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BANK OF MAURITIUS

Guideline on Transactions or Conditions respecting Well-being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius

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TABLE OF CONTENTS

1. Introduction 2

2. Authority 3

3. Statutory Requirements 3

3.1 Subsection 39(16) of the Banking Act 2004 3

3.2 Subsection 39 (17) of the Banking Act 2004 4

4. Well-being of a Financial Institution 4

5. Reportable Transactions or Conditions 4

5.1 Transactions or conditions requiring a change in accounting basis, or a note disclosure 4

5.2 Material adverse changes in risks inherent in the financial institution's business, with potential to jeopardize its ability to continue as a going concern 4

5.3 Information available to the auditor, indicating a material breach of the governing statutes or guidelines 5

5.4 Transactions or conditions indicating that the financial institution has significant weaknesses in its internal controls and management processes that render it vulnerable to material risks and exposures, leading to potential impairment of its ability to continue as a going concern 5

5.5 Transactions or conditions violating the assumption of management's good faith 6

5.6 Serious conflict between decision-making echelons of the financial institution 6

5.7 Transactions or conditions warranting a reservation in the auditor's opinion 6

5.8 Auditor's intention to resign or planned removal of the auditor 6

5.9 Serious conflict among directors and dissension among shareholders 6

5.10 Aggressive strategies detriment to the interest of depositors and the financial institution 7

5.11 Risk of complex group and overseas operations 7

6. Other Considerations 7

7. Timing of Reporting to the Bank of Mauritius 7

1. Introduction

This guideline applies to banks, non-bank deposit taking institutions, foreign exchange dealers, and money changers, collectively designated as 'financial institutions'. It lays down the ground rules respecting certain types of relationships between financial institutions and their external auditors. The relationships are described in terms of categories of transactions or conditions impinging on the well-being of financial institutions that must be reported by their external auditors to the Bank of Mauritius. The reportable transactions and conditions will be those that are encountered by external auditors in the course of financial statement audits.

The reporting requirement does not oblige the external auditor to provide an assurance on the reported matters. It is, however, necessary for him to understand his reporting responsibility, assess the likelihood that transactions or conditions relevant to the well-being of financial institutions will be encountered during the audit, and assess the significance of such transactions or conditions for reporting to the Bank of Mauritius. All of this will likely entail the auditor reorienting his work and taking a small amount of extra time in carrying out the financial statement audit. The additional planning and follow-up procedures would not constitute an extension of the scope of the financial statement audit because the auditor is not changing the nature, depth and timing of his audit procedures for the financial statement audit.

Although the external auditor normally expresses his opinion on a point in time financial statements, the opinion is based on the assumption of going concern. This propels the auditor to extend the scope of his inquiry, including discussions with management, to ensure that there are no doubts about the financial institution's ability to continue as a going concern. This points to a degree of convergence of interests of the auditor and the supervisor who must monitor the present and future viability of the financial institution to foster its safety and soundness.

International Accounting Standard 1 (IAS 1) issued by the International Accounting Standards Board outlines the assumption of 'going concern', applicable to the financial statement presentation. According to IAS 1, "In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date." It states further that in cases where an enterprise may not have a history of profitable operations and ready access to financial resources, "management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy that the going concern basis is appropriate." The external auditors, in providing assurance on the financial statement, must determine the adequacy of the basis used by management of a financial institution in applying the assumption of going concern.

The term 'external auditor(s)' used in the guideline applies to individual auditors as well as to the firm of auditors to which they might belong. When a firm of auditors exists, the obligations for meeting the requirements of the guideline shall devolve on the firm.

2. Authority

The guideline is issued under the authority of the Bank of Mauritius Act and the Banking Act. It shall come into effect on 24 February 2003.

3. Statutory Requirements

3.1 Subsection 39(16) of the Banking Act 2004

Subsection 39(16) of the Banking Act 2004 requires the following:

"Where in the course of the performance of his duties under the Act, an auditor comes across transactions or conditions in a financial institution affecting its well-being and he has reason to believe that -

a) there has been a material adverse change in the risks inherent in the business of the financial institution with the potential to jeopardise its ability to continue as a going concern;

b) there has been or there is a breach of any of the provisions of the banking laws, or the Companies Act 2001 relating to the accounting records and audit;

c) measures to counter the possibility of money laundering or the funding of terrorist activities in accordance with any enactment have not been or are not being properly implemented;

d) guidelines or instructions issued by the central bank have not been or are not being properly followed;

e) a criminal offence involving fraud or other dishonesty has been, is being or is likely to be committed;

f) losses have been incurred which reduce the amount paid as stated capital or assigned capital, as the case may be, of the financial institution by 50 per cent or more;

g) serious irregularities have occurred, including those that jeopardise the security of depositors and creditors; or

h) he is unable to confirm that the claims of depositors and creditors are still covered by the assets,

he shall immediately inform the central bank of the matter and, as soon as practicable, submit a report thereon to the central bank.

