



# **AUDITORS AND ACCOUNTING STANDARDS MODULE**



**MODULE:**

**AA (Auditors and Accounting Standards)**

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MODULE	AA:	Auditors and Accounting Standards
CHAPTER	AA-A:	Introduction

## AA-A.1 Purpose

### *Executive Summary*

AA-A.1.1 This Module presents requirements that have to be met by investment firm licensees with respect to the appointment of external auditors. This Module also sets out certain obligations that external auditors have to comply with, as a condition of their appointment by investment firm licensees.

AA-A.1.2 This Module is issued under the powers given to the Central Bank of Bahrain ('CBB') under Decree No. (64) of 2006 with respect to promulgating the Central Bank of Bahrain and Financial Institutions Law 2006 ('CBB Law'). It supplements Article 61 of the CBB Law, which requires licensees to appoint an external auditor acceptable to the CBB.

### *Legal Basis*

AA-A.1.3 This Module contains the CBB's Directive **(as amended from time to time)** relating to auditors and accounting standards used by investment firm licensees, and is issued under the powers available to the CBB under Article 38 of the CBB Law. The Directive in this Module is applicable to all investment firm licensees.

AA-A.1.4 For an explanation of the CBB's rule-making powers and different regulatory instruments, see Section UG-1.1.



<b>MODULE</b>	<b>AA: Auditors and Accounting Standards</b>
<b>CHAPTER</b>	<b>AA-A: Introduction</b>

## **AA-A.2 Module History**

### *Evolution of Module*

AA-A.2.1 This Module was first issued in April 2006 by the BMA, as part of the first phase of Volume 4 (Investment Business) to be released. Any material changes that have subsequently been made to this Module are annotated with the calendar quarter date in which the change was made: Chapter UG-3 provides further details on Rulebook maintenance and version control.

AA-A.2.2 When the CBB replaced the BMA in September 2006, the provisions of this Module remained in force. Volume 4 was updated in July 2007 to reflect the switch to the CBB; however, new calendar quarter dates were only issued where the update necessitated changes to actual requirements.

AA-A.2.3 A list of recent changes made to this Module is provided below:

Module Ref.	Change Date	Description of Changes
AA-A.1	07/2007	New Rule AA-A.1.3 introduced, categorising this Module as a Directive.
AA-1.2	07/2007	Rule AA-1.2.3 redrafted to clarify reporting obligation.
AA-1.5	07/2007	Paragraphs AA-1.5.4 and AA-1.5.6 updated to reflect CBB Law requirements on auditor independence.
AA-3.1.1	04/2008	Clarified that auditor's review is to be attached to the QPR.
AA-1.5	10/2009	Paragraphs AA-1.5.2 and AA-1.5.3 updated to clarify outsourcing of internal audit function.
AA-3.1.1	10/2009	Updated to reflect requirement in Module BR.
AA-5	07/2010	New Chapter added regarding Reporting Accountants.
AA-A.1.3	01/2011	Clarified legal basis.
AA-1.1.1A	01/2011	Added Guidance referring to the CBB's power to appoint an external auditor should the investment firm licensee fail to do so.

### *Superseded Requirements*

AA-A.2.4 This Module supersedes the following provisions contained in circulars or other regulatory instruments:

Circular / other reference	Provision	Subject
Standard Conditions and Licensing Criteria: investment advisers/brokers.	Article 7	Auditors
Standard Conditions and Licensing Criteria: broking company	Article 6	Auditors
Standard Conditions and Licensing Criteria: stockbrokerage	Article 6	Auditors

AA-A.2.5 Guidance on the implementation and transition to Volume 4 (Investment Business) is given in Module ES (Executive Summary).



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-B: Scope of Application

## AA-B.1 Investment Firm Licensees

AA-B.1.1 The contents of this Module – unless otherwise stated – apply to all investment firm licensees.

AA-B.1.2 The contents of Chapters AA-1 to AA-4 apply to both Bahraini investment firm licensees and overseas investment firm licensees.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-B: Scope of Application

## AA-B.2 Auditors

AA-B.2.1 Certain requirements in this Module indirectly extend to auditors, by virtue of their appointment by investment firm licensees. Auditors appointed by investment firm licensees must be independent (cf. Sections AA-1.4 and AA-1.5). Auditors who resign or are otherwise removed from office are required to inform the CBB in writing of the reasons for the termination of their appointment (cf. Sections AA-1.2). Other requirements are contained in Sections AA-1.3 (Audit partner rotation) and AA-3.1 (Auditor reports).



