



cutting through complexity

FINANCIAL SERVICES

# Governance of central banks

Taking financial oversight to  
the next level

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# TAKING FINANCIAL OVERSIGHT TO THE NEXT LEVEL

Governance has been placed in the spotlight in recent years, driving a clear trend towards improving oversight in many global institutions.

For central banks, the focus on governance has been driven by their public-interest mandate, which demands both accountability and independence. A good governance structure instils confidence that a central bank can deliver effectively on its objectives and be seen as a credible and accountable organisation that contributes to a stable economic environment.

Given their significant public-interest mandate, it is important that central banks lead by example and are at the forefront in adapting to a changing environment.

This publication focuses specifically on *financial* oversight, one of the key pillars of governance and the most subject to change. We identify the characteristics and underlying principles of effective financial oversight and, using publicly available information, highlight some of the key aspects of implementing these principles. Through examples, we show how some central banks are addressing the challenges, and we also draw attention to emerging issues.

We expect this publication to be of interest to anyone involved in central bank governance, especially board and audit committee members. We hope that you find it helpful in taking the effectiveness and transparency of financial oversight in your organisation to the next level.

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## AT A GLANCE ...

Effective financial oversight is integral to the governance of any organisation, including a central bank.

Governance is the responsibility of the board of a central bank. However, because financial oversight is often delegated to the audit committee, this publication is written from that perspective. Regardless of the institutional arrangements, the considerations and practices discussed here are applicable and transferable to any central bank in taking financial oversight to the next level.

### Principles underlying an effective audit committee

The right principles can help ensure that practices are applied effectively – that is, by the right people with the right information, processes and perspectives. Principles underlying an effective audit committee include the following.

- Clearly defined responsibilities supported by the right tone at the top.
- Independent mindset that supports professional judgement and scepticism.
- Appropriate background and experience in financial matters.
- Understanding of current and emerging issues affecting a central bank.
- Proactive, risk-based approach.
- Appropriate structure, including committee size, frequency of meetings, time commitment and access to information.

### Corporate reporting process

It is good practice for a central bank to publish financial statements and an annual report, even if it is not obliged to, because this provides a level of transparency and accountability that is consistent with its public-interest mandate. The audit committee is usually tasked with overseeing the corporate reporting process on behalf of the board. This includes the following.

- Assessing the completeness, clarity and transparency of financial statements.
- Evaluating the appropriateness of the central bank's financial reporting framework.
- Assessing management's judgements, including its choice of accounting policies and estimates.
- Evaluating significant financial reporting issues, including the treatment of any unusual or complex transactions and disclosures.
- Reviewing other information, such as an annual report that includes the financial statements.
- Evaluating the expertise and adequacy of the finance function and the CFO.

## Risk management and internal control systems

The public-interest role of central banks means they need to be more proactive in managing risks. The audit committee's oversight responsibilities with regard to risk management and controls are typically delegated to it by the board and include the following.

- Clarifying the responsibilities and remit of the audit committee, especially when responsibilities are shared with another committee, such as a risk committee.
- Reviewing and assessing the effectiveness of internal controls within the remit of the audit committee.
- Reviewing fraud-related risks, as well as bribery and corruption risks; and reviewing the related controls and prevention programmes – e.g. whistle-blowing.

## Internal audit function

An effective internal audit function will have a positive impact on the operation of internal controls. A key attribute is its ability to be objective when evaluating and reporting on whether management activities and internal controls are operating effectively. Audit committee oversight in this area typically involves the following.

- Establishing clear lines of reporting and communication protocols that promote objectivity.
- Determining the remit of the internal audit function.
- Assessing internal audit resources.
- Assessing the annual work plan and regularly monitoring progress against it.
- Reviewing significant findings or recommendations, and monitoring management's response and the implementation of agreed recommendations.
- Assessing internal audit's performance and effectiveness.
- Periodically reviewing the structure of the internal audit function to consider the most appropriate sourcing method.

## External audit

Legislation often requires an independent external audit of a central bank's financial statements. Oversight of external audit is within the audit committee's remit and comprises the following.

- Establishing effective two-way communication with the external auditor to share matters relevant to each other's responsibilities on a timely basis.
- Monitoring the audit cycle, including understanding the audit scope and planned approach, and reviewing audit findings.
- Assessing the effectiveness of the external audit process.
- Assessing the external auditor's independence and objectivity.
- When appropriate, making recommendations to the board on the appointment, reappointment and removal of the external auditor, and on approving the external auditor's fees and terms of engagement.

# CHAPTER 1: PRINCIPLES UNDERLYING AN EFFECTIVE AUDIT COMMITTEE

An audit committee with the right people who have the right information, processes and perspectives enables the board to focus on achieving its strategic objectives.

As a body, the audit committee should be an informed, vigilant and effective overseer of the financial reporting process. How an audit committee fulfils its remit will vary according to the clarity with which responsibilities are assigned to it, the tone set by the board and the behaviours and abilities of individual audit committee members.

This chapter explains the principles underlying effective audit committees, which are fundamental to an audit committee's behaviour and underpin everything else discussed in this publication. The Appendix builds on these principles and addresses other practices that can be established for a more effective audit committee.

## CLEARLY DEFINED RESPONSIBILITIES

In general, audit committees are responsible for overseeing the central bank's financial reporting process, including:

- its exposure to financial reporting and related risks;
- the effectiveness of internal controls;
- the independence, accountability and effectiveness of the external auditor; and
- the transparency of financial reporting and disclosures.

In delegating these and other oversight responsibilities to the audit committee, the board should factor in the central bank's own unique needs, dynamics and culture. It is important that the responsibilities of the audit committee are:

- reasonable, clearly defined and clearly communicated to those involved;
- appropriately focused on essential issues, activities and responsibilities; and
- supported by the board and the tone at the top.

## Direct responsibility for external audit

One of the most significant changes resulting from recent regulatory requirements is the audit committee's direct responsibility for external audit. This responsibility may include recommending the external auditor's appointment and fees to the board, and then overseeing the audit work and the external auditor's compliance with independence requirements.

Effective oversight requires active engagement with the external auditor through timely and open two-way communication. It is therefore important that the audit committee works with the external auditor to establish a mutual understanding of the form, general content and timing of communications to take place (see [chapter 5 'External audit'](#)).

## What's involved?

- Clearly defined responsibilities supported by the right tone at the top.
- Independent mindset that supports professional judgement and scepticism.
- Appropriate background and experience in financial matters.
- Understanding of current and emerging issues affecting a central bank.
- Proactive, risk-based approach.
- Appropriate structure, including committee size, frequency of meetings, time commitment and access to information.

## TONE AT THE TOP

The board, supported by the governor, CFO and other management across the central bank, should be unequivocal in its commitment to ethical practices, and to accuracy and transparency in financial reporting. It is therefore important that the audit committee assesses whether the central bank has set the right tone, by understanding how this commitment has been communicated and implemented so as to provide direction to the rest of the organisation.

## INDEPENDENT MINDSET THAT SUPPORTS PROFESSIONAL JUDGEMENT AND SCEPTICISM

Independence from management is one of the cornerstones of an effective audit committee, particularly when overseeing areas in which judgements and estimates are significant. At its heart is a willingness to appropriately challenge management when necessary.

Audit committee members need to be willing to question significant judgements made by management and other key parties such as internal and external auditors and, when appropriate, challenge any issues they believe to be questionable or unacceptable. This requires individuals who have:

- the personal and professional characteristics necessary to engage in open and frank discussions; and
- the ability to stand back and exercise an appropriate level of professional scepticism and judgement.

## BACKGROUND AND EXPERIENCE IN FINANCIAL MATTERS

If the audit committee is to provide meaningful oversight, then its members need to collectively possess sufficient financial acumen to discharge their responsibilities.

However, it is not critical for every audit committee member to have recent and relevant experience in financial matters. In fact, there is often great value in having members from diverse backgrounds with the confidence to ask 'simple' questions that often shed light on relevant issues, but that can be overlooked by more experienced members.

Accordingly, at least one member of the audit committee should have recent and relevant experience in finance, accounting or auditing. What constitutes 'relevant' experience will, of course, vary between central banks and countries. Each board should determine its own criteria, considering the circumstances of its central bank and any local regulations.

## UNDERSTANDING OF RELEVANT CURRENT AND EMERGING ISSUES

A fully engaged audit committee is:

- knowledgeable about relevant current affairs;
- mindful of relevant emerging issues and their impacts; and
- up to date with recent developments in financial reporting and regulatory requirements.

Emerging issues can have a direct or indirect effect on a central bank's risks, control environment and financial reporting, as well as the audit process. In a continually changing global environment, understanding how the central bank responds to challenges is fundamental to an audit committee's ability to discharge its responsibilities. Audit committee members usually keep themselves updated through participation on the committee and by attending in-house and external briefings and seminars. Meetings with the head of internal audit, the external auditor and the CFO allow members to discuss current financial reporting issues and the status of any areas of focus.

### More guidance

#### Enhancing professional scepticism

The quality of judgements can be affected when decision makers fall prey to unconscious biases that can impede their ability to exercise an appropriate level of professional scepticism.

Studies have shown that once we are aware of these biases, we can take steps to mitigate their effect and improve our judgement skills. A good source of information on this is the paper [Enhancing Board Oversight: Avoiding Judgment Traps and Biases](#), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).



New audit committee members need to make a particular effort to understand their responsibilities and to become aware of current issues and the particular circumstances of the central bank. It is therefore good practice to establish a formal induction programme, and to tailor it for individual needs.

Induction programmes may include meetings with senior management and site visits, which will give the new audit committee members direct access to the central bank's operations. Although each programme will be different, the type of information that will be relevant to any new member includes:

- the audit committee's terms of reference, recent committee minutes and presentations to the board;
- relevant central bank policies, including the code of conduct and whistle-blowing policy;
- an overview of the central bank's internal control, risk and compliance frameworks;
- the most recent annual – and quarterly, if applicable – financial statements;
- any reports – internal or external – related to internal controls and financial reporting;
- internal audit's terms of reference, work plan and recent reports; and
- any written communications received from the external auditor.

### PROACTIVE RISK-BASED APPROACH

The audit committee's high-level view and cumulative knowledge and experience mean it is well-positioned to proactively focus its oversight efforts on the higher risk areas.

A proactive risk-based approach involves:

- appropriately communicating and co-ordinating with other committees whose areas of oversight may overlap – e.g. risk and remuneration committees;
- considering what could go wrong in a significant way or what the significant risks are;
- assessing how those risks have been identified, evaluated and managed by assessing:
  - whether the central bank's risk identification process has a sufficiently broad perspective, is dynamic enough and extends sufficiently far into the future – e.g. the process includes both external macroeconomic and systemic risks, and internal risks such as financial reporting risks and exposure to fraud and irregularities;
  - how each identified risk is assessed, both in terms of the probability of the risk occurring and its likely impact; and
  - the effectiveness of the related internal controls used to manage these risks; and
- paying particular attention to areas where significant deficiencies have been identified, including whether appropriate, timely action is being taken to address and/or remedy such items.

### More guidance

#### Discussion papers

- BIS – [Central bank governance and financial stability](#) and [Issues in the governance of central banks](#).
- BCBS – [External audits of banks](#) (including expectations and recommendations relevant to banking supervision).

