

# NATIONAL RESERVE BANK OF TONGA

## Prudential Statement No.7 Revised 2017

### AUDIT ARRANGEMENTS

#### Introduction

1. This statement is issued in terms of Section 15(3) of the Financial Institutions Act 2004 .
2. The Reserve Bank's supervisory process depends on information<sup>1</sup> provided by **LFI**s. 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.
3. The Reserve Bank expects that LFIs put in place arrangements, including reporting to senior management, the Board and the Board Audit Committee, the results of work performed by both internal and external auditors. Such arrangements would also include processes to monitor the implementation of recommendations made by internal and external auditors.
4. Section 23 of the Act provides that a licensed financial institution shall, with the consent of the Reserve Bank, appoint an external auditor for each financial year.
5. Section 23(2) of the Act requires that the auditor of a licensed financial institution shall:
  - (a) Carry out each year an audit of the **financial statements, including disclosures, as applicable** in accordance with international accounting and auditing standards;
  - (b) Provide the Reserve Bank with an **opinion**<sup>2</sup>, attached to the **financial statements verifying that they are complete** and give a true and fair view of the financial condition of the LFI;
  - (c) Perform such other functions as are required under this Act, or any other Act and Regulations;
  - (d) Disclose to the Reserve Bank any information relating to the affairs of the licensed financial institution, if in the opinion of the auditor the licensed

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<sup>1</sup> Information includes statutory and prudential returns, financial statements and risk management system descriptions.

<sup>2</sup> This should express the auditor's opinion on the bank's balance sheet, profit and loss account, financial position and the results of its operations and cash flows. If necessary the auditor should also provide detail on whether or not the opinion has been 'qualified'. Where an auditor feels it necessary to issue a 'qualified' audit opinion the Reserve Bank will seek additional information from the auditor on the background and reason for the issuance of a qualified opinion.

financial institution is insolvent or is in serious financial difficulties or has breached any provisions of this Act or any other Act; and

- (e) If requested by the Reserve Bank, discuss the audit directly and provide any additional information required, including copies of the auditor's working papers if deemed necessary by the Reserve Bank.

6. In accordance with section 23(2)(c) of the Financial Institutions Act, the external auditor should also:

- (i) advise the LFI on maintaining proper accounting systems and procedures; and
- (ii) advise the LFI on the effectiveness of its internal controls and risk management systems and procedures.

7. Pursuant to section 23(2)(d) of the Financial Institutions Act, external auditors are obliged to disclose on any given day during the external auditing process any arising issue confirmed such as insolvency, serious financial difficulties, or legal breaches with the Reserve Bank through requesting a special meeting. The external auditor must also notify the LFI's Board and/or audit committee of such circumstances as soon as practicable after the auditor becomes aware of the situation. Such information includes any act by any member of the Board or Senior Management, or any shareholder, controlling person, employee or agent of the LFI that constitutes fraud, embezzlement, or a material violation of any provision of the Act, or any other Act, or any regulation issued by the Reserve Bank.

8. Section 23(3) of the Financial Institution Act also provides that the Reserve Bank may, appoint an external auditor to perform a financial or operational audit on a licensed financial and any expense incurred shall be paid by that licensed financial institution.

9. The Reserve Bank's consent to the appointment of an external auditor in terms of Section 23(1) of the Financial Institution Act is subject to a fit and proper assessment of the Auditing firm and the partner responsible in terms of the Prudential Statement 8 – Fit and Proper Requirements. The fit and proper criteria require that the auditor:

- a. Must not be a director or employee of the licensed financial institution or of a related entity<sup>3</sup>;
- b. Must have appropriate formal qualifications and be a member of a recognised professional body;
- c. Must have a minimum 5 years experience in auditing in the banking and finance industry.

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<sup>3</sup> Related Entity refers to a) subsidiary of the LFI; b) company that controls the LFI; c) Any company that is controlled by: (i) a member of the Board or Senior Management of the LFI, or controlling person of the LFI; (ii) a member of the Board, Senior Management, or controlling person of any subsidiary of the LFI, or of any company that controls the LFI; (iii) A close relative of a person referenced in subparagraphs (c) or (d)

10. The Reserve Bank would generally expect that the external auditor of a LFI is the external auditor of its subsidiaries. Where this is not the case, the Reserve Bank should be informed of the reasons and the external auditor of the LFI should ensure that he is aware of the coverage and requirements of section 12(3) of the Financial Institution Act and results of the subsidiary as well as the systems employed to ensure that group risks are appropriately measured and controlled.
11. In terms of the Act no civil, criminal or disciplinary proceedings shall lie against any auditor arising from the disclosure of information to the Reserve Bank under the Act.
12. A LFI should give notice in writing to the Reserve Bank if it proposes to terminate the appointment of the approved auditor. The LFI must set out the reasons for the termination of the approved auditor.
13. Appointed auditors may resign from their appointment at any time and must also state the reasons for their resignation. In this event the appointed auditor and the LFI must promptly notify the Reserve Bank of the resignation and the stated reasons.
14. Where an auditor of a LFI has resigned or been dismissed, no other auditor shall accept an appointment as auditor of the LFI, or consent to such appointment, until he has requested and received from the first auditor a written statement of the circumstances and reasons as to why the first auditor resigned or why, in the first auditor's opinion, he was dismissed.
15. Paragraph 14 does not apply where no reply from the first auditor is received within fifteen days after a request under that paragraph is made. In that event, the auditor may accept the appointment after providing the Reserve Bank with written notification of the circumstances.
16. Unless paragraph 15 applies, an appointment of a new auditor for a LFI is void if paragraph 14 has not been complied with.
17. The Reserve Bank may expect, subject to the size of the audit firm, that the partner or auditor responsible for conducting audits of a LFI be rotated at least once in every five (5) years to avoid the potential for any conflicts of interest to arise. In addition, auditors (including the audit firm) should not provide services to LFIs (for example, consultancy work) which they will subsequently be auditing.