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-1: Auditor Requirements

## AA-1.1 Appointment of Auditors

**AA-1.1.1** Investment firm licensees must obtain prior written approval from the CBB before appointing or re-appointing their auditors.

**AA-1.1.1A** Where an investment firm licensee fails to appoint an external auditor within four months from the beginning of the financial year, Article 61 (b) of the CBB Law provides the CBB with the power to appoint the external auditor.

**AA-1.1.2** As the appointment of auditors normally takes place during the course of the firm's annual general meeting, investment firm licensees should notify the CBB of the proposed agenda for the annual general meeting in advance of it being circulated to shareholders. The CBB's approval of the proposed auditors does not limit in any way shareholders' rights to subsequently reject the Board's choice.

**AA-1.1.3** The CBB, in considering the proposed (re-) appointment of an auditor, takes into account the expertise, resources and reputation of the audit firm, relative to the size and complexity of the licensee. The CBB will also take into account the track record of the audit firm in auditing investment firm licensees within Bahrain; the degree to which it has generally demonstrated independence from management in its audits; and the extent to which it has identified and alerted relevant persons of significant matters.

**AA-1.1.4** In the case of overseas investment firm licensees, the CBB will also take into account who act as the auditors of the parent firm. As a general rule, the CBB does not favour different parts of an investment group having different auditors.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-1: Auditor Requirements

## AA-1.2 Removal or Resignation of Auditors

### AA-1.2.1

Investment firm licensees must notify the CBB as soon as they intend to remove their auditors, with an explanation of their decision, or as soon as their auditors resign.

### AA-1.2.2

Investment firm licensees must ensure that a replacement auditor is appointed (subject to CBB approval as per Section AA-1.1), as soon as reasonably practicable after a vacancy occurs, but no later than three months.

### AA-1.2.3

In accordance with the powers granted to CBB under Article 63 of the CBB Law, auditors of investment firm licensees must inform the CBB in writing, should they resign or their appointment as auditor be terminated, within 30 calendar days, of the event occurring, setting out the reasons for the resignation or termination.





MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-1: Auditor Requirements

### AA-1.3 Audit Partner Rotation

#### AA-1.3.1

Unless otherwise exempted by the CBB, investment firm licensees must ensure that the audit partner responsible for their audit does not undertake that function more than five years in succession.

#### AA-1.3.2

Investment firm licensees must notify the CBB of any change in audit partner.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-1: Auditor Requirements

## AA-1.4 Auditor Independence

### AA-1.4.1

Before an investment firm licensee appoints an auditor, it must take reasonable steps to ensure that the auditor has the required skill, resources and experience to carry out the audit properly, and is independent of the licensee.

### AA-1.4.2

For an auditor to be considered independent, it must, among things, comply with the restrictions in Section AA-1.5.

### AA-1.4.3

If an investment firm licensee becomes aware at any time that its auditor is not independent, it must take reasonable steps to remedy the matter and notify the CBB of the fact.

### AA-1.4.4

If in the opinion of the CBB, independence has not been achieved within a reasonable timeframe, then the CBB may require the appointment of a new auditor.



<b>MODULE</b>	<b>AA: Auditors and Accounting Standards</b>
<b>CHAPTER</b>	<b>AA-1: Auditor Requirements</b>

## **AA-1.5 Licensee/Auditor Restrictions**

### *Financial Transactions with Auditors*

#### **AA-1.5.1**

Investment firm licensees must not provide regulated investment services to their auditors.

### *Outsourcing to Auditors*

#### **AA-1.5.2**

Investment firm licensees may not outsource their internal audit function to the same firm that acts as their external auditors.

AA-1.5.3 Further Guidance on this issue is provided in the Risk Management Module.

### *Other Relationships*

#### **AA-1.5.4**

Investment firm licensees and their auditors must comply with the restrictions contained in Article 217 (c) of the Commercial Companies Law (Legislative Decree No. (21) of 2001), as well as in Article 61(d) of the CBB Law.