#### International standards<sup>1</sup>

- [IASB](#) – e.g. the new International Financial Reporting Standards (IFRSs) IFRS 9 on financial instruments accounting and IFRS 15 on revenue accounting.
- [IAASB](#) – e.g. the changes to International Standards on Auditing (ISAs) relating to auditor reporting (see [page 28](#)).
- [IESBA](#) – e.g. the *Code of Ethics for Professional Accountants* (see [page 31](#)).

#### Practical guidance

- KPMG UK Audit Committee Institute – [Audit Committee Handbook](#).
- KPMG [Insights into IFRS](#).
- KPMG [IFRS Institute](#).

For other KPMG guidance, see [page 40](#).

1. Many jurisdictions have adopted standards based on IFRS for preparing financial statements, and ISAs as the auditing framework. This publication is based on the use of IFRS and ISAs, but the principles apply to any central bank regardless of its accounting and auditing frameworks.



## APPROPRIATE STRUCTURE

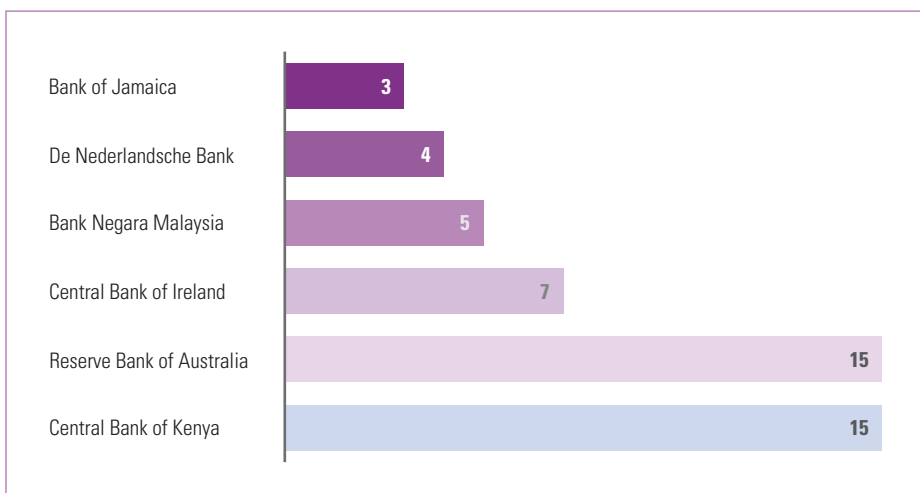
### Size of the audit committee

The size of the audit committee will vary depending on the needs and culture of the central bank and the extent of the responsibilities delegated by the board.

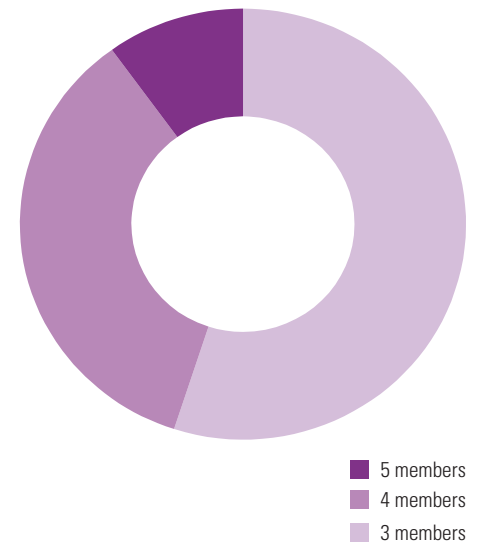
We looked at a selection of 20 central banks and found that more than half of their audit committees have only three members, about a third have four members and a tenth have five members.

### Frequency of meetings

To illustrate how varied the formal activities of audit committees can be in practice, we then reviewed the number of meetings held by six central banks during one financial year. As the chart shows, they ranged from three to 15 meetings.



### Size of the audit committee



### Time commitment and access to information

An audit committee will prove ineffective if it does not have both access to and an understanding of relevant information. Audit committee members therefore need to be prepared to invest the necessary time to understand:

- the central bank's operations, including the substance of complex transactions and how they are reflected in the financial statements; and
- why critical accounting policies were chosen, how they were applied and why the end result fairly presents the central bank's operations.

## CHAPTER 2: CORPORATE REPORTING PROCESS

Publicly available financial statements provide a level of transparency and accountability that is consistent with the public-interest mandate of central banks.

It is good practice for a central bank to publish financial statements and an annual report, even if it is not obliged to.

The audit committee is generally tasked with overseeing the corporate reporting process and evaluating the finance function and CFO on behalf of the board.

### COMPLETENESS, CLARITY AND TRANSPARENCY OF FINANCIAL STATEMENTS

A significant role of the audit committee is to assess the overall completeness, clarity and transparency of the financial statements, in the context of a relevant financial reporting framework.

Questions to consider include the following.

- Do the financial statements adequately refer to or describe the applicable financial reporting framework?
- Is the information presented in the financial statements relevant, reliable, comparable and understandable?
- Do the financial statements adequately disclose the significant accounting policies selected and applied?
- Do the financial statements provide disclosures that enable the intended users to understand management's judgements and the effect of unusual or complex transactions and events?
- Has the audit committee discussed the external auditor's views on the qualitative aspects of the central bank's accounting practices, including the overall neutrality, consistency and clarity of its disclosures?
- Has management made the audit adjustments or disclosure changes recommended by the external auditor?

### FINANCIAL REPORTING FRAMEWORK

Financial statements are prepared with reference to the requirements and guidance set out in a relevant financial reporting framework. Unless local law specifies the framework to be used, central banks often have a degree of flexibility in identifying an appropriate framework. When a central bank has this ability and is considering changing its framework, it is important that the audit committee:

- understands how and why the financial reporting framework was selected – e.g. because it was a generally accepted framework such as IFRS; and
- is satisfied that the framework being considered is appropriate for preparing the financial statements.

#### What's involved?

- Assessing the completeness, clarity and transparency of financial statements.
- Evaluating the appropriateness of the central bank's financial reporting framework.
- Assessing management's judgements, including its choice of accounting policies and estimates.
- Evaluating significant financial reporting issues, including the treatment of any unusual or complex transactions and disclosures.
- Reviewing other information, such as an annual report that includes the financial statements.
- Evaluating the expertise and adequacy of the finance function and the CFO.

The appropriateness of a framework may be determined by considering the extent to which the financial statements exhibit:

- relevance to the information needs of stakeholders;
- a faithful representation and understandability of the transactions and activities entered into by the central bank; and
- comparability to those of other entities operating in the jurisdiction and/or other central banks.

## JUDGEMENTS, ESTIMATES AND ACCOUNTING POLICIES

The preparation of financial statements usually entails numerous judgements and estimates, each of which can have a significant effect on the financial statements – each estimate usually has a range of possible and supportable outcomes.

The audit committee should therefore focus on the appropriateness of management's approach to these issues, and how they are reflected in the financial statements. It may also be helpful to obtain the external auditor's view on these matters, especially because auditing standards require external auditors to communicate their views on these and other matters to the audit committee.

### Assessing management's overall approach

In assessing management's overall approach, the audit committee should aim to:

- understand the central bank's position and current market conditions;
- understand the central bank's information systems and controls relevant to financial reporting, and the extent to which internal audit has been involved in evaluating and testing the design, implementation and operation of those systems and controls;
- understand the financial reporting roles and responsibilities, and the extent to which the central bank has the necessary resources to address financial reporting matters; and
- understand the facts, circumstances and economics of significant transactions.

### Assessing the appropriateness of accounting policies

In assessing the appropriateness of accounting policies, the audit committee should consider:

- whether the accounting policies are consistent with the applicable financial reporting framework;
- why the policies were selected, if acceptable alternative policies exist;
- how the accounting policies compare with those followed by other central banks;
- the effect of significant accounting policies in emerging areas or areas that are unique to central banks, particularly if there is a lack of authoritative guidance or consensus – e.g. accounting for physical gold holdings; and
- why significant accounting policies have been changed, if applicable, and the potential effect of each change on the current and future periods.

### More guidance

#### Financial reporting framework

The use of different frameworks makes the comparison of financial statements across a number of central banks challenging. Some central banks apply all of the requirements of IFRS; others adapt IFRS to suit their own purposes. Central banks in the Eurosystem – i.e. those that have adopted the euro – apply a framework developed by the European Central Bank (ECB).

It is important that the financial reporting framework is appropriately described in the financial statements, avoiding imprecise, qualifying or limiting language that may mislead users – e.g. the financial statements are in 'substantial compliance' with IFRS.

## Assessing the appropriateness of significant judgements and estimates

In assessing the appropriateness of significant judgements and estimates, the audit committee should consider:

- how management makes significant estimates – including the methods used, the controls over making and approving significant estimates, and the extent to which experts are used;
- the key assumptions and management's support for them, their internal consistency and their sensitivity to change;
- the relevant accounting guidance, including any alternative accounting treatments and practices that may be followed by other central banks with similar transactions; and
- whether there is any potential for management bias, taking particular care not to disregard the potential for earnings management; although central banks are not necessarily regarded as profit-oriented entities, pressure does exist to achieve positive results and demonstrate good use of budgetary resources.

### Matters to consider

#### Significant accounting policies

<b>Classification of financial instruments</b>	The policy on determining the classification of financial instruments will often drive their measurement, which will impact balance sheet values and potential revaluations to be recognised in profit or loss.
<b>Provisions</b>	Certain non-IFRS frameworks permit the recognition of provisions for various risks, which can often be a way to build up reserves for potential future losses.
<b>Translation of foreign currency</b>	Similarly, non-IFRS frameworks may permit the recognition of translation differences on the balance sheet, and may have specific policies to reclassify/recognise these in profit or loss.
<b>Accounting for physical gold holdings</b>	In practice, a number of central banks measure physical gold holdings on a fair value basis. Depending on the reasons for holding this gold, and depending on the accounting framework, changes in fair value may be appropriately included in profit or loss, in other comprehensive income or recorded in a liability account.

#### Significant judgements and estimates

<b>Measurement of financial instruments</b>	The fair value of financial instruments may be subject to estimates, especially when they are classified as Level 2 or Level 3 measurements – i.e. when applying IFRS or similar. <sup>2</sup>
<b>Impairment</b>	Estimates and judgements are often required in the impairment assessment of financial assets, which can have a significant effect on profit or loss, given the homogeneity of certain portfolios – i.e. when there is a large exposure to a single counterparty or country.
<b>Employee benefits</b>	Discount rates, mortality rates etc are estimates that can affect the measurement of employee benefits and pension benefits. In certain circumstances (and under certain frameworks), there can be a perceived conflict between: <ul style="list-style-type: none"> <li>• an estimate for accounting purposes (often based on the actual market rates, which are typically higher); and</li> <li>• the central bank's long-term inflation target.</li> </ul>

### In practice

#### Diversity in accounting for gold

We looked at a selection of 18 central banks' accounting policies, reporting under a number of different frameworks, and found that:

- five did not hold any gold reserves;
- the remaining 13 central banks measured gold on a fair value basis; however, there were some variations in the method used and the source of the market price; and
- the methods used for recognising changes in fair value were split into three categories:
  - five recognised changes in fair value through profit or loss;
  - two recognised changes in fair value through other comprehensive income; and
  - six recorded changes in fair value (at least unrealised gains) in liability accounts.

In addition to these 18 central banks, we found that central banks in the Eurosystem, which apply a framework developed by the ECB, transferred unrealised revaluation gains on gold to a revaluation account on the liabilities side of the balance sheet. Any unrealised losses that exceeded any previous revaluation gains were recognised in profit or loss.

