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## Board Audit Report Examination Year 2000

### Introduction

1 The matters raised in this report are those, noted during our examination, which we believe need to be brought to your attention. They are not a comprehensive record of all matters arising. In particular, we are not responsible for reporting all risks in your business or all control weaknesses.

2 Because of its limited purposes and bases, this board report is intended solely for information and use by the board, executive committee, management, and others within the BES group. It is not intended to be and should not be used by anyone other than BES-related parties. It is not to be made available or shown to any third party and we accept no responsibility to any such third party, which in the event of inadvertent sight or unauthorised possession of copy of the report, might choose to rely on it. In the event that any regulatory authorities require copy or sight of the report, we are to be informed immediately so that proper arrangements can be made for our involvement in its discussion with regulators.

3 Section 380 of generally accepted auditing standards in the USA obliges the independent auditor to communicate certain matters to the Board Audit Committee (BAC) or, in the absence of such committee, to the Board of Directors (BOD) of the bank.

4 In compliance with Section 380, this board audit report is required to deal with the following matters, to the extent applicable:

- significant accounting principles and policies
- areas involving significant management judgements and accounting estimates
- significant changes
- narrative reporting
- independence
- other information in published documents containing financial information

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- accounting matters
- difficulties encountered in conducting audit
- internal control – areas for improvement
- unadjusted differences.

**Significant accounting principles and policies**

5 The accounting policies and practices of BES and its subsidiaries are established mostly by Bank of Portugal and are overseen by its Banking Supervision Department (DSB). In cases, certain practices are also established by law in Portugal. Some subsidiaries are regulated by the insurance regulator. The involvement of the stock exchange regulator with published financial information is usually limited to certain matters of form, presentation and disclosure for capital market purposes.

6 The more significant accounting policies used by BES for Portuguese reporting purposes are summarised in its published financial statements. Bank of Portugal accounting rules tend to be conservative. Independent awards have identified BES several times in recent years as a leader in financial reporting standards, disclosures and presentations in Portugal. Over the years, we have worked closely with management of the accounting services (DPC) to raise the quality of the statutory and other presentations. Overall, we consider BES's accounting policies to be reasonable and appropriate in the circumstances for reporting under the accounting framework established by the Bank of Portugal. Occasionally, reference is made to other global accounting standards for assistance in implementing certain detailed aspects of Portuguese rules, for example:

- pension plan cost recognition
- hedge accounting
- related party disclosures
- deferred tax accounting
- transactions between controlled entities
- impairment of long-lived assets.

7 The primary financial statements included in Form 20-F filing for US purposes are presented in US format but are prepared using Portuguese principles. The explanatory notes to financial statements used for US filings include additional disclosures specifying the effects on net results and on shareholders' equity of using accounting principles generally accepted in the United States of America to prepare consolidated financial statements for BES.

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8 BES group needs a formal Accounting and Reporting Manual specifying principles, practices, methodologies and guidelines expected to be followed by management of BES and of its subsidiaries and associates when implementing the Portuguese rules, ESFG standard forms and determining proposed adjustments under US GAAP. Financial information for regulatory consolidation purposes is prepared shortly after each year end and before statutory accounts are finalised. However, the guidance in the present instructions is not a substitute for a proper manual. No guidance appears to be given to group entities regarding materiality levels for notification of potential late adjustments for group consolidation purposes. The manual is also needed to assist BES and its key subsidiaries and associates to prepare information for the annual US filing. The main aim of the manual should be to give practical guidance as to how accounting principles are to be implemented.

9 During 2000, there were no new accounting policies of significance to BES group introduced by Portuguese regulators although a number of amendments and revisions, affecting disclosures, were made.

10 US regulators have issued numerous new pronouncements, interpretations and related guidance, including FAS 133 Accounting for Derivative Instruments and Hedging Activities which became effective for BES on 1 January 2001 but requires certain initial impact disclosures currently.

11 SEC has called for filers generally to pay closer attention to revenue recognition, improved disclosures of market and other risks and of strategies for monitoring, controlling and mitigating them. FRR 56 introduced significant changes in Auditors Independence Requirements. The content of the Management Discussion and Analysis has been made more rigorous. The foreign issuer form 20-F used by the bank has been updated by SEC Release No. 33-7745 - International Disclosure Standards. BES is affected particularly by the changes in related party disclosures in the US filing. FAS 125 dealing with asset transfers has been revised by FAS 140; amongst other matters, it raises the issue as to whether or not financial statements of special purpose vehicles used for discretionary management of customers funds give rise to a need for US GAAP consolidation adjustments to net results and shareholders' equity. The US GAAP reconciliation cannot be used to correct errors in the underlying Portuguese financial statements (BES has respected this point in recent years). Financial statements of associates must be adjusted to the filer's accounting bases before equity accounting for the investment.