AA-1.5.5 Article 217(c) prohibits an auditor from (i) being the chairman or a member of the Board of Directors of the company he/she audits; (ii) holding any managerial position in the company he/she audits; and (iii) acquiring any shares in the company he/she audits, or selling any such shares he/she may already own, during the period of his audit. Furthermore, the auditor must not be a relative (up to the second degree) of a person assuming management or accounting duties in the company.

AA-1.5.6 Article 61(d) prohibits an auditor from (i) being the chairman or a member of the Board of Directors of the company he/she audits; (ii) acting as a managing director, agent or representative of the company concerned; and (iii) taking up any administrative work in the company, or supervising its accounts, or having a next of kin in such a position.

AA-1.5.7 The restriction in Paragraph AA-1.5.4 applies to overseas investment firm licensees as well as Bahraini investment firm licensees.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-1: Auditor Requirements

## AA-1.5 Licensee/Auditor Restrictions (continued)

### *Other Relationships (continued)*

#### AA-1.5.8

A partner, Director or manager on the engagement team of auditing an investment firm licensee may not serve on the Board or in a controlled function of the licensee, for two years following the end of their involvement in the audit, without prior authorisation of the CBB.

AA-1.5.9 Chapter AU-1.2 sets out the CBB's "controlled functions" requirements.

### *Definition of 'Auditor'*

#### AA-1.5.10

For the purposes of Section AA-1.5, 'auditor' means the partners, Directors and managers on the engagement team responsible for the audit of the investment firm licensee.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-2: Access

## AA-2.1 CBB Access to Auditors

### AA-2.1.1

Investment firm licensees must waive any duty of confidentiality on the part of their auditors, such that their auditors may report to the CBB any concerns held regarding material failures by the investment firm licensee to comply with CBB requirements.

### AA-2.1.2

The CBB may, as part of its on-going supervision of investment firm licensees, request meetings with a licensee's auditors. If necessary, the CBB may direct that the meeting be held without the presence of the licensee's management or Directors.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-2: Access

## AA-2.2 Auditor Access to Outsourcing Providers

**AA-2.2.1** Outsourcing agreements between investment firm licensees and outsourcing providers must ensure that the licensee's internal and external auditors have timely access to any relevant information they may require to fulfil their responsibilities. Such access must allow them to conduct on-site examinations of the outsourcing provider, if required.

AA-2.2.2 Further Rules and Guidance on outsourcing will be contained in Module RM (Risk Management), to be issued later in 2007.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-3: Auditor Reports

## AA-3.1 Review of Quarterly Prudential Returns

### AA-3.1.1

Investment firm licensees must arrange for their auditors to review the licensee's Quarterly Prudential Return for the quarter ending 30 June (or semi-annually depending on the licensee's financial year-end) prior to its submission to the CBB, unless otherwise exempted in writing by CBB. Auditors must complete the prescribed form attesting to their review, which must be attached to the Quarterly Prudential Return.

### AA-3.1.2

Investment firm licensees are required to submit a Quarterly Prudential Return (QPR). Investment firm licensees may apply in writing to CBB for an exemption from the requirement that the QPR be reviewed by the licensee's external auditors: this exemption would normally only be given where the licensee had established a track record of accurate and timely reporting, and there were no other supervisory issues of concern. Further details on the CBB's reporting and related requirements, including the precise scope of the auditor's review and attestation, will be contained in Module BR (CBB Reporting).



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-3: Auditor Reports

## AA-3.2 Report on Compliance with Client Asset Rules

### AA-3.2.1

Investment firm licensees that hold or control client assets must arrange for their external auditors to report on the licensee's compliance with the requirements contained in Module CL (Client Assets), at least once a year.

### AA-3.2.2

The report must be in the form agreed by CBB, and must be submitted to the CBB within four months of the licensee's financial year-end.

### AA-3.2.3

Further information on the above can be found in Section CL-1.5.





MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-3: Auditor Reports

### AA-3.3 Report on Compliance with Financial Crime Rules

**AA-3.3.1** Investment firm licensees must arrange for their external auditors to report on the licensee's compliance with the requirements contained in Module FC (Financial Crime), at least once a year.