2. In IFRS, Level 2 measurements are those whose inputs are observable but are not quoted prices in active markets for identical instruments. Level 3 measurements are those with unobservable inputs.

## UNUSUAL OR COMPLEX TRANSACTIONS

The audit committee should assess the appropriateness of any significant unusual or complex transactions, by considering:

- the parties involved and the business or operational rationale for the transaction;
- the processes and controls implemented to approve and process the transaction; and
- the accounting treatment for the transaction, including any new accounting policies and related note disclosures, and whether it is in accordance with the requirements of the applicable financial reporting framework.

### Matters to consider

#### Unusual or complex transactions

**Withdrawal of a series of bank notes** that may or may not cease to be legal tender in the future and that may or may not have a legal expiry date.

- Disclosure of the event.
- Timing and frequency with which amounts are taken from the balance sheet (liability for bank notes in circulation) to income.
- Methodology for estimating the amount of bank notes that will never return.

**Newly implemented monetary policy measures**, such as term loans, liquidity facilities, reverse repo transactions and other monetary operations that involve asset purchases, collateral posting or receipt etc.

- Disclosure of the event or new instrument.
- Disclosure of the accounting policy.
- Whether internal processes, systems and controls have been adapted and are ready to handle the new instrument.

**Creation of new entities** under the control of the central bank to facilitate local economy bail-outs, or similarly purposed entities.

- Disclosure of the transaction, taking into account confidentiality issues.
- Disclosure of accounting policies, including consolidation in the central bank's financial statements.

## DISCLOSURES

Financial statements are increasingly being used as instruments of communication, not simply as compliance documents. The quality of disclosures in financial statements is integral to their overall completeness, clarity and transparency.

In assessing the quality of disclosures, the audit committee should consider the materiality of the information from the users' perspective and whether the information disclosed:

- is relevant to the circumstances of the central bank;
- has been selected and presented without bias; and
- enhances the intended users' understanding.

### Emerging issues

#### Improving disclosures

There have been calls from users and preparers to de-clutter financial statement disclosures, and to provide more entity-specific information in the statements.

Major standard setters have taken heed of these calls and are responding positively. As a first step in the IASB's 'disclosure initiative' project, it has issued narrow-scope amendments designed to encourage preparers to apply judgement in assessing the quality of disclosures rather than applying a boilerplate or checklist approach.

The IASB's amendments are relevant to financial statement disclosures generally, not just IFRS. They clarify that:

- materiality applies to the financial statements as a whole, including the notes;
- specific disclosures need be presented only if they are material – and disclosure of immaterial information can obscure material information;
- preparers have flexibility in achieving a presentation that is appropriate for their circumstances because:
  - the specific ordering of notes is not mandatory; and
  - accounting policies do not have to be presented in a separate summary section of the notes; and
- disaggregation/aggregation of line items is appropriate if it is relevant to an understanding of the entity's financial position and performance.

## OTHER INFORMATION SUCH AS AN ANNUAL REPORT THAT INCLUDES THE FINANCIAL STATEMENTS

Central banks may be required by law or regulation to publish other information – such as an annual report. Such information may complement a central bank's financial statements by providing more information on its activities and future direction. The information may be financial or non-financial in nature.

The audit committee should obtain an understanding of the process followed to prepare the annual report, and should determine whether the annual report is fair, balanced and understandable, by ensuring that:

- the risks and other matters discussed are those of significance and concern to the central bank;
- the financial information covered in the annual report builds on, and is consistent with, similar information provided in the financial statements;
- important messages are appropriately highlighted – e.g. positive messages are well supported, and less positive ones are appropriately discussed and not obscured by immaterial detail;
- cross-referencing is used effectively and repetition is avoided;
- significant changes from the prior period are properly explained;
- complex issues are clearly explained, avoiding jargon and boilerplate text; and
- it seeks the external auditor's views, including whether they have identified any material inconsistencies or material misstatements of fact in their reading of the whole report.

## TIMELINESS

For the audit committee's oversight role to be effective, it is important that it reviews drafts of the audited annual financial statements and annual report before they are approved by the board.

It is also important that the audit committee has the necessary meetings with management and the internal and external auditors to help support its review.

The audit committee should therefore:

- review any year-end timetables, including the planned publication date; and
- agree an appropriate schedule with management.

## Emerging issues

### Integrated reporting

The International Integrated Reporting Council (IIRC) recently published its Integrated Reporting Framework.

Integrated reporting aims to reshape the direction and focus of corporate reporting to provide investors with a more complete picture of how an organisation creates value over time.

It extends beyond financial reporting to consider how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.

Although this framework is primarily intended for profit-oriented companies, its principles can be adapted and applied by public sector and not-for-profit organisations.

Central banks may therefore wish to consider how the principles of integrated reporting could be applied to their annual report to enhance the quality and usefulness of information provided.

## EVALUATING THE FINANCE FUNCTION AND CFO

The significance and complexity of the finance function – and the need for it to keep pace with changes in the economic environment, and with emerging risks – highlight the importance of periodically:

- questioning whether the status quo is the most effective way to operate; and
- assessing the adequacy, expertise and experience of the available resources, including the CFO.

### Evaluating the finance function

The audit committee's various oversight responsibilities position it well to be involved in evaluating the finance function. It may, for example, evaluate the expertise and adequacy of available resources by:

- inviting key finance personnel other than the CFO to attend audit committee meetings and present or discuss relevant topics;
- requesting an assessment from the CFO – e.g. a report analysing the function's strengths and weaknesses;
- discussing the function's effectiveness with individuals who have regular contact with it, such as other department heads, internal audit and the external auditor; and
- appointing an external party to perform an evaluation that could include benchmarking or progress assessments.

### Evaluating the CFO

The increased focus on governance has put a spotlight on the performance of the CFO and the role that the audit committee can play in assessing it. Some corporate governance regimes have addressed this matter, and now recommend that a formal review takes place periodically.

The approach to evaluating the role may vary by central bank. In some cases, the governor may have primary responsibility for evaluating the CFO's performance. However, given the significance of the role, it is important that the audit committee understands and is satisfied with the process for this evaluation, and that its views are taken into account. For example, its interactions with the CFO enable the audit committee to consider whether the CFO:

- oversees the creation of effective financial reporting and internal control processes;
- speaks up and challenges ideas;
- has integrity;
- has a co-operative attitude towards the audit committee and shows a willingness to help when complex issues arise;
- is committed to transparency in corporate reporting; and
- has the ability to recruit, manage and retain good staff.



## CHAPTER 3: RISK MANAGEMENT AND INTERNAL CONTROL SYSTEMS

The public-interest role of central banks means they need to be more proactive in managing risks.

Most central banks have some policy responsibility for financial stability<sup>3</sup>, as well as for monetary matters. This usually includes being a 'lender of last resort' to commercial banks or other financial institutions that face liquidity problems.

In addition, following the global financial crisis, central banks have grown their balance sheets and sometimes invested in a more diverse range of financial assets than previously, as part of quantitative easing or similar measures that aim to provide liquidity to the financial system. Although central banks might conventionally be thought of as conservative institutions with a low appetite for risk, these measures can pose significant financial risks and require decisions that have to be made swiftly or are the subject of intense political interest.

Effective risk management therefore relies on a regular assessment of the nature and extent of the risks facing a central bank.

Central banks need systems of internal control that can help ensure the orderly and efficient conduct of operations and manage risks – e.g. market, interest rate, liquidity, IT and fraud risks. This includes compliance with laws and regulations, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of accounting records and the timely preparation of internal and external reports.

### What's involved?

- Clarifying the responsibilities and remit of the audit committee, especially when responsibilities are shared with other committees.
- Reviewing and assessing the effectiveness of internal controls within the remit of the audit committee.
- Reviewing fraud-related risks, as well as bribery and corruption risks; and also reviewing the related controls and prevention programmes – e.g. whistle-blowing.

### CLEAR RESPONSIBILITIES FOR AUDIT COMMITTEE OVERSIGHT

The board is responsible for maintaining sound risk management and internal control systems, and ordinarily decides on the level of oversight to be delegated to the audit committee. Legislation may also set out an audit committee's responsibilities.

Often, the audit committee's remit may extend only to internal control over financial reporting. However, in some jurisdictions the oversight exercised by some audit committees, sometimes together with a risk committee, can extend to financial and operational risks that could affect a central bank's financial position. It can also include oversight over strategic, operational and compliance risks, and the internal controls of the entire organisation.



3. See [Central bank governance and financial stability](#) and [Issues in the governance of central banks](#), Bank for International Settlement, May 2011 and May 2009.

## In practice

## How seven central banks assign responsibility for the oversight of risk management and internal controls

The key areas identified include 'traditional' matters such as the oversight of internal audit, the external auditor and internal financial control systems, as well as business and operational risks and even ethical and fraud matters. In some cases, responsibilities may be shared between two committees – e.g. the audit committee and risk committee.

Central bank	Name of committee(s)	Areas of responsibility
<b>De Nederlandsche Bank (the Netherlands)</b>	Audit committee	<ul style="list-style-type: none"> <li>• Supervise external audit.</li> <li>• Supervise compliance with internal procedures.</li> <li>• Oversee operational risks.</li> </ul>
<b>Central Bank of Belize</b>	Audit committee	<ul style="list-style-type: none"> <li>• Help the board to oversee, and to give strategic direction to, the management of the bank's operations.</li> <li>• Provide comfort that risk identification and management are embedded in the bank's culture.</li> <li>• Ensure systematic review of the bank's established risk identification and management arrangements.</li> </ul>
<b>Reserve Bank of Australia</b>	Audit committee	<ul style="list-style-type: none"> <li>• Help the board to fulfil its obligations over: <ul style="list-style-type: none"> <li>– the preparation of the annual report, including a report on operations and the financial statements;</li> <li>– the bank's internal control environment; and</li> <li>– the operational and financial risks inherent in the bank's activities.</li> </ul> </li> </ul>
<b>Central Bank of Kenya</b>	Audit committee	<ul style="list-style-type: none"> <li>• Oversee: <ul style="list-style-type: none"> <li>– internal control;</li> <li>– financial reporting;</li> <li>– risk management;</li> <li>– internal audit; and</li> <li>– external audit.</li> </ul> </li> <li>• Evaluate the control culture and internal control system.</li> <li>• Review compliance of the financial statements with IFRS.</li> <li>• Review the effectiveness of the system for monitoring compliance with laws and regulations.</li> </ul>
<b>Central Bank of Chile</b>	Audit and compliance committee	<ul style="list-style-type: none"> <li>• Report on the effectiveness of internal control systems and procedures.</li> <li>• Assess the reliability, integrity and timeliness of information, including information in the financial statements.</li> <li>• Co-ordinate responsibilities with internal audit.</li> <li>• Propose the hiring of the external auditor.</li> </ul>
<b>Swiss National Bank</b>	Audit committee	<ul style="list-style-type: none"> <li>• Monitor financial reporting, assess the adequacy and effectiveness of the internal control system and monitor the activities of the internal and external auditors.</li> </ul>
	Risk committee	<ul style="list-style-type: none"> <li>• Monitor financial risks and assess the governance of investment processes.</li> </ul>
<b>Banque de France</b>	Audit committee	<ul style="list-style-type: none"> <li>• Oversee financial reporting, internal and external auditing, internal control and risk management.</li> </ul>
	Risk committee	<ul style="list-style-type: none"> <li>• Set out the risk framework under which market operations will be conducted – i.e. review authorised issuers, countries and instruments, set risk limits etc.</li> </ul>

## ASSESSING THE EFFECTIVENESS OF INTERNAL CONTROLS

Overall, it is important to remember that the audit committee's oversight responsibilities are not an executive function. Instead, the audit committee's objective is to determine whether there is a well-established and strong system of internal control in place to identify and manage risks, to assign proper accountability and to monitor and respond to changes in the central bank's risk profile.

