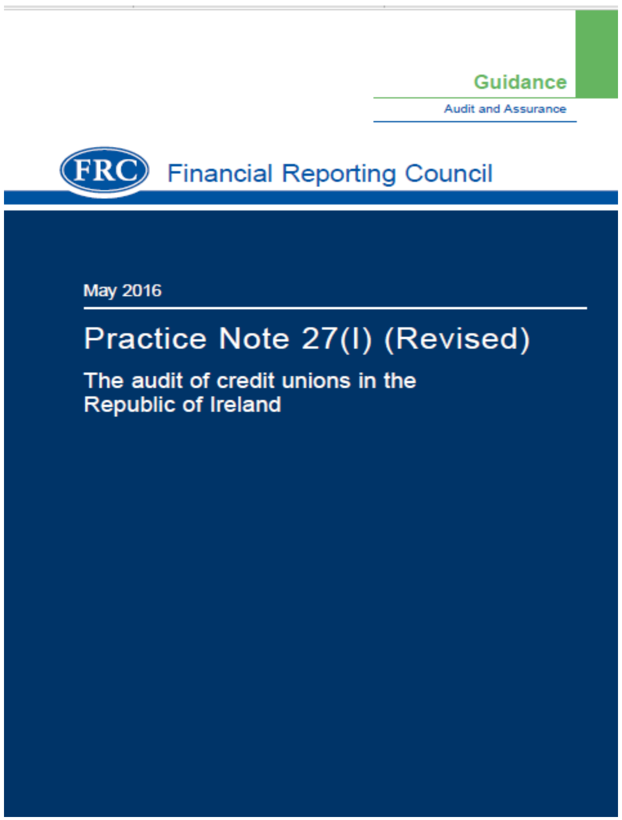
- Adherence to obligations by auditors.
- Quality of reporting in management letter and content of the management letter response.
- Quality of engagement with credit unions.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Practice Note 27(I) – The Audit of Credit Unions in the Republic of Ireland

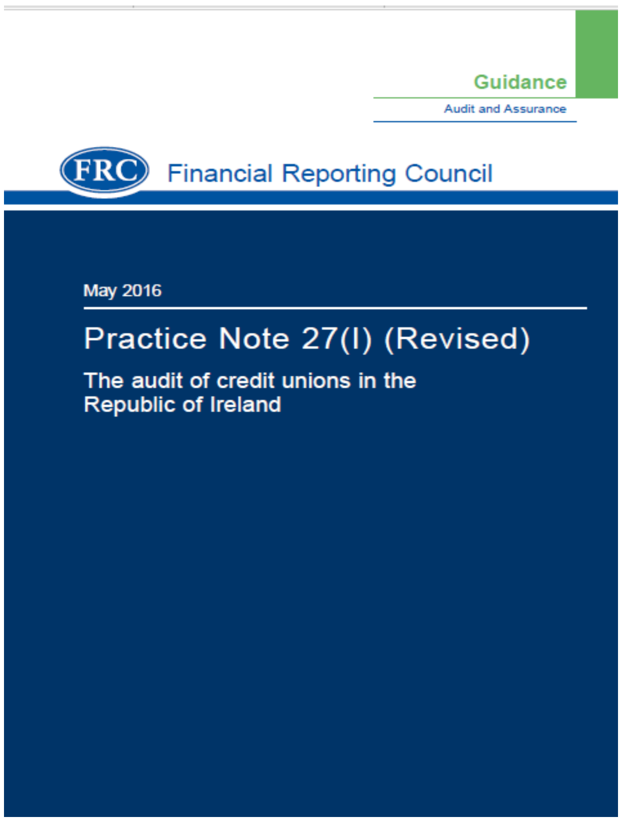
Practice Note 27(I) – The Audit of Credit Unions in the Republic of Ireland

- Following consultation Revised Practice Note 27(I) published in May 2016.
- https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Practice-Note-27(I)-(Revised)-The-audit-of-credit.pdf
- Important resource for credit union auditors covering a wide range of topics.