### **External Audit Reporting Requirements**

18. In addition to a report on the financial accounts, external auditors should, within 3 months of the annual balance date of a LFI, provide simultaneously to the Reserve Bank and the LFI's Audit Committee or Board, a report up to the latest balance date detailing the external auditor's opinions as to whether:

- (a) The LFI has observed all Prudential Statements issued by the National Reserve Bank of Tonga;
  - (b) The statistical and financial data provided by the LFI to the Reserve Bank are reliable;
  - (c) The LFI 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 LFI's operations; and
  - (d) The LFI is insolvent or in serious financial difficulties.
19. Management Letters relating to work undertaken by the auditor, which have a bearing on the auditor's opinions as required in the previous paragraph, should accompany the report to the Reserve Bank.
20. LFIs should ensure that external auditors are made aware of Reserve Bank's supervisory requirements and correspondences including reports of any on-site examinations.
21. Consistent with Section 23(3) of the Financial Institutions Act, the Reserve Bank may request an external auditor to undertake a specific review of a particular aspect of a LFI's operations or risk management system. The review should cover the strengths and weaknesses of the risk management system in the designated area(s). The report should be submitted to the Reserve Bank and the LFI simultaneously within six months of it being commissioned by the Reserve Bank. The cost of specific reviews will be borne by the LFI.

### **Reserve Bank Liaison with External Auditors**

22. In the normal course an annual tripartite meeting will be held between the Reserve Bank, a LFI and its external auditor to discuss matters arising from the external auditor's report and any review of risk management systems etc. However, any one of the three parties can initiate meetings or discussions at any time should it consider necessary. Moreover, notwithstanding the tripartite relationship, a LFI's external auditor and the Reserve Bank may, in exceptional circumstances hold bilateral discussions.

### **Internal Audit**

23. LFIs 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 LFI's operations does not justify maintaining a full time internal audit function, the LFI should agree on alternative review arrangements with the Reserve Bank.
24. If the LFI chooses to outsource internal auditing function to an auditing firm, the LFI will ensure that the chosen auditing firm will be a separate firm from their external auditing firm. This will draw a clear independent reporting line from each firm to the LFI and to avoid conflict of interest.

25. The internal audit scope should include a review of compliance with laws, regulations and the Reserve Bank's prudential guidelines, and internal operating rules established by the LFI's Board or Senior Management. Specifically, the internal audit function should have the authority to:
- (a) examine all documents of the LFI;
  - (b) monitor the work of the LFI at each stage without restrictions;
  - (c) require explanations from the employees of the LFI concerning any deficiencies or errors discovered by the internal audit function;
  - (d) analyse any such deficiencies or errors;
  - (e) prepare proposals for the elimination of such deficiencies and for measures to prevent errors;
  - (f) meet with the LFI's Board, audit committee and/or Senior Management regarding subparagraphs (a) through (e) of this paragraph;
  - (g) prepare reports of the activities of the internal audit function on a regular basis and submit the reports to the Board and Management of the LFI pursuant to the procedure approved by the Board; and
  - (h) perform other tasks related to the above as determined by the Board.
26. The internal audit function should report to the Board's audit committee, and should operate pursuant to policies approved by the Board.
27. The head of the internal audit function should be appointed to and removed from office by the Board.
28. The head of the internal audit function and the staff of the internal audit function must be fit and proper persons in accordance with the Prudential Statement No.8 Fit & Proper Requirements.
29. The number of staff of the internal audit function must be sufficient for the performance of the duties assigned thereto.
30. The head of the internal audit function, or a member of the internal audit staff designated by the head of the internal audit function, should attend meetings of the audit committee, and should have the authority to attend meetings of the full Board.
31. Internal auditors should be represented in tripartite meetings with the Reserve Bank, the LFI and its external auditor.
32. The Reserve Bank would expect that in the case of foreign owned LFIs which are audited by audit staff from the LFI's parent or Head Office, these auditors meet with the Reserve Bank to discuss the results of the audit.

### **Compliance with Prudential Statement No. 7**

33. This statement is effective from 1<sup>st</sup> April 2017. Non-compliance with the requirements

of this Prudential Statement will be subject to corrective actions as provided under section 33 of the Financial Institutions Act 2004 and the administrative penalties outlined in Prudential Statement No.3 Administrative Penalties.

National Reserve Bank of Tonga  
February 2017