The audit committee could use the internationally recognised COSO internal control framework<sup>4</sup> as a model, which comprises the following five elements:

- control environment;
- risk assessment;
- control activities;
- information and communication; and
- monitoring activities.

### Control environment

The control environment provides the discipline and structures that form the basis for internal control. With board oversight, this structure is usually established by management to achieve the organisation's objectives and should enable the central bank to hold individuals accountable for their internal control activities.

In assessing the strength of the control environment, the audit committee should consider:

- the communication and enforcement of integrity and ethical values;
- management's commitment to competence;
- management's philosophy and operating style;
- the assignment of reporting lines, authority and responsibility; and
- the direction provided by the board.

### Identification and assessment of risks

The central bank should have processes to identify and evaluate risks that may threaten the achievement of its strategic objectives and to manage those risks.

The board should have a clear understanding of the strategic objectives that are crucial to the central bank's success. In most cases, a central bank's strategic objectives will be derived from its mandate, which is in turn often determined by its constitution or legislation.

It is worth noting that risks associated with IT systems, viewed as a discrete area in the past, have become increasingly pervasive in the operations of a central bank and need to be considered at the same level as other risks. For example, a successful cyber attack on a central bank could compromise its whole banking system.

## Emerging issues

### Responding to a changing environment

Overall responsibility for holistic risk assessment lies with the board.

The audit committee will probably focus on the risks that fall within its direct remit and expertise – i.e. those risks that have a direct impact on financial reporting. However, it is important that the audit committee understands how potential risks are identified and assessed, and the methods for dealing with risks that may be emerging in view of the environment in which the central bank operates. These could include:

- new types of external cyber threats;
- the effects of new types of instruments; and
- increasing demands for transparency, which have to be balanced against the confidentiality needs of a central bank.

4. [Internal Control – Integrated Framework: Executive Summary](#), May 2013.

The risk identification process should ...	
<b>Have a sufficiently broad perspective</b>	External risks such as macroeconomic factors and systemic risks should be considered, along with internal risks such as weak internal controls and compliance-related matters.
<b>Be dynamic</b>	The 2008 financial crisis showed that risks can materialise quickly – any risk identification process should have the flexibility and capacity to integrate emerging risks into the wider framework.
<b>Extend sufficiently far into the future</b>	Although it may be tempting to focus on the short term for immediate operating and reporting issues, it is important also to consider the central bank's future environment – e.g. a five-year horizon – and the types of emerging risks that it may face.
<b>Be able to identify fast-changing operational risks</b>	For example, an evolving IT environment can give rise to new risks, such as: <ul style="list-style-type: none"> <li>• the risk of unauthorised persons gaining access to confidential information; or</li> <li>• the risk of sabotage or loss of systems that are critical to the wider economy, such as payment systems.</li> </ul>

### In practice

#### Bank of England chief information security officer

In the UK, a new chief information security officer role has been created by the Bank of England to target issues relating to information security, including cyber threats. It reflects the importance that the bank attaches to information security, and builds on its existing work in this area. The CISO reports directly to the bank's chief operating officer.

In assessing whether the process meets these aims, the audit committee should:

- review how risks are identified and ensure that the board is fully informed of the significant risks facing the central bank's operations; and
- judge the impact – both financial and reputational – that each identified risk could have on the central bank and the likelihood of it occurring.

### Identification and implementation of appropriate control activities

'Control activities' are policies and procedures to reduce risks to levels that the board deems acceptable. They are implemented and performed at all levels of an organisation.

The audit committee need not address the fine detail of how every risk is mitigated and controlled, but it should be satisfied that proper control activities have been established and are operating effectively.

### Information and communication

The audit committee should be satisfied that the central bank has information and communication systems that support the functioning of its internal controls – i.e. capture and disseminate information in a timely manner and in a form that enables people to carry out their responsibilities.

## Review and monitoring of controls

The monitoring procedures set up by management make up an important part of the overall internal controls, but they need to be independent of the controls that they are meant to check. Monitoring can be achieved in several ways, including:

- directing internal audit to review and test management's self-assessment;
- directing internal audit to test specific controls; or
- commissioning special reviews by external auditors or specialists.

Although effective monitoring is essential, the board should not rely solely on embedded monitoring processes to discharge its responsibilities. This is where the audit committee comes into play.

The audit committee's process for reviewing and monitoring the controls should factor in the scope and frequency of the reports provided by management and internal audit. These reports should give a balanced assessment of the significant risks and the effectiveness of the system of internal control in the activities that they cover. Any significant control deficiencies should be discussed in the reports – including potential and actual impacts, and the actions being taken to rectify each issue.

When reviewing reports, the audit committee should consider:

- the significant risks, and how they have been identified and evaluated;
- the effectiveness of the related system of internal control in managing the significant risks, in particular considering any significant deficiencies that have been reported;
- how any significant control deficiencies arose, and whether they have resulted in unforeseen outcomes or contingencies, or may do so in the future; and
- whether appropriate action is being taken on a timely basis to remedy any significant deficiencies.

## FRAUD, BRIBERY AND CORRUPTION, AND WHISTLE-BLOWING

Direct responsibility for anti-fraud efforts generally rests with a member of senior management – e.g. the CFO or chief compliance officer. The internal audit function can also play a key role in these activities and can support management in reviewing and assessing anti-fraud controls and performing other fraud risk assessments.

Although the audit committee is not involved in day-to-day management, it can usefully focus attention on the need for proper policies and procedures to help prevent and/or detect fraud.

The audit committee's remit over the system of internal control should also cover the review of fraud-related and bribery/corruption risks, controls and prevention programmes – e.g. whistle-blowing. This review includes:

- determining whether management has considered the risks that are likely to have the greatest financial or reputational impact;
- assessing whether internal controls are able to prevent and/or detect what could go wrong;
- reviewing management's monitoring of those controls;
- ensuring that the board and senior management are providing visible and active commitment to ethical behaviour and anti-fraud/bribery policies; and
- maintaining professional scepticism in its interaction with senior management and being alert to the possibility of senior management override of controls.

### How can a central bank demonstrate commitment to ethical behaviour?

- Assign responsibility for the design, implementation and monitoring of policies and procedures to a member of management with the appropriate authority and competence.
- Establish and communicate a clear anti-fraud/bribery policy – e.g. a zero-tolerance policy – and code of conduct.
- Establish and communicate policies and procedures that respond to the assessed risks, that are, at a minimum, consistent with relevant laws and regulations, and that address key areas such as:
  - gifts, hospitality and facilitation payments;
  - travel expenses;
  - charitable and political contributions;
  - the use of outside advisers or third parties, including vetting, due diligence and appropriate risk assessments;
  - procurement and contract management procedures; and
  - confidential communication channels to provide advice and enable the raising of concerns – e.g. whistle-blowing procedures and a confidential hotline.
- Establish information systems to identify, capture and process relevant information – e.g. all transactions are captured and records are maintained.
- Implement mandatory training on the code of conduct and policies and procedures.
- Enforce policies by applying consistent sanctions if board members, management, employees or business partners fail to comply.
- Establish processes to investigate incidents and report results to an appropriate level of management and, as appropriate, to the board or equivalent body.
- Establish processes to monitor the effectiveness of policies and procedures, and to communicate and follow up on deficiencies on a timely basis.

### Whistle-blowing

Whistle-blowing is critical to any anti-fraud measures, and can act as both a preventative and a detective control. However, in many jurisdictions cultural differences or pressure can play a role in the effectiveness of whistle-blowing procedures or processes.

Having an environment in which management visibly supports confidential whistle-blowing procedures will encourage the use of such procedures, increase their effectiveness and reduce any potential for victimisation of the whistle-blower. Therefore, the audit committee should:

- consider how management can promote whistle-blowing policies and procedures; and
- assess the extent to which established confidential facilities are secure and accessible, and enable employees and others to easily raise concerns and report violations without risk of reprisal.

## CHAPTER 4: INTERNAL AUDIT FUNCTION

Internal audit evaluates management activities and internal controls, giving the audit committee an objective assessment of whether a central bank's processes are operating effectively.

The audit committee's oversight and support is key to an effective internal audit function, which in turn will have a positive impact on the operation of internal controls. The internal audit function can also help the audit committee to achieve its objectives. The importance of internal audit is recognised by the International Monetary Fund because internal audit is one of the five areas that it considers in its 'safeguards assessment' of central banks.<sup>5</sup>

### SUPPORTING INTERNAL AUDIT OBJECTIVITY

A key attribute of an effective internal audit function is its ability to be objective when evaluating and reporting on management activities and internal controls. This can be a significant challenge, given that internal audit is effectively 'employed' by management and often has a dual-reporting role.

The audit committee can play an important role in addressing this inherent conflict by implementing processes that support the objectivity of the internal audit function and help ensure that no constraints or restrictions are placed on its role by management.

#### Establishing clear lines of reporting

Internal audit's organisational structure – including its authority and accountability – support its ability to be objective. It is therefore imperative that clear reporting lines are established to ensure that internal audit is free of conflicting responsibilities or undue influence from those who can override its conclusions.

The following table shows which matters may be best dealt with by which party.

Internal audit reports to ...	
Senior management on ...	Audit committee on ...
<ul style="list-style-type: none"> <li>Budgeting and management accounting matters.</li> <li>Human resources matters.</li> <li>Internal communications.</li> <li>Internal administration, such as expense approvals, logistics etc.</li> </ul>	<ul style="list-style-type: none"> <li>Terms of reference.</li> <li>Risk assessment, audit plan and budget.</li> <li>Results of internal audit activities.</li> <li>Appointment, removal, evaluation and compensation of the head of internal audit.</li> </ul>

#### What's involved?

- Establishing clear lines of reporting and communication protocols that promote objectivity.
- Determining the remit of the internal audit function.
- Assessing internal audit resources.
- Assessing the annual work plan and regularly monitoring progress against it.
- Reviewing significant findings or recommendations, and monitoring management's response and the implementation of agreed recommendations.
- Assessing internal audit's performance and effectiveness.
- Periodically reviewing the structure of the internal audit function to consider the most appropriate sourcing method.

5. For additional information, see the International Monetary Fund's [Factsheet – Protecting IMF Resources: Safeguards Assessments of Central Banks](#), October 2014.



### Maintaining an open relationship with internal audit

Regularly scheduled meetings can play an important role in developing a trusting and respectful relationship between the audit committee and the head of internal audit. Private sessions enable the audit committee to ask questions that might not have been specifically addressed by internal audit's formal work plan, but on which the head of internal audit might have valuable views and opinions. They also enable the head of internal audit to provide candid, and often confidential, comments to the audit committee.

#### Questions that may be asked in a private meeting

- How strong is the relationship between internal audit and management?
- Does internal audit receive appropriate co-operation from function/department heads?
- Have any requests for information been denied or otherwise obstructed?
- Is internal audit subject to undue pressure from any source?
- How constructive is the relationship with external audit?
- What is management's attitude towards risk management and internal controls?
- Are adequate resources devoted to key areas of the business and control functions?