Guidance
Audit and Assurance
FRC Financial Reporting Council
May 2016
Practice Note 27(I) (Revised)
The audit of credit unions in the Republic of Ireland

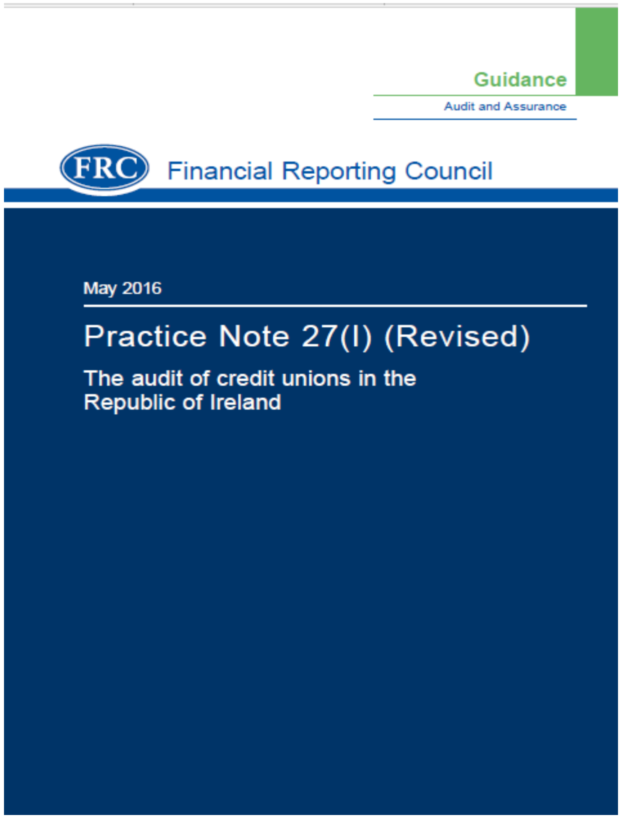
Practice Note 27(I) – The Audit of Credit Unions in the Republic of Ireland

- Overall Objectives Of The Independent Auditor And The Conduct Of An Audit In Accordance With International Standards On Auditing (UK And Ireland)
- Agreeing The Terms Of Audit Engagements
- Quality Control For An Audit Of Financial Statements
- The Auditor's Responsibilities Relating To Fraud In An Audit Of Financial Statements
- Consideration Of Laws And Regulations In An Audit Of Financial Statements
- The Auditor's Right And Duty To Report To Regulators In The Financial Sector
- Communication With Those Charged With Governance
- Communicating Deficiencies In Internal Control To Those Charged With Governance And Management
- Planning An Audit Of Financial Statements
- Identifying And Assessing The Risks Of Material Misstatement Through Understanding The Entity And Its Environment


Guidance
Audit and Assurance
FRC Financial Reporting Council
May 2016
Practice Note 27(I) (Revised)
The audit of credit unions in the Republic of Ireland

Practice Note 27(I) – The Audit of Credit Unions in the Republic of Ireland

- Auditor’s Responses To Assessed Risks
- Audit Considerations Relating To An Entity Using A Service Organisation
- External Confirmations
- Analytical Procedures
- Auditing Accounting Estimates, Including Fair Value Accounting Estimates, And Related Disclosures
- Related Parties
- Subsequent Events
- Going Concern
- Written Representations
- Using The Work Of Internal Auditors
- The Independent Auditor’s Report On Financial Statements
- Modifications To The Opinion In The Independent Auditor’s Report
- The Auditor’s Responsibilities Relating To Other Information In Documents Containing Audited Financial Statements


Guidance
Audit and Assurance
FRC Financial Reporting Council
May 2016
Practice Note 27(I) (Revised)
The audit of credit unions in the Republic of Ireland

Practice Note 27(I) – ISA (UK and Ireland) 240- The Auditor's Responsibilities Relating To Fraud In An Audit Of Financial Statements

- Objectives of the auditor are:
  - To identify and assess the risks of material misstatement of the financial statements due to fraud;
  - To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
  - To respond appropriately to fraud or suspected fraud identified during the audit.