**AA-3.3.2** The report specified in Rule AA-3.3.1 must be in the form agreed by the CBB, and must be submitted to the CBB within four months of the licensee's financial year-end.

AA-3.3.3 Further information on the above can be found in Section FC-3.3.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-4: Accounting Standards

## AA-4.1 General Requirements

- AA-4.1.1** Investment firm licensees must comply with International Financial Reporting Standards / International Accounting Standards and, to the extent that they undertake Shari'a compliant activities, relevant standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).
- AA-4.1.2 Overseas investment firm licensees that do not, at the parent company level, apply IFRS/IAS are still required under Paragraph AA-4.1.1 to produce pro-forma accounts for the Bahrain branch in conformity with these standards. Where this requirement is difficult to implement, the Bahraini investment firm licensee should contact the CBB in order to agree to a solution.
- AA-4.1.3 Paragraph AA-4.1.1 requires investment firm licensees that operate exclusively on a Shari'a compliant basis to apply relevant AAOIFI Financial Accounting Standards, depending on the type of Islamic finance contracts entered into. Investment firm licensees that undertake both conventional finance and Shari'a compliant transactions are required by Paragraph AA-4.1.1 to apply AAOIFI Financial Accounting Standard 18, "Islamic Financial Services Offered by Conventional Financial Institutions".



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-5: Role of Reporting Accountants

## AA-5.1 Introduction

**AA-5.1.1** The content of this chapter is applicable to all investment firm licensees and concerned auditors in the Kingdom of Bahrain.

AA-5.1.2 The purpose of the contents of this chapter is to set out the roles and responsibilities of reporting accountants when appointed pursuant to Article 114 of the CBB Law (see EN-2). This Article empowers the CBB to assign some of its officials or others to inspect licensees’ or listed companies’ businesses.

AA-5.1.3 The CBB uses its own inspectors to undertake on-site examinations of licensees as an integral part of its regular supervisory efforts. In addition, the CBB may commission reports on matters relating to the business of licensees in order to help it assess their compliance with CBB requirements, as contained in Article 114 of the CBB Law. Such inspections may be carried out either by the CBB’s own officials, by duly qualified “Reporting Accountants” appointed for the purpose by the CBB, or a combination of the two. Article 111 requires licensees to make available to the CBB’s inspectors, their books and other records, and to provide all relevant information within the time limits deemed reasonable.

**AA-5.1.4** Investment firm licensees must provide all relevant information and assistance to reporting accountants on demand as required by Articles 111 and 114 of the CBB Law. Failure by licensees to cooperate fully with the CBB’s inspectors or reporting accountants, or to respond to their examination reports within the time limits specified, will be treated as demonstrating a material lack of cooperation with the CBB which will result in other enforcement measures being considered, as described elsewhere in EN Module. This rule is supported by Article 114(a) of the CBB Law.

AA-5.1.5 Article 163 of the CBB Law provides for criminal sanctions where false or misleading statements are made to the CBB or any person /reporting accountant appointed by the CBB to conduct an inspection on the business of the licensee or the listed company.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-5: Role of Reporting Accountants

## AA-5.1 Introduction (continued)

AA-5.1.6 The CBB will not, as a matter of general policy, publicise the appointment of reporting accountants, although it reserves the right to do so where this would help achieve its supervisory objectives. Both the reporting accountants and the CBB are bound to confidentiality provisions restricting the disclosure of confidential information with regards to any such information obtained in the course of the investigation.

AA-5.1.7 Unless the CBB otherwise permits, reporting accountants should not be the same firm appointed as external auditors of the licensee.

AA-5.1.8 Reporting accountants will be appointed in writing, through an appointment letter, by the CBB. In each case, the CBB will decide on the range, scope and frequency of work to be carried out by reporting accountants.

AA-5.1.9 Reporting accountants will report directly to and be responsible to the CBB in this context and will specify in their report any limitations placed on them in completing their work (for example due to the relevant licensee's group structure). The report produced by the reporting accountants is the property of the CBB (but is usually shared by the CBB with the firm concerned).

AA-5.1.10 Compliance by reporting accountants with the contents of this chapter will not, of itself, constitute a breach of any other duty owed by them to a particular licensee (i.e. create a conflict of interest).