### DETERMINING THE REMIT OF INTERNAL AUDIT

Internal audit's remit will vary based on factors such as the scale, diversity and complexity of the central bank's activities, the size of the internal audit function and cost-benefit considerations.

#### In practice

##### Roles and objectives

The table below provides examples of the roles and objectives of the internal audit function at a few central banks, including their stated reporting lines. There is some commonality among the objectives, with some central banks also explicitly acknowledging that information systems and fraud are areas of importance.

Central bank	Stated purpose of internal audit	Reporting lines
<b>Central Bank of Belize</b>	Provides assurance to management and the audit committee through independent appraisal of the bank's operations and controls, evaluating the adequacy and effectiveness of controls, disciplines, systems and procedures to reduce operational risks in a cost-effective manner.	Reports to the audit committee (sub-committee of the board of directors)
<b>Central Bank of Malta</b>	Provides a systematic and disciplined approach designed to evaluate and improve the effectiveness of the risk management, control and governance processes, including efficient use of the bank's resources. Internal audit provides reasonable assurance on the adequacy and effectiveness of the bank's operational, control and monitoring frameworks.	Under the direct responsibility of the board of directors through the audit committee
<b>Norges Bank (Norway)</b>	Contributes to the attainment of Norges Bank's objectives by ensuring that there is adequate and effective risk management in the bank, and appropriate and satisfactory internal control.	Reports to the audit committee (established by the executive board)
<b>Monetary Authority of Singapore</b>	Conducts financial, operational and information systems audits; performs independent checks for compliance with policies, guidelines, laws and regulations; and evaluates the reliability of financial records and the security and integrity of information systems. Also reviews the controls in new systems and business processes.	Reports to the audit committee (sub-committee of the board of directors)
<b>Central Bank of Nigeria</b>	Examines and evaluates the adequacy and effectiveness of the bank's risk management system; examines, evaluates and reviews all activities, records, processes and operations in the bank's internal controls and governance processes; offers advisory and consulting services to management; carries out investigations when required; ensures compliance with statutes, regulations, directives and policies; and safeguards the bank's assets and liabilities.	Reports to the governor's directorate (representing the governor and the board of directors)

### From preserving value to creating value

Internal audit's focus areas and strategy may need to vary from one financial year to the next, in order to respond appropriately to environmental changes affecting the operations of a central bank (e.g. internal audit's focus would need to change if prudential supervision were taken over by a central bank).

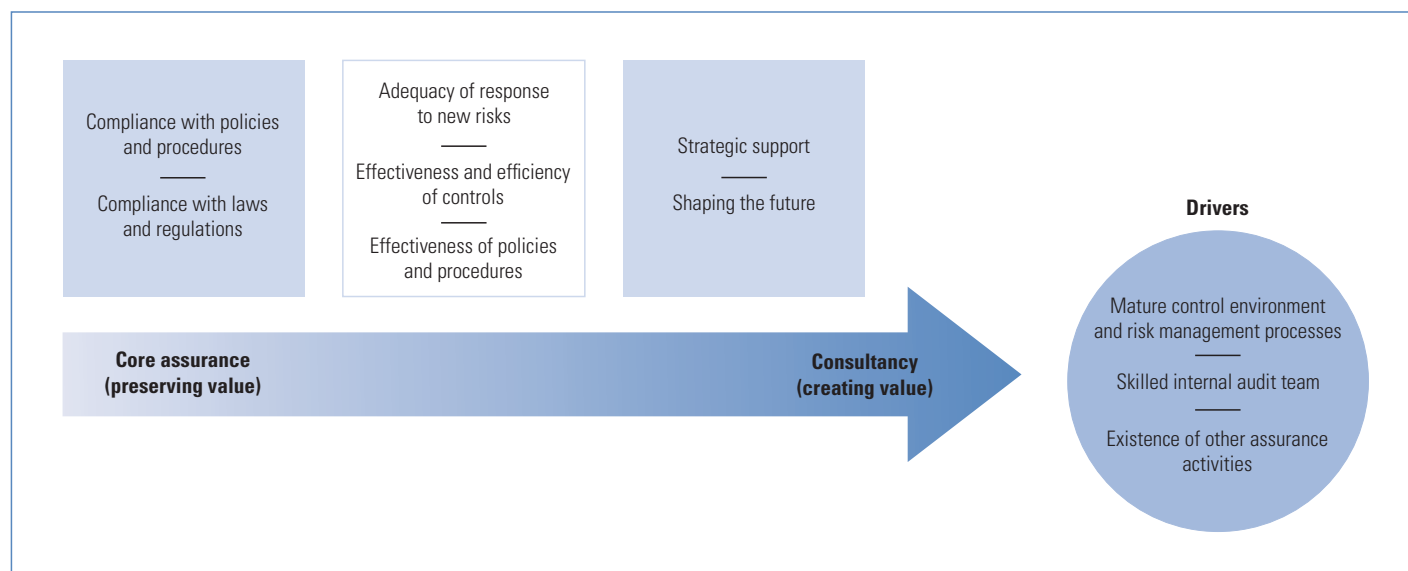
It is important to get the right balance between core compliance activities aimed at preserving value (e.g. testing of controls) and value-adding activities (e.g. activities that support major change programmes). It is also important to have an appropriate level of audit committee oversight to:

- ascertain whether those value-adding activities result in any conflicting responsibilities (e.g. having managerial or operational duties that are subject to internal audit); and
- ensure that safeguards exist to protect internal audit's objectivity if there are any conflicting responsibilities.

Internal audit would not be expected to create value for all aspects of the organisation, but it should be able to add value within the remit of its responsibilities by, for example, providing input that is relevant to real-time decision making.

A newly established internal audit function may be more likely to focus on 'basic' processes and controls. As the internal audit function of a central bank matures, it may progress from preserving value to creating value, by focusing on more strategic and risk-based activities (e.g. being part of a team to implement a new information system). The speed of change will depend on the key drivers permitting this progression, as noted below.

### Shifting focus



## ASSESSING INTERNAL AUDIT RESOURCES

It is important that the internal audit function has adequate resources to fulfil its mandate. It is also important that the internal auditors have the necessary technical competence and skills, and that their work is carried out with due professional care.

In assessing internal audit resources, the audit committee should consider:

- the adequacy of internal audit resources in relation to the size and complexity of the central bank;
- the appropriateness of policies relating to hiring, training and assigning internal auditors to internal audit engagements;
- whether the internal auditors have adequate technical training and proficiency; and
- whether the internal auditors receive appropriate support through review and supervision of their work, and through work programmes.

## ASSESSING THE ANNUAL WORK PLAN

Internal audit will normally prepare an audit work plan, explaining how the central bank's key systems and processes will be audited throughout the audit cycle, together with expected resources. There should be some flexibility in this plan to allow for ad hoc projects or audits – e.g. arising from unforeseen incidents or the implementation of a new monetary policy.

The audit committee's oversight responsibilities include:

- reviewing and recommending the approval of the audit work plan;
- resolving any issues over the timing of audit activities with management; and
- monitoring progress against the plan and in achieving objectives.

### Areas that may be subject to internal audit

- Bank note production and destruction.
- Bank note issuance and inventory of notes on hand.
- Physical inventory stock-taking of gold holdings – or other holdings – held in vaults.
- Controls over the adequacy of collateral held against loans – e.g. when a fair value 'haircut' is required.
- Processes over the valuation of financial instruments – e.g. whether for financial reporting or internal operational models.
- Process and execution of the payment system.
- Physical safeguarding of assets – e.g. access to vaults.
- Issuance of securities – e.g. when the central bank acts as the government's agent.

## REVIEWING FINDINGS AND MONITORING MANAGEMENT'S RESPONSE

There should be processes for communicating information, to help the audit committee carry out its oversight responsibilities. The level of detail can be tailored to each committee's specific needs, and might involve:

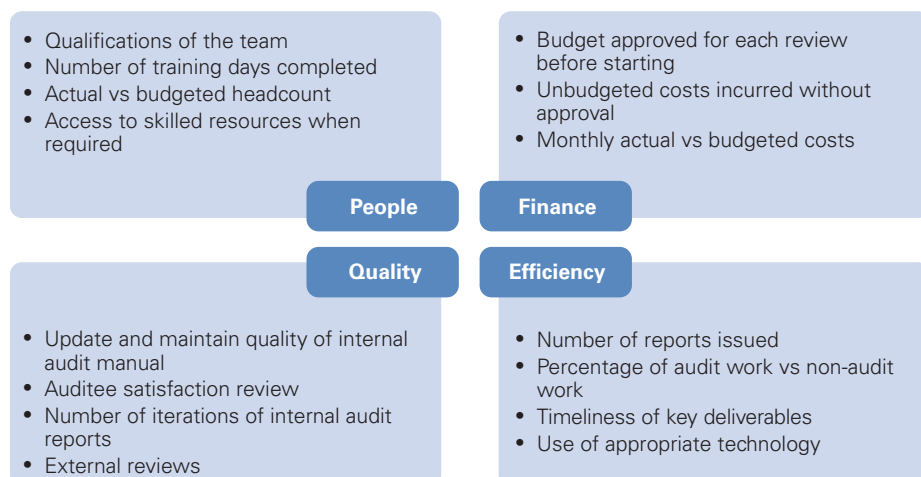
- reading and considering internal audit reports, summaries of reports or exception reports on a periodic basis;
- considering findings or recommendations, with a focus on those that are significant;
- reviewing progress reports that set out findings, analysis of root causes, planned actions and the individuals responsible for implementation; and
- balancing relationships with management with the need to remain objective and impartial, and to maintain professional scepticism.

## ASSESSING INTERNAL AUDIT'S PERFORMANCE

The audit committee can play an important role in monitoring the performance and effectiveness of internal audit, including any matters affecting internal audit's objectivity.

When agreeing appropriate performance measures, the audit committee should recognise that each central bank will be subject to its own specific circumstances. However, the diagram below illustrates some of the more common measures used to monitor internal audit performance. These measures can be monitored by considering:

- a self-assessment carried out by the head of internal audit;
- the audit committee's own conclusions based on its experience and contact with internal audit;
- input from individuals within the organisation, such as the finance director (or equivalent) and function/department heads; and
- input from the external auditor or an independent external evaluation.



## DETERMINING THE STRUCTURE OF INTERNAL AUDIT

In practice, there are many possible approaches to structuring and implementing the internal audit function, and an in-house function may not always be the most appropriate. A decision to outsource would be driven by the availability of appropriate skills and the breadth and depth of experience to cover the central bank's operations. Costs may also vary significantly between the available options.

The table below highlights some of the benefits of each model, as well as challenges that could be faced.