Practice Note 27(I) – ISA (UK and Ireland) 240 - The Auditor’s Responsibilities Relating To Fraud In An Audit Of Financial Statements

Examples of conditions or events particularly relevant to credit unions which may increase the risk of fraud include:

- the non-participation in the direction of the credit union on the part of some of the directors or officers leading to a small number of their colleagues dominating the credit union’s management;
- inactive board oversight committee;
- inactive or inexperienced internal audit, risk management or compliance functions;
- excessive influence of the manager or a few officers;
- excessive influence on officers of a credit union by their extended family;
- lack of adequate training for directors and other officers of the credit union;
- inadequate segregation of duties between credit union staff;
- failure to document or follow the credit union’s standard operating policies and procedures;
- failure to control properly share withdrawals on dormant accounts;
- failure to exercise proper control over cash and bank accounts;
- unusual application of loan interest rates;
- loans granted in circumstances which do not appear to comply with the stated policies and procedures of the credit union;
- failure to reconcile regularly funds received through payroll deductions, particularly where the credit union’s membership has an employment common bond;
- failure to prepare on a timely basis bank reconciliations and other control accounts in order to present periodic management accounts to the board of directors;
- funds disbursed, even if with board approval, in circumstances which do not appear to fall within the authorised activities of the credit union;
- issuance of loans to members already failing to meet the repayment schedule of existing loans, or failure to make appropriate bad debts provision in respect of such existing loans; or
- failure to exercise the same controls, both as regards physical safekeeping and reflecting transactions promptly in the credit union’s records in relation to savings stamps as would be done in relation to cash balances.

Practice Note 27(I) – ISA (UK and Ireland) 250

Section B - The Auditor’s Right and Duty to Report to Regulators in the Financial Sector

- The objective of the auditor of a regulated entity is to bring information of which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditor’s audit responsibilities to the attention of the appropriate regulator as soon as practicable when:
  - The auditor concludes that it is relevant to the regulator’s functions having regard to such matters as may be specified in statute or any related regulations; and
  - In the auditor’s opinion there is reasonable cause to believe it is or may be of material significance to the regulator.

Practice Note 27(I) – ISA (UK and Ireland) 250

Section B - The Auditor's Right and Duty to Report to Regulators in the Financial Sector

- Examples of control failures which may not be significant in financial terms but may have a significant effect on the Central Bank's consideration of whether the credit union was satisfactorily controlled and was behaving properly towards its members could include:
  - failure to reconcile bank accounts and share and loan accounts on a regular basis;
  - absence of policies and procedures required by the CU Act 1997, as amended;
  - absence of an effective internal control, risk management or compliance function;
  - absence of a strategic plan including financial projections;
  - failure to prepare management accounts in a timely manner; and
  - absence of a quarterly loan book review.

Practice Note 27(I) – ISA (UK and Ireland) 265 Communicating Deficiencies In Internal Control To Those Charged With Governance And Management

- Objective of the auditor:
  - To communicate appropriately to those charged with governance and management, deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgement, are of sufficient importance to merit their respective attentions.

- A deficiency in internal control exists when:
  - A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
  - A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Practice Note 27(I) – ISA (UK and Ireland) 265 Communicating Deficiencies In Internal Control To Those Charged With Governance And Management

- Examples of internal controls, the absence of which might be considered a deficiency in the internal control system:
  - Bank reconciliations;
  - Share and loan reconciliations;
  - Daily cash counts and reconciliations;
  - Loan book reviews;
  - Expenditure authorisation;
  - IT security;
  - Investment reconciliations.

Practice Note 27(I) – ISA (UK and Ireland) 570 Going Concern

- Objectives of auditor:
  - To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;
  - To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
  - To determine the implications for the auditor's report.