3.2 Subsection 39 (17) of the Banking Act 2004

Subsection 39 (17) of the Banking Act 2004 states that 'Where, in the performance of his duties, the auditor finds any matter which in his opinion is of material importance to the well-being of the financial institution, he shall call a meeting of the Audit Committee for the purpose of considering the matter.'

4. Well-being of a Financial Institution

All of the above reporting requirements relate to the well-being of banks. In the interest of prudential supervision, these requirements shall also apply to non-bank deposit taking institutions, and foreign exchange dealers and money changers, as appropriate. In addition, the Bank of Mauritius has issued a number of guidelines, requiring financial institutions to conduct their operations in a specified manner, all directed to the well-being of the financial institutions. Therefore, the term 'well-being' used in this guideline represents the broad scope herein outlined.

5. Reportable Transactions or Conditions

The requirements of Subsection 39 (16) are quite specific and must be adhered to. The following elaborates on these requirements, as necessary, and sets out the broad categories of transactions or conditions that are reportable to the supervisor under the well-being reporting requirement.

5.1 Transactions or conditions requiring a change in accounting basis, or a note disclosure

Transactions or conditions that necessitate a change in the accounting basis or require a disclosure by way of a note to the financial statements to explicitly draw the reader's attention to the possibility that the financial institution may not be able to continue realizing its assets and discharging its liabilities in the ordinary course of business. The circumstances present doubts about the continuing validity of the going concern assumption.

5.2 Material adverse changes in risks inherent in the financial institution's business, with potential to jeopardize its ability to continue as a going concern

In this category, the auditor may conclude that while the transactions or conditions encountered in the course of his audit do not affect the validity of using the going concern assumption, there are circumstances pointing to significant risks that could potentially impair the ability of the financial institution to continue as a going concern. In making his determination, the auditor will take into account all evidence collected in the course of the audit, including discussions with management and its assessment of the situation, as well as the auditor's own knowledge of the financial institution's business, the industry and economic conditions.

In assessing the significance of exposure of the institution to risks, the auditor will need to identify and assess the key factors affecting the risks, how the identified factors could change, and whether the changes have more than a remote chance of occurring.

As an example, a financial institution may have loans or investments that result in excessive concentration in an industry sector. The auditor will consider if there is more than a remote chance of changes occurring in the sector that would cause losses to the financial institution, jeopardizing its ability to continue as a going concern. In making his assessment, the auditor will of course take into account the financial institution's ability to mitigate the effects of the concentration by having in place appropriate risk management policies and its capacity to absorb the losses that might ensue.

In another example, a financial institution may have loans or investments that result in significant mismatching of assets and liabilities. The auditor will determine whether or not there is more than a remote chance of changes occurring in interest rates or foreign exchange rates that would lead to losses, impairing the ability of the institution to continue as a going concern. Again in this case, the auditor will take into account any risk management policies and procedures that would mitigate the adverse effects of the mismatch and the institution's ability to absorb losses ensuing from the mismatch.

5.3 Information available to the auditor, indicating a material breach of the governing statutes or guidelines

Financial institutions are subject to a variety of laws, regulations and guidelines. A serious breach of their requirements can have a material impact on an institution's safety and soundness, with adverse consequences for depositors and creditors. Some examples are the violation of the legislated ownership ceiling, Capital Adequacy Ratio, Credit Impairment Measurement and Income Recognition, Corporate Governance, and Related Party Transactions, and laws relating to anti-money laundering or prevention of terrorism.

5.4 Transactions or conditions indicating that the financial institution has significant weaknesses in its internal controls and management processes that render it vulnerable to material risks and exposures, leading to potential impairment of its ability to continue as a going concern

During the course of the financial statement audit, the auditor may become aware that the internal control systems of the financial institution are seriously deficient in the management of risks, such as those relating to liquidity, interest rates, asset concentration, asset valuation, derivative financial instruments, and credit granting. Such deficiencies must be reported to the Bank of Mauritius if the auditor concludes that they may potentially impair the financial institution's ability to continue as a going concern.