Benefits and challenges of internal audit sourcing models		
Sourcing model	Benefits	Challenges
<b>In-house function</b>	<ul style="list-style-type: none"> <li>• Continuity of staff</li> <li>• Better control of costs</li> <li>• Full control of the function</li> <li>• Training ground for employees</li> <li>• Greater cultural alignment</li> </ul>	<ul style="list-style-type: none"> <li>• May be difficult to simultaneously achieve both effectiveness and efficiency objectives</li> <li>• May be difficult to acquire/retain the diverse skills and experience necessary</li> <li>• Continuous investment in training</li> <li>• Recruitment challenges</li> <li>• Retention and development strategies</li> <li>• Risk of ineffectiveness due to complacency or familiarity over time</li> </ul>
<b>Co-sourced</b>	<ul style="list-style-type: none"> <li>• Long-term presence on site through head of internal audit</li> <li>• Access to specialist skills</li> <li>• Access to experience</li> <li>• Quick implementation</li> <li>• Skills transfer</li> <li>• Reduced training costs</li> </ul>	<ul style="list-style-type: none"> <li>• Possible cost impact</li> <li>• Recruitment and relationship development</li> <li>• Risk of over-dependency on third parties</li> <li>• Possible lack of staff continuity</li> <li>• Confidentiality issues</li> </ul>
<b>Fully outsourced</b>	<ul style="list-style-type: none"> <li>• Established methodologies and benefit of experience across other organisations</li> <li>• Up-to-date, skilled staff</li> <li>• Access to a wide range of skills</li> <li>• No time required to manage resources</li> <li>• Clearly defined service level and performance measures</li> </ul>	<ul style="list-style-type: none"> <li>• Possible cost impact</li> <li>• Possible lack of staff continuity</li> <li>• Remoteness from overall business and culture</li> <li>• Confidentiality issues</li> <li>• May be prohibited by local regulation</li> </ul>

## CHAPTER 5: EXTERNAL AUDIT

Effective two-way communication with the external auditor can provide the audit committee with useful insights that are relevant to its role and help enhance and safeguard the auditor's independence.

Legislation often requires an independent external audit of a central bank's financial statements. Although the responsibility for performing independent audits of financial statements rests with the external auditor, direct responsibility for oversight of external audit is within the audit committee's remit. Formal and informal communications between the audit committee and the external auditor will help the audit committee and external auditor achieve their respective objectives.

### ESTABLISHING EFFECTIVE TWO-WAY COMMUNICATION

The audit committee should be confident that it is being made aware of any matters that are significant and relevant to its responsibility, and that this information is being communicated early enough to enable appropriate action. It is therefore good practice for the audit committee chair and, where relevant, the whole committee to:

- invite the external auditor to attend all relevant audit committee meetings and other meetings as appropriate;
- communicate with the audit partner before an audit committee meeting that the external auditor is attending, to review agenda items and minimise any surprises that may arise at the meeting;
- look to the external auditor for support, using their insights to help the audit committee understand potential issues early, and how they may be mitigated; and
- have private sessions with the audit partner without management, particularly when controversial or difficult items are identified. Examples of such issues include:
  - indications of inappropriate management override of controls, or suspected management fraud, bribery or corruption; and
  - significant difficulties encountered during the audit, such as management's reluctance to provide access to records.

### What's involved?

- Establishing effective two-way communication with the external auditor to share matters relevant to each other's responsibilities on a timely basis.
- Monitoring the audit cycle, including understanding the audit scope and planned approach, and reviewing audit findings.
- Assessing the effectiveness of the external audit process.
- Assessing the external auditor's independence and objectivity.
- When appropriate, making recommendations to the board on the appointment, reappointment and removal of the external auditor, and on approving external auditor's fees and terms of engagement.

### Communications to expect from the external auditors

External auditors are required by professional standards to establish effective two-way communication with audit committees. For example, ISAs impose such an obligation, requiring specific matters to be communicated, such as:

- the external auditor's responsibilities as auditor and an overview of the planned scope and timing of the audit; and
- timely observations arising from the audit that are significant and relevant to the audit committee's responsibility to oversee the financial reporting process.

## MONITORING THE AUDIT CYCLE

Monitoring the audit cycle encompasses all aspects of the audit process, from audit planning to audit findings and the auditor's report.

A proper timetable of activities, communications and key dates should be agreed with the external auditor and the CFO up front.

### The audit plan

The audit committee needs to understand the scope of the audit and how it will be approached, so that it can oversee the audit effectively.

This understanding and agreement can often be achieved by meeting the external auditor before the audit plan is finalised, thereby providing the audit committee with an opportunity to:

- understand the external auditor's planned response to areas that may give rise to significant risks, such as:
  - accounting policies that are not specifically provided for in the financial reporting framework – e.g. provisions and reserves, and accounting for gold holdings;
  - areas that require significant judgements and estimates – e.g. the valuation and impairment of financial instruments;
  - unusual or complex transactions – e.g. newly implemented monetary policy measures and the creation of new entities as a result of some bail-out schemes;
  - transactions with related parties – e.g. government; and
  - transactions or relationships with other agencies – e.g. the International Monetary Fund;
- understand the external auditor's planned approach to internal controls that are relevant to the audit, and to using the work of internal audit; and
- identify areas in which the committee was expecting work to be performed by the external auditor but where no work is planned, and to request additional procedures.

If the external auditor plans to rely on internal audit's work, then the audit committee may help by:

- checking that the external auditor is aware of the work done by internal audit;
- confirming that the external auditor has access to internal audit's reports, working papers and plans; and
- considering how the external auditor has taken account of internal audit's work when planning and performing the external audit.

## Matters to consider

### Materiality

Information is considered material if its omission or misstatement could influence decisions that users make on the basis of the financial report.<sup>6</sup>

In conducting an audit of financial statements, the overall objectives of the external auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements. The concept of materiality is entity-specific and relates to information that is relevant to the decision making of intended users, whether based on the nature or magnitude of the information disclosed in the entity's financial report.

The audit committee should discuss the materiality level applied by the auditor to the financial statements as a whole, and the factors considered in arriving at that level.

6. Paragraph QC11 of the IFRS *Conceptual Framework for Financial Reporting*.



## External audit findings

The matters that external auditors communicate to the audit committee are significant and relevant to the audit committee's responsibility to oversee the financial reporting process. It is therefore important that the audit committee:

- reviews the external auditor's findings, including any changes to the audit approach or any modification to the audit opinion;
- discusses both:
  - major issues that arose during the audit and have been resolved; and
  - unresolved issues, including obtaining explanations about why certain errors might remain uncorrected; and
- discusses any other significant matters – e.g. the appropriateness of accounting estimates and judgements, the appropriateness of accounting policies given the circumstances of the central bank, and the overall balance and clarity of the financial statements.

## Matters to consider

### Key audit matters

The IAASB recently issued new and revised ISAs that will transform the external auditor's report for listed companies. They will expand it to include a description of matters that were of most significance to the audit (key audit matters), and of how these matters were addressed by the external auditor.

This expanded reporting is not required for public-interest entities such as central banks. However, it may be instructive for central bank audit committees to discuss the types of matter that the external auditor would include in an expanded report were it to be applicable to central banks.

## Communicating external audit findings to the audit committee

Findings	External auditor responsibilities	Audit committee responsibilities
<b>Accounting policies</b>  Selection, changes, initial application and appropriateness of accounting policies, and their effect if they are in controversial or emerging areas.	<ul style="list-style-type: none"> <li>• Discuss with management to establish the accounting policies applied, and whether there have been any changes from previous periods.</li> <li>• Consider significant qualitative aspects of accounting policies and their effects, if necessary. Inquire of management about the process for deriving significant accounting estimates, and assess the risk of material misstatement.</li> </ul>	<ul style="list-style-type: none"> <li>• Review and consider the external auditor's views. In so doing, it is important that the audit committee understands the underlying reasons for the relevant accounting policies, estimates or disclosures, and the context in which they were made.</li> </ul>
<b>Accounting estimates</b>  For any significant estimate, management's process for identifying input factors, and its methods of estimation and determining estimation uncertainty; and whether there was a tendency to consistently use a higher or lower value within an acceptable range, which could indicate possible management bias.	<ul style="list-style-type: none"> <li>• Inquire of management about the basis for judgements made in formulating sensitive financial statement disclosures.</li> <li>• Consider the impact on the financial statements as a whole of the choice of accounting policies, the methods for deriving accounting estimates and the basis for judgements made in disclosures. Communicate views to the audit committee.</li> </ul>	<ul style="list-style-type: none"> <li>• Discuss with the CFO the rationale for the selection of policies and estimation methods or changes made.</li> </ul>
<b>Disclosures</b>  Issues involved and related judgements made in formulating particularly sensitive financial statement disclosures.		<ul style="list-style-type: none"> <li>• Talk to the external auditor about their views and concerns – e.g. the selection of assumptions or point estimates within a range that are consistent with a desired outcome.</li> <li>• Consider the overall neutrality, consistency and clarity of disclosures in the financial statements.</li> <li>• Decide on an appropriate course of action.</li> </ul>
<b>Significant difficulties encountered</b>	<ul style="list-style-type: none"> <li>• Discuss significant difficulties with management and, if possible, how they may be resolved.</li> <li>• Inform the audit committee of the nature of any difficulties encountered, management's reaction and their effect, if any, on the audit.</li> </ul>	<ul style="list-style-type: none"> <li>• Review matters communicated by the external auditor.</li> <li>• Ask the external auditor about the underlying reasons for any difficulties encountered.</li> <li>• Decide on an appropriate course of action.</li> </ul>

Communicating external audit findings to the audit committee		
Findings	External auditor responsibilities	Audit committee responsibilities
<b>Significant matters discussed with management</b>	<ul style="list-style-type: none"> <li>Consider whether there are significant matters that are discussed or subject to correspondence with management.</li> <li>Communicate any significant matters discussed with management, including written representations that the external auditor has requested.</li> </ul>	<ul style="list-style-type: none"> <li>Review and evaluate matters communicated by the external auditor.</li> <li>Consider the process followed by management or the board to enable them to make written representations to the auditor.</li> <li>Discuss the matters represented with the external auditor, to determine whether the external auditor is relying solely on written representations for audit evidence.</li> <li>Decide on an appropriate course of action.</li> </ul>
<b>Misstatements identified</b>  Even if they are not material to the financial statements, uncorrected misstatements may indicate a lack of neutrality and possible management bias in preparing financial statements.	<ul style="list-style-type: none"> <li>Consider whether there are any misstatements that have not been corrected by management, and the effect that they may have on the financial statements.</li> <li>Consider the impact of uncorrected misstatements on:               <ul style="list-style-type: none"> <li>the risk of material misstatement in the financial statements;</li> <li>the risk of management fraud; and</li> <li>the audit opinion.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Review uncorrected misstatements. In doing so, it is important that the audit committee understands:               <ul style="list-style-type: none"> <li>the materiality benchmark used by management and the external auditor in concluding that uncorrected misstatements, either individually or in aggregate, are not material; and</li> <li>the underlying reasons for the misstatements, including whether they have arisen as a result of a deficiency in internal control, and why they have not been corrected.</li> </ul> </li> <li>Discuss uncorrected and corrected misstatements with the external auditor. Consider whether the cumulative effect of uncorrected misstatements, when coupled with other matters that the external auditor may have observed, highlight areas of concern – e.g. the selective correction of misstatements brought to management's attention.</li> <li>Decide whether it is appropriate to encourage management to correct all misstatements identified.</li> </ul>
<b>Deficiencies in internal control</b>  Significant deficiencies have to be communicated in writing and on a timely basis.  Management should provide written responses to any recommendations made or issues raised by the external auditor, and the audit committee should review and monitor management's responses as part of its ongoing monitoring process.	<ul style="list-style-type: none"> <li>Consider whether any of the deficiencies in internal control identified during the external audit are of sufficient importance to merit the attention of the audit committee.</li> <li>If necessary, communicate those deficiencies in internal control, together with recommendations for improvements, to the audit committee as and when they arise.</li> </ul>	<ul style="list-style-type: none"> <li>Review the issues identified and the recommendations made by the external auditor, together with management's written responses.</li> <li>Discuss with management the underlying reasons for the deficiencies or issues related to internal control.</li> <li>Agree steps to take and monitor progress in rectification.</li> <li>Consider whether any of the above actions should be delegated to internal audit for follow-up.</li> </ul>

## ASSESSING EXTERNAL AUDIT EFFECTIVENESS

Assessing the effectiveness of the external audit process can help to optimise the external auditor's performance and encourage good communication between the external auditor and the audit committee.