Practice Note 27(I) – ISA (UK and Ireland) 570

Going Concern

- In reviewing going concern, the auditor may consider the following areas, and others as considered appropriate, in addition to those set out in ISA (UK and Ireland) 570
  - capital adequacy and regulatory reserve ratios – review of management's analysis and rationale for ensuring that the credit union is capable of maintaining adequate financial resources in excess of the minimum;
  - liquidity indicators – review of the credit union's liquidity management process for signs of undue deterioration;
  - loan to asset ratio;
  - inability to pay a dividend;
  - yields on investments;
  - trends in lending volumes – a marked decline in new lending volumes during the year or subsequently may indicate going concern difficulties;
  - yields on loans to members;
  - trends in loan defaults – a significant increase in or excessive exposure to troubled industry sectors may indicate cause for concern;
  - frequency of breaches of lending limits;
  - cost to income ratio;
  - trends in levels of members' savings;
  - the strategic plan of the credit union; and
  - reputational and other indicators – review of the financial press and other sources of market intelligence for evidence of deteriorating reputation; review of correspondence with the Central Bank.

Discussion

- Responsibilities relating to Fraud.
- Deficiencies in Internal Controls.
- Going Concern.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Interaction of External Auditor with Internal Audit and Finance Functions

Interaction with Internal Audit

- The internal audit function should maintain open communication with the auditor. This should include a clear delineation of responsibilities, plans and procedures for co-operation to ensure effective audit coverage and to minimise duplication of effort.
- ISA (UK and Ireland) 700 Using the work of Internal Auditors
  - External auditor retains responsibility for the opinion on the financial statements of the credit union
  - External auditor might use the work of the internal audit function in relation to areas of low risk involving limited judgements

Interaction with Finance Function

- Competence and capability of individuals in finance function?
  - Manager/dedicated finance function
- Quality of material provided to auditor?
- Quality of interaction?

Discussion

- Quality of outputs from internal audit.
- Competence of finance functions and quality of outputs.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Provisioning for Impaired Loans

Provisioning for Impaired Loans

- Section 11 of FRS102 outlines requirements in relation to the assessment of impairment and the calculation, measurement and recognition of provisions.
- It is required that at the end of each reporting period an entity must assess whether there is objective evidence of impairment of any financial assets which are measured at cost or amortised cost.
- Where it is deemed there is objective evidence of impairment, the entity shall recognise a provision in profit or loss immediately.

Provisioning for Impaired Loans

- Responsibility in relation to Provisioning in Credit Unions:
  - Board of Directors Responsibilities
  - Credit Union Manager Responsibilities
- Responsibility of Auditors includes obtaining sufficient audit evidence to assess whether:
  - Provision estimates are reasonable taking account of the circumstances of the credit union;
  - Provision disclosures in the financial statements are adequate.

Provisioning for Impaired Loans

- In assessing the adequacy of provisions on loans, the auditor should evaluate:
  - Key assumptions underpinning the collective and individual loan assessments,
  - Assessments of the credit union in relation to loan categories which may have higher risk characteristics,
  - Key assumptions relating to managements assessment of losses in the loan book which have been incurred but not yet identified on individual loans.

Discussion

- Experience of provisioning frameworks in credit unions.
- Challenges experienced in assessing the adequacy of the provisioning figure in the financial statements including discussion with credit union management and the board.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

FRS102 – observations following 2016 Year End

Year end 2016

- 2016 year end represented the first mandatory reporting period for credit unions under FRS 102.
- FRS 102 introduced a number of new requirements for credit unions including:

Loan Provisioning
- Ensuring objective evidence of impairment;
- 'Discounted cash flow' approach versus previous 'best estimate' approach.

Asset Valuation
- Required differentiation between 'basic' and 'complex' financial instruments and the valuation implication for both.

Income Recognition
- Effective Interest Method for basic financial instruments;
- Fair value movement for complex financial instruments.

Disclosures
- Additional disclosures introduced e.g. credit risk disclosure, management personnel compensation.