AA-5.1.11 The CBB may appoint one or more of its officials to work on the reporting accountants' team for a particular licensee.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-5: Role of Reporting Accountants

## AA-5.2 The Required Report

- AA-5.2.1** Commissioned reporting accountants would normally be required to report on one or more of the following aspects of a licensee's business:
- (a) Accounting and other records;
  - (b) Internal control systems;
  - (c) Returns of information provided to the CBB;
  - (d) Operations of certain departments; and/or
  - (e) Other matters specified by the CBB.
- AA-5.2.2** Reporting accountants will be required to form an opinion on whether, during the period examined, the licensee is in compliance with the relevant provisions of the CBB Law and the CBB's relevant requirements, as well as other requirements of Bahrain Law and, where relevant, industry best practice locally and/or internationally.
- AA-5.2.3** The reporting accountants' report should follow the format set out in Appendix EN 1.
- AA-5.2.4** Unless otherwise directed by the CBB or unless the circumstances described in section AA-5.3 apply, the report should be discussed with the board of directors and/or senior management in advance of it being sent to the CBB.
- AA-5.2.5** Where the report is qualified by exception, the report should clearly set out the risks which the licensee runs by not correcting the weakness, with an indication of the severity of the weakness should it not be corrected. Reporting accountants will be expected to report on the type, nature and extent of any weaknesses found during their work, as well as the implications of a failure to address and resolve such weaknesses.



MODULE	AA:	Auditors and Accounting Standards
CHAPTER	AA-5:	Role of Reporting Accountants

## AA-5.2 The Required Report (continued)

### AA-5.2.6

If the reporting accountants conclude, after discussing the matter with the licensee, that they will give a negative opinion (as opposed to one qualified by exception) or that the issue of the report will be delayed, they must immediately inform the CBB in writing giving an explanation in this regard.

### AA-5.2.7

The report should be completed, dated and submitted, together with any comments by directors or management (including any proposed timeframe within which the licensee has committed to resolving any issues highlighted by the report), to the CBB within the timeframe applicable.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-5: Role of Reporting Accountants

### AA-5.3 Other Notifications to the CBB

#### AA-5.3.1

Reporting accountants should communicate to the CBB, during the conduct of their duties, any reasonable belief or concern they may have that any of the requirements of the CBB, are not or have not been fulfilled. These may include:

- (a) Criteria for licensing (see Module AU);
- (b) Material loss or significant risk of a material loss; or
- (c) Client interest at risk because of adverse changes in the financial position, management or other resources of the licensee.

Notwithstanding the above, it is primarily the licensee's responsibility to report such matters to the CBB.

#### AA-5.3.2

The CBB recognises that reporting accountants cannot be expected to be aware of all circumstances which, had they known of them, would have led them to make a communication to the CBB as outlined above. It is only when reporting accountants, in carrying out their duties, become aware of such a circumstance that they should make detailed inquiries with the above specific duty in mind.

#### AA-5.3.3

If reporting accountants decide to communicate directly with the CBB in the circumstances set out in paragraph AA 5.3.1 above, they may wish to consider whether the matter should be reported at an appropriate senior level in the licensee at the same time and whether an appropriate senior representative of the licensee should be invited to attend the meeting with the CBB.



MODULE	AA: Auditors and Accounting Standards
CHAPTER	AA-5: Role of Reporting Accountants

#### AA-5.4 Permitted Disclosure by the CBB

AA-5.4.1	Information which is confidential and has been obtained under, or for the purposes of, this chapter or the CBB Law may only be disclosed by the CBB in the circumstances permitted under the Law. This will allow the CBB to disclose information to <u>reporting accountants</u> to fulfil their duties. It should be noted, however, that <u>reporting accountants</u> must keep this information confidential and not divulge it to a third party except with the CBB's permission and/or unless required by Bahrain Law.
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<b>MODULE</b>	<b>AA: Auditors and Accounting Standards</b>
<b>CHAPTER</b>	<b>AA-5: Role of Reporting Accountants</b>

## **AA-5.5      Trilateral Meeting**

- AA-5.5.1      The CBB may, at its discretion, call for a trilateral meeting(s) to be held between the CBB and representatives of the relevant licensee and the reporting accountants. This meeting will provide an opportunity to discuss the reporting accountants' examination of, and report on, the licensee.