When assessing the effectiveness of the external audit process, the audit committee should consider:

- whether the external auditor has met the agreed audit plan and timeline;
- whether there were changes in perceived risks, and whether/how the external auditor adjusted the audit plan to respond to these risks;
- the external auditor's robustness and perceptiveness in addressing key accounting and audit judgements, responding to questions from the audit committee and commenting where appropriate on the systems of internal control;
- feedback about the external audit from key stakeholders such as the head of finance and head of internal audit;
- the timeliness and quality of communications between the external auditor and the audit committee; and
- the degree to which the external auditor has been able to engage with the audit committee on broader business and strategic issues that may impact the central bank.

## ASSESSING AUDITOR INDEPENDENCE AND OBJECTIVITY

The external auditor is required to remain independent and objective (in fact and in appearance) at all times, to preserve the integrity and credibility of their audit.

The audit committee can help reinforce the auditor's independence and objectivity by:

- agreeing a policy on the provision and pre-approval of any non-audit services;
- agreeing a policy on the employment of former partners and employees of the external auditor's firm, considering relevant ethical requirements governing the accounting profession – including any local regulations – and, in particular, incorporating appropriate cooling-off periods;
- asking the external auditor to confirm, at least annually, the engagement team's and the firm's compliance with relevant ethical requirements regarding independence;
- evaluating the nature and extent of services provided by the external auditor in addition to the audit engagement and, when applicable, the effectiveness of any safeguards that may have been applied to eliminate identified threats to independence;
- evaluating the relationship between the audit partner, the governor and the head of finance, to help ensure that it involves appropriate constructive challenge and is not so close as to threaten the auditor's objectivity;
- inquiring about other matters that can have a bearing on the auditor's relationship with the central bank and senior management, such as:
  - the external auditor's economic dependence, if any, through its relationship with the central bank; and
  - any personal and business relationships of the external auditor's partners and immediate family with the central bank; and
- following up on any matters that may arise, and addressing potential issues.

### In practice

#### Bank of England

The Bank of England specifies that its audit and risk committee should:

- assess the extent to which non-audit services are provided by the external auditor to the central bank;
- assess the associated fees and judge whether there is an appropriate balance; and
- pre-approve any non-audit services to be delivered by the external auditor (subject to any delegation to the finance director) and the related fees.<sup>7</sup>

### Emerging issues

#### Audit quality framework

The IAASB's framework for audit quality describes the input, process and output factors that contribute to audit quality for financial statement audits at the engagement, audit firm and national levels. Under this framework, a quality audit is likely to be achieved by an engagement team that:

- exhibits appropriate values, ethics and attitudes;
- has the requisite knowledge, skills and experience and sufficient time allocated to perform the audit work;
- applies a rigorous audit process and quality control procedures that comply with law, regulation and applicable standards;
- provides useful and timely reports; and
- interacts appropriately with relevant stakeholders.

### More guidance

#### Communication on external auditor independence

ISAs require a listed entity's external auditor to provide a statement to the audit committee, confirming that they have complied with independence requirements and, if threats were identified, that the related safeguards have been applied.

7. Bank of England, [Governance of the Bank including matters reserved to Court](#), November 2013.

## APPOINTING THE EXTERNAL AUDITOR

Making recommendations to the board on the appointment, reappointment and, when necessary, removal of the external auditor is a key role of the audit committee.

With respect to the appointment of the external auditor, the audit committee should:

- oversee the external auditor selection process and ensure it is conducted in a fair and unbiased manner;
- consider a range of factors relating to the proposed external auditor's competence and capabilities, including:
  - their experience in central bank audits and credentials in providing services to central banks;
  - their understanding of the environment in which the central bank operates and the risks that it faces;
  - the results of inspections conducted by audit oversight regulators, by reviewing publicly available reports or making enquiries of the proposed auditor; and
  - the number of planned partner/senior staff hours, including specialists, and the extent of their collective experience;
- present its recommendation regarding appointment to the board;
- satisfy itself that the level of fees is appropriate and that an effective audit can be conducted for such fees; and
- approve the terms of the engagement.

Additional parameters or requirements may be imposed by local laws and regulations, and could impact the selection process or even restrict the appointment. This is especially true for central banks, given that they are often legislated through acts of parliament (or equivalent). Even if this leads to the appointment of a government auditor, this does not relieve the audit committee of its responsibilities – the audit committee should interact with a government auditor in the same way that it would interact with an external auditor from an audit firm.

### Emerging issues

#### IESBA Code of Ethics

The IESBA recently approved changes to its *Code of Ethics for Professional Accountants*, which is typically followed (at a minimum) in setting internal ethical standards by audit firms that are part of global networks.

The new provisions address breaches of independence and require the external auditor to report to the audit committee any breach 'as soon as possible', unless alternative timing for reporting less significant breaches has been agreed. If the auditor determines that actions can be or have been taken to satisfactorily address the consequences of a breach, the auditor is required to obtain agreement with that conclusion from the audit committee.

Audit committee members should discuss this issue with the external auditor and agree the appropriate level of reporting.

### Emerging issues

#### Auditor rotation

An increasing number of jurisdictions are considering introducing mandatory auditor rotation or mandatory audit tendering for public companies as well as other public-interest entities, which may include central banks. The audit committee should monitor these developments to assess any potential impact.

### In practice

#### Restrictions imposed by local laws or regulations

Our review of the situation in five jurisdictions illustrates the diversity in regulations on auditor appointments.

Central bank	Type of audit	Rotation requirements	Government auditor?
<b>Bank of Canada</b>	Joint auditors	Five years for each auditor; staggered rotation period	No
<b>Reserve Bank of New Zealand</b>	Single auditor	None	Yes, under the Reserve Bank of New Zealand Act 1989
<b>Reserve Bank of South Africa</b>	Joint auditors	Yearly reconfirmation	No
<b>Central Bank of Luxembourg</b>	Single auditor	Five years	No
<b>Oesterreichische Nationalbank (Austria)</b>	Single auditor, but an alternate auditor is also appointed	Yearly reconfirmation to a maximum of five years	No

## APPENDIX: CREATING AND SUSTAINING AN EFFECTIVE AUDIT COMMITTEE

The characteristics and practices described here can help to create and sustain a strong and effective audit committee.

This is not a checklist, but rather a description of components in a process that can be continually improved to enhance the committee's effectiveness.

### MEMBERSHIP

#### Terms of appointment

The terms of appointment of an audit committee member should be clearly set out at the time of appointment. All members of the audit committee should have a clear understanding of:

- what will be expected of them in the role, including the time commitment;
- how their individual performance will be appraised; and
- the duration of their appointment and how often it can be renewed.

#### Size of committee

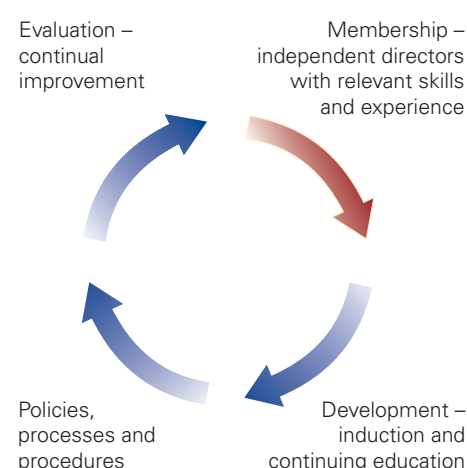
The size of the audit committee will vary depending on the needs and culture of the central bank and the extent of the responsibilities delegated to the committee by the board. Too many members may stifle discussion and debate. Too few may mean that the committee has insufficient expertise and perspectives to help the chair make informed decisions.

The objectives are to allow the committee to function efficiently, encourage all members to participate and ensure appropriate diversity of skills, knowledge and experience.

#### Rotation policy

Rotation can provide a practical way to refresh and introduce a new perspective. It also creates the opportunity for more members of the board to gain a greater first-hand understanding of the important issues dealt with by the audit committee, thereby contributing to greater understanding on the board.

However, given the complex nature of the committee's role, rotation needs to be balanced with the objective of having members who possess the necessary skills and experience to discharge their responsibilities effectively.



## Independence

Independence is one of the cornerstones of an effective audit committee, particularly when overseeing areas in which judgements and estimates are significant. Audit committee members should be adept at communicating with management and internal and external auditors, and should be ready to challenge and ask probing questions.

It is the board's responsibility to assess the integrity and independence of an audit committee candidate, so every appointment is an occasion for careful deliberation. Although business relationships can often pose a threat to independence, some people may consider this to be less of a risk at a central bank. However, independence should always be considered both in fact and in appearance; as such, the task of ensuring that any candidate is independent should be taken seriously. For example, independence may be compromised when the candidate:

- has recently been an employee of the central bank – e.g. in the past five years;
- has held a business relationship with the central bank in the past three years – e.g. as the external audit partner;
- receives remuneration or other fees from the central bank for other work not related to the board;
- has close family ties with the central bank's senior management or other directors; or
- has served on the board for an extended period of time.

In addition to independence, audit committee members should always declare any matter in which they have a conflict of interest. Audit committee policies on conflicts of interest generally follow those of the board, and it is up to the chair to determine the appropriate course of action in the circumstances. For example, the member with the conflict of interest might simply be asked to leave a meeting while a particular item of business is discussed or, in more extreme cases, the member could be asked to resign from the committee.

## Background and experience in financial matters

As discussed in [chapter 1](#), if the audit committee is to provide meaningful oversight, then its members need to collectively possess sufficient financial acumen to discharge their responsibilities. At least one member of the audit committee should have recent and relevant experience in finance, accounting or auditing. In many cases, 'recent and relevant' will go beyond familiarity with financial statements. Members should be able to understand the rules and principles underpinning their duties, including understanding the external auditor's judgements. Each board should determine its own criteria, considering the circumstances of its central bank and any local regulations.

## Audit committee chair

The entire committee's effectiveness often relies on the chair's effectiveness. The essential characteristics of a strong chair are often personal attributes. The chair should be recognised for both leadership skills and vision, and be perceived by other committee members and management as being able to set and manage the committee's agenda.

Formal meetings are at the heart of the audit committee's work. They should not, however, be its only point of contact with the central bank. The audit committee chair should keep in touch with other key stakeholders, such as the governor, CFO, head of internal audit and lead external audit partner. Regular meetings may be set up with the various stakeholders to help the chair set the committee's agenda and ensure that the appropriate issues are tackled.

In the end, it is not the chair's responsibility to do all of the committee's work. Instead, the chair should engage other members in the committee's work. One possible approach is to delegate specific responsibilities or areas and have a standing agenda item – not necessarily at every meeting – to discuss those matters, therefore ensuring participation by all members.

## DEVELOPMENT: INDUCTION AND CONTINUING EDUCATION

### Induction

As discussed in [chapter 1](#), it is good practice to establish a formal induction programme for new members, and to tailor it for individual needs.

Induction programmes help to ensure that audit committee members understand their responsibilities, current issues and the particular circumstances of the central bank. This programme may include meetings with senior management and site visits to give the new committee member direct access to the central bank's operations.

In some cases, it might also be appropriate to set up meetings with the head of internal audit, the external auditor and senior management, to allow the new member to discuss current financial reporting issues and the status of any areas of focus.