An example of a breakdown in internal controls is when the Chief Executive Officer disregards the allocation of responsibilities and accountabilities between the board of directors and himself and exposes the financial institution to undue risks without the knowledge and approval of the board. This could occur when he deliberately exceeds the prudential limits, for example, in credit concentration, or engages in the disposal of securities and other assets beyond his authority and without the approval of the board. These excesses might not at the time seem to prejudge the institution's capacity to continue as a going concern but the behaviour, if unchecked, could lead to serious consequences for

the institution. The auditor must be alert to such serious weaknesses in controls and bring the matter to the attention of the Bank of Mauritius.

5.5 Transactions or conditions violating the assumption of management's good faith

In the course of a financial statement audit, the auditor collects a variety of evidence, which he scrutinizes for adequacy and validity. In his scrutiny, he is guided by the assumption of management's good faith. If he determines that any transactions or conditions contradict that assumption, the matter is deemed serious and must be reported to the Bank of Mauritius. The lack of management's good faith exposes the financial institution to significant risks. The transactions or conditions affected could involve fraud or other irregularities at the highest levels of management. For example, the auditor may conclude that management has deliberately provided misleading information to the Bank of Mauritius or the public, or has misled the auditor in important aspects of the institution's business.

5.6 Serious conflict between decision-making echelons of the financial institution

When the auditor concludes that there is serious dissension or conflict between the decision-making levels of management, which has significantly impaired or has the potential to significantly impair the risk management capacity of the financial institution, the matter will be reportable to the Bank of Mauritius. An indication of such dissension or conflict may be the unexpected departure of a manager in a key function.

5.7 Transactions or conditions warranting a reservation in the auditor's opinion

The reservation of opinion on the financial statements of a financial institution is normally a very serious matter as it could significantly impair public confidence in the institution. Any transactions or conditions that lead the auditor to conclude that a reservation of his opinion is necessary, will be reportable to the Bank of Mauritius.

5.8 Auditor's intention to resign or planned removal of the auditor

When the auditor has decided that he would want to resign from his position as the auditor of a financial institution, or has become aware that management of the financial institution intends to remove him from his office, he should report the matter to the Bank of Mauritius. A timely reporting of the information would permit the Bank of Mauritius to investigate the matter before it becomes serious enough to threaten the safety and soundness of the institution.

5.9 Serious conflict among directors and dissension among shareholders

Situations may arise where for some reasons there may be serious conflicts among directors or dissension among shareholders of a financial institution. Such situations may remain unresolved over a long lapse of time to the extent that they may thwart the proper running of the financial institution and cause prejudice to the depositors and other stakeholders. The auditor shall immediately report such instances to the Bank of Mauritius.

5.10 Aggressive strategies detrimental to the interest of depositors and the financial institution

Financial institution may engage in aggressive strategies with the aim of improving balance sheet items over a short lapse of time or boosting short term profit. This may involve dealing in new products, such as deposit product, structured deposit product and overtrading in derivative financial instruments etc. Such strategies may not be sustainable in the long term and may jeopardize the financial soundness of the financial institution. Where the auditor determines that such strategies may adversely have a serious impact on the profitability of the financial institution, he/she shall expeditiously report the matter to the Bank of Mauritius.

5.11 Risk of complex group and overseas operations

Some financial institutions may operate in complex group structure or may have significant investments overseas through the establishment of branches, subsidiaries or affiliates. Financial institutions operating within a complex group environment are much more exposed to risk of failure of an entity in the group. Similarly, financial institutions having overseas investment face country risk which includes among others political risk, exchange rate risk, economic risk, sovereign risk and transfer risk. In case the auditor is aware that the changes in the business environment may adversely affect operating profits or the value of these foreign investments he/she shall immediately report same to the Bank of Mauritius.

6. Other Considerations

The above lists the broad categories of transactions and conditions that are reportable to the Bank of Mauritius under the well-being reporting requirements. However, there may be other situations, which are not covered in the list but are, in the opinion of the auditor, of sufficient importance to be brought to the attention of the Bank of Mauritius to ensure the financial institution's continued well-being. The auditor will be expected to advise the Bank of Mauritius of such transactions or conditions.

7. Timing of Reporting to the Bank of Mauritius

Subsection 39 (16) of the Banking Act 2004 states that when an auditor is satisfied that a reportable situation exists, he shall immediately report the matter to the Bank of Mauritius.

Bank of Mauritius