Supervisory Observations from 2016 Year End

- Some specific issues noted during review of the 2016 accounts included the following:

Income Recognition:

- Some credit unions continuing to account for loan interest income on a cash receipts basis;
- Loan interest income often mis-classified between income on ‘performing’ and ‘impaired’ loans.

Loans/Provisioning:

- Lack of adequately documented provisioning methodology;
- Lack of documented estimation techniques to support objective evidence of impairment.

Supervisory Observations from 2016 Year End

Investments:

- Inconsistency between classification of ‘basic’ v ‘complex’ financial instruments;
- Resulting impact on investment valuation i.e. fair value v amortised cost.

Cash Flow Statement:

- Requirement for reconciliation to cash and cash equivalents;
- Often reconciliation performed to cash and investments or cash only.

Disclosures:

- In a number of instances required disclosures were either incomplete or omitted.

Supervisory Observations from 2016 Year End

Generally the year end issues identified appeared to result from:

- Lack of understanding & appreciation of the separate & distinctive roles of key stakeholders.
- Lack of preparedness for first time adoption.
- An over-reliance by credit unions on their auditors in relation to preparation of the year end accounts.
- Under-resourced finance functions in credit unions.
- Lack of understanding of the new accounting standard.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

RCU Expectations for 2017 Year End

RCU Expectations for 2017 Year End

- The annual external audit is an important source of information relevant to our supervisory process.
- In making an assessment of the financial condition and performance of each credit union we rely on the annual audited accounts and the independent opinion expressed by the auditor to the members.
- We expect auditors to produce high quality outputs specific to the credit union being audited.
- Professional scepticism.
- Independence.

Managing and Preparing for Year-end

- Key stakeholders:
  - Credit Union Directors
  - Statutory Auditors
  - Registry of Credit Unions
- Directors must prepare financial statements in accordance with applicable law and generally accepted accounting practice ("GAAP") in Ireland:
  - Credit Unions Act, 1997; and
  - Accounting standards issued by the Financial Reporting Council (including FRS 102).
- Credit Union Act, 1997 requires Directors to prepare financial statements which give a true & fair view:
  - Select suitable accounting policies & apply them consistently;
  - Make judgments & estimates which are reasonable & prudent; &
  - Use going concern basis unless it is inappropriate to do so.
- Directors are also responsible for ensuring:
  - Systems & controls for the business & records of the credit union are established & maintained;
  - Proper accounting records are kept; &
  - Credit union assets are safeguarded & reasonable steps taken to prevent & detect fraud.
- Credit unions and auditors should prepare well in advance of year-end to ensure that the process operates as smoothly as possible

2017 Year End Expectations

- In requesting credit unions to submit their financial statements, RCU's priority focus is on:
  - The financial position of the credit union:
    - Underlying financial performance; &
    - Viability.
  - The adequacy of bad debt provisions & capital reserves;
  - The prudence & sustainability of any proposed distribution to members.

- RCU expects compliance with all legislative & regulatory requirements:
  - This includes adoption & full compliance with FRS 102.

- RCU **does not approve** the financial statements, the Directors approve the financial statements.

2017 Year End Expectations

- Awareness of director's role and responsibilities;
  - Appreciation of the parameters with respect to the remit of the statutory audit.
- Adequately resourced finance functions with the appropriate expertise to support effective, timely and accurate management, prudential and financial reporting.
- Compliance by credit unions:
  - With all applicable legislative & regulatory requirements; &
  - With current GAAP – which includes full compliance with FRS 102.

2017 Year End Expectations

- Specific expectations for auditors:
  - Awareness of auditors role and responsibilities;
    - Practice Note 27(I).
  - Early engagement with credit union;
  - Comprehensive management letters outlining issues identified throughout the audit;
  - Constructive challenge with credit union management/board around estimates included in the financial statements;
  - Reporting of issues identified to Registry in a timely manner.

Discussion

- Learnings from 2016 year-end.
- Looking ahead to 2017 year-end.
- Engagement with the Central Bank.

Conclusion

- AOB
- Closing Remarks