### Ongoing professional development

Even in times of stability, change is constant – not only in financial reporting, but also in regulatory compliance, and technological and business risks. The audit committee chair is responsible for monitoring professional development requirements and continually evaluating the effectiveness of the audit committee itself to highlight any development needs.

Audit committee members usually pursue continuing professional education, both through participation on the committee and from external sources. Development opportunities should be identified and made available to them; these might include anything from in-house briefings or externally organised seminars to conversations with the CFO, the head of internal audit or the external auditor.

## POLICIES, PROCESSES AND PROCEDURES

### Terms of reference

The audit committee's terms of reference should set out its main roles and responsibilities. These are likely to include:

- monitoring the completeness, clarity and transparency of the financial statements (see [chapter 2](#));
- reviewing risk management and internal control systems (see [chapter 3](#));
- monitoring and reviewing the effectiveness of the internal audit function (see [chapter 4](#));



- making recommendations to the board on the appointment, reappointment and removal of the external auditor, and approving the fees and terms of engagement (see [chapter 5](#));
- reviewing and monitoring the external auditor's independence and objectivity, and the effectiveness of the audit process, taking into consideration any relevant regulatory requirements (see [chapter 5](#)); and
- developing and implementing a policy on the engagement of the external auditor to supply non-audit services (see [chapter 5](#)).

The audit committee's terms of reference should be clear on the scope of its responsibilities and how they should be discharged. The role of the committee is ultimately for the board to decide, subject to any regulatory requirements. However, it is essential for the committee to be independent and to have sufficient authority and resources to form its own opinion and to report according to its mandate. It is important to remember that the audit committee is not a body that makes binding decisions in its own right; rather, it exists exclusively to help the board discharge its responsibilities.

### Setting meeting agendas

A detailed agenda is vital for keeping the committee focused. Effective agendas are set with input from key stakeholders, including the CFO, head of internal audit and external auditor. The audit committee chair, however, should retain accountability for the agenda and should not allow management to dictate the content.

The agenda helps to drive the committee's work. For this reason, the agenda should be closely linked to the committee's terms of reference – and the overall yearly agenda should be derived from a detailed work plan. However, this does not imply that a fixed agenda for each meeting need be determined from the outset; indeed, the committee should be able to react and develop the details of its agenda based on evolving requirements as the year progresses.

In any event, distribution of the agenda and materials in a timely fashion is key to having an effective meeting – members need to be able to read and consider the materials before the meeting to provide a meaningful contribution.

### Frequency and timing of meetings

Scheduling meetings to coincide with key dates within the financial reporting and audit cycle enables the audit committee to make timely and influential decisions. Equally, it is critical to have enough time available at each meeting to cover all agenda items, hold a full and meaningful discussion, and enable all parties to provide input.

Sufficient time should be allowed after audit committee meetings for any work arising from them to be carried out and reported on as appropriate, before other related meetings.

### Meeting attendees

Only the audit committee members should be *entitled* to attend any meeting of the audit committee.

However, audit committees may regularly invite the CFO, head of internal audit or external auditor to attend. These individuals are generally invited to report or brief the committee on specific issues that are relevant to the committee's agenda.

### Private meetings

A number of audit committees hold meetings with only the formal committee members present (sometimes referred to as '*in camera* sessions'). This gives the members a good opportunity to discuss any issues or concerns among themselves, and positions them to better understand and challenge management and internal audit. It is also good practice to hold separate private meetings – i.e. without management – with the internal and external auditors. These sessions are frequently held at the end of the meeting, once management has been excused.

### Communications

The audit committee chair should report to the board after every meeting, and in sufficient depth to enable the board to fulfil its oversight responsibilities. Minutes should be prepared promptly after every meeting, capturing the key points of discussion, conclusions reached and any action points to take forward. These minutes can often be used as a starting point to brief the board at its next meeting. If timing does not permit this, then the audit committee chair would be expected to provide an oral update and then circulate the minutes when they are complete. In any event, it is good practice also to provide the minutes to the head of internal audit and the external auditor.

### Relationships

Audit committees need to determine the best way to work together. Having strong relationships is paramount to that success.

However, striking the right balance between strong relationships and robust oversight is at the heart of the committee's role. A committee that fails to understand the line between oversight and management can easily find itself in a poor relationship with management. Effective oversight is difficult to achieve if management sees the audit committee as nothing more than a corporate governance burden. Equally, an overly cosy relationship avoids the challenging questions that bring robustness to the process. The ideal is for those working with the committee to see it as a useful partner or sounding board – the exchange of information increases in such circumstances, leading to better oversight.

### Responding to unusual events

A central bank, like any other private sector organisation, may from time to time encounter difficulty due to fraud or other illegal acts. On such occasions, the board is responsible for crisis management and remedial action. The audit committee is often ideally placed to advise the board and provide oversight in dealing with these matters, because they often relate to the circumvention of internal controls and have the potential to be material to the central bank and its financial position. Furthermore, because the central bank frequently represents the highest authority for the banking sector within its jurisdiction, and may also be the regulator in the local market, these perceptions can have severely damaging effects on public trust and the central bank's authority and credibility.

The central bank also needs to avoid being perceived as passive – it could be seen as trying to avoid the issue or not taking it seriously. Approaching any investigation in a proactive manner can therefore offer important advantages and allow the central bank to take control of the situation and mitigate the potential negative effects. The committee needs to be able to respond promptly, and should consider whether outside experts – such as legal advisers or forensic accountants – are required, and whether their independent advice could help to scope the investigation.

## Evaluating audit committee effectiveness

The audit committee should regularly review its own effectiveness and the adequacy of its terms of reference and work plans. This will help to identify any processes that could be improved, or any knowledge gaps.

As part of this process, the chair should review the membership annually and consider succession planning – with the aim of ensuring that there is continuous access to suitable candidates when the current members' terms expire.

In carrying out its self-evaluation, the committee should:

- consider whether the board is satisfied with its performance;
- compare its activities with any relevant guidelines – e.g. local requirements;
- compare its activities with leading practices – e.g. in the wider banking sector;
- compare its activities with previously identified improvement points; and
- assess its activities against its terms of reference, any aspirations and any objectives set by the board.

In some instances, it may also be appropriate to request feedback from other stakeholders, such as management, the head of internal audit or the external auditor. Questionnaires are one mechanism that committees can use to do this, but consultation and face-to-face meetings may improve the feedback received – through informal meetings with the various stakeholders or through private sessions.

In the end, the committee's evaluation serves as a key feedback measure to ensure that it is doing things in the right way – achieving outcomes, not simply performing the activity. The evaluation can also confirm that the committee is spending time on the areas where time should be spent, and therefore allow it to assess the value that it adds to the overall governance of the central bank.

## SOURCES AND CONTACTS

Central bank	Source(s)
Bank Negara Malaysia	<a href="#">Annual Report 2013</a>
Bank of Canada	<a href="#">Bank of Canada Act</a>
Bank of England	<a href="#">Annual Report 2014</a> , <a href="#">Governance webpage</a>
Bank of Jamaica	<a href="#">Annual Report 2013</a>
Banque de France	<a href="#">Annual Report 2013</a>
Central Bank of Belize	<a href="#">Annual Report 2013</a> , <a href="#">Internal Audit webpage</a>
Central Bank of Chile	<a href="#">Annual Report 2013</a>
Central Bank of Ireland	<a href="#">Annual Report 2013</a>
Central Bank of Kenya	<a href="#">Annual Report 2013</a>
Central Bank of Luxembourg	<a href="#">Organic Law of the Central Bank of Luxembourg</a>
Central Bank of Malta	<a href="#">Internal control and management of risk webpage</a>
Central Bank of Nigeria	<a href="#">Frequently Asked Questions – Internal Audit</a>
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Oesterreichische Nationalbank	<a href="#">Federal Act on the Oesterreichische Nationalbank</a>
Reserve Bank of Australia	<a href="#">Annual Report 2014</a>
Reserve Bank of New Zealand	<a href="#">Reserve Bank of New Zealand Act 1989</a>
Reserve Bank of South Africa	<a href="#">South African Reserve Bank Act 90 of 1989</a>
Swiss National Bank	<a href="#">Annual Report 2013</a>

## KPMG'S CENTRAL BANKING PRACTICE

KPMG's Global Central Banking practice has a wealth of industry experience and specialist knowledge, tapping into a global network of over 34,000 financial services professionals. Member firms have worked with central banks in mature and emerging economies, and have close relationships with many of the major market players, regulators and leading industry bodies. Our Regulatory Centres of Excellence help shape the latest regulatory developments while our Financial Services High Growth Markets network champions new innovations, as well as advising and challenging financial institutions and their boards on appropriate strategies and operations.

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## KEEPING YOU INFORMED

In addition to this publication, more in-depth discussions are included in the following publications, which are available at [kpmg.com](http://kpmg.com).

### CENTRAL BANKING

- [Creating a world class central bank](#), May 2014.
- [Evolving Banking Regulation](#), January 2014.
- [Frontiers in Finance](#) magazine.
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- [Current trends in central bank financial reporting practices](#), October 2012.
- [Central bank accountability and transparency](#), October 2009.

### AUDIT COMMITTEES

- [Audit Trends](#), January 2015.
- [Audit Committee Handbook](#), May 2013.

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User need	Publication series	Purpose
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	<a href="#">IFRS Newsletters</a>	Highlights recent IASB and FASB discussions on the financial instruments, insurance and leases projects. Includes an overview, analysis of the potential impact of decisions, current status and anticipated timeline for completion.
	<a href="#">The Balancing Items</a>	Focuses on narrow-scope amendments to IFRS.
	<a href="#">New on the Horizon</a>	Considers the requirements of consultation documents such as exposure drafts and provides KPMG's insight. Also available for specific sectors.
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<b>Application issues</b>	<a href="#">Insights into IFRS</a>	Emphasises the application of IFRS in practice and explains the conclusions that we have reached on many interpretative issues. The overview version provides a high-level briefing for audit committees and boards.
	<a href="#">IFRS Practice Issues</a>	Addresses practical application issues that an entity may encounter when applying IFRS. Also available for specific sectors.
	<a href="#">IFRS Handbooks</a>	Includes extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard.
<b>Interim and annual reporting</b>	<a href="#">Guide to financial statements – Illustrative disclosures</a>	Illustrates one possible format for financial statements prepared under IFRS, based on a fictitious multinational corporation. Available for annual and interim periods, and for specific sectors.  To start answering the question 'How can I improve my business reporting?', visit <a href="https://kpmg.com/betterbusinessreporting">kpmg.com/betterbusinessreporting</a>
	<a href="#">Guide to financial statements – Disclosure checklist</a>	Identifies the disclosures required for currently effective requirements for both annual and interim periods.
<b>GAAP comparison</b>	<a href="#">IFRS compared to US GAAP</a>	Highlights significant differences between IFRS and US GAAP. The overview version provides a high-level briefing for audit committees and boards.
<b>Sector-specific issues</b>	<a href="#">IFRS Sector Newsletter</a>	Provides a regular update on accounting and regulatory developments that directly impact specific sectors.
	<a href="#">Application of IFRS</a>	Illustrates how entities account for and disclose sector-specific issues in their financial statements.
	<a href="#">Impact of IFRS</a>	Provides a high-level introduction to the key IFRS accounting issues for specific sectors and discusses how the transition to IFRS will affect an entity operating in that sector.



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