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**Areas involving significant management judgements and accounting estimates**

12 We are not aware of any material misstatements in the financial statements of BES at 31 December 2000.

13 We are required to notify you, solely for information purposes, of the areas in which we believe management has had to make its most significant accounting judgements and estimates, as follows:

- provisions for possible future credit losses on loans and advances, and other assets, including particularly direct and indirect exposures to non-financial subsidiaries and associates of Espírito Santo International Holdings SA (ESIH) - (See discussion later in this document)
- provisions for other-than-temporary decline in value of securities
- valuation of derivative transactions
- extent of early retirements and other reductions in employee numbers and whether curtailment accounting is required under US pronouncements
- impairment, under US rules, of long-lived assets, particularly of goodwill, investments in IASA, PT group (discussed later in this document) and Finet
- having regard for the fall in global interest rates during the past decade, the appropriateness of the expected long term rate of earnings assumed in the determination of pension responsibilities
- impact of future salary increase assumptions on pension responsibilities
- expected realisable values of property assets recovered from non-performing customers
- provisions for contingent risk exposures of a fiscal nature including others arising from guarantees in respect of the sale agreement for BBIA group.

14 The bank is significantly exposed to ESIH related companies both directly and indirectly through other intermediate companies of the Espírito Santo Financial Group SA (ESFG) group to which some advances are close to being pass-through arrangements. The Portuguese regulator has instructed the bank to take action to reduce exposures of ESFG group to non-financial companies of ESIH. Although the directors are of the opinion that no provisions are required for these exposures, negligible documentary evidence and support for their conclusion is available in bank credit files. See later recommendations under Internal Control section.

15 Certain loans and advances abroad appear to be carried outside of the consolidated control of the bank's credit department. These credits include loans of Euro 785 million



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secured mostly on Portuguese equity securities with market values at the year end which are lower than the loans by some Euro 100 million. If quoted security values do not recover, repayment of the loans will be dependent on the creditworthiness of the ultimate beneficial owners. Their net worth is not a matter of credit record because management represents that it knows its customers' circumstances. See later recommendations under Internal Control section.

### **Significant changes**

16 No comments are provided in this report because significant changes are amply highlighted in monthly material presented to board members and also on annual offering circulars and periodic updates and related comfort letters given by board members to investment banks acting as arrangers, managers and dealers in connection with the Euro Medium Term Note Programme.

### **Narrative reporting**

17 The bank is required by the Portuguese Stock Exchange Regulator (CMVM) and SEC to provide significant additional disclosures, beyond those made in the financial statements, in its board reports and MD&A (management discussion and analysis). We do not examine and report on individual detailed financial data and information included therein but we do read the documents and assess their formats for overall compliance with the requirements and for their consistency with information contained in financial statements examined by us.

### **Independence**

18 Under US GAAS, more particularly Independence Standard Board (ISB) Standard No. 1, auditors are required to disclose to the audit committee or board any matters that could reasonably be expected to affect their independence.

19 We believe that non-audit services rendered to the bank group by us during the year to 31 December 2000, in the fee amount of Euro xxx thousand, have not impaired our independence because we have not directly or indirectly operated or supervised the activities of the information systems of group companies, or managed their local area networks, assumed management responsibilities or made management decisions on behalf of BES group.

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20 In those areas where management has sought our comments on its intended accounting for certain transactions, or changes in systems, we have restricted our involvement to tendering advice for management to consider in making its final decisions. In particular, we confirm that we have not been involved in designing or implementing hardware or software systems that aggregate source data underlying financial statements or generate information significant to such financial statements.

21 We confirm that although we liaise with internal audit services of the bank, in order to avoid unnecessary duplication of audit activity, no internal audit services have been outsourced to us during the year, or previously.

22 No valuation services have been performed by us for BES group because these are not permitted under US independence rules. We have assisted group companies and affiliates with due diligence procedures related to acquisitions of equity interests - the specific procedures performed and on which we reported were agreed with management in advance of the assignments.

23 One member of the audit team engaged on the audit of the financial statements for the year to 31 December 1999 left the firm in the summer of year 2000 to join the accounting services of BES prior to the commencement of the annual examination of the year 2000.

24 To confirm the independence of all individual partners and staff members, we have previously sought individual specific confirmations for BES/ESFG related assignments but this system was not very efficient. Accordingly, the current methodology provides for an annual confirmation to the Risk Management Partner who notifies the engagement partner of any reported problems. Engagement partners on BES group audits are obliged to seek specific individual confirmations only in respect of individuals who have worked on relevant assignments after the date of the last independence letter to BES. Compliance with independence aspects of non-audit assignments is ensured by the group engagement partner reviewing the firm's work in progress records and through his contacts with the relevant engagement partner for the non-audit assignments. Annual instructions sent by us to other offices abroad include a requirement for BES/ESFG independence confirmations with respect to those offices.

#### **Other information in published documents**

25 To comply with requirements of CMVM, we recommended verbally to DPC that the draft annual board report for year ended 31 December 2000 should also carry an explanation that pursuant to reclassification of investments in PT, substantial provisions

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previously charged to earnings of the first and second quarters of the year 2000, had been reversed to earnings in the fourth quarter in the amount of Euro 95 million. Management did not act on the recommendation.

### **Accounting matters**

#### ***Interests in Portugal Telecom group***

26 During the period to 31 October 2000 the bank invested some Euro 428 million in shares of companies of Portugal Telecom group which at that date had an aggregate market value of Euro 333 million (Euro 311 million in April 2001). The shares were held in BES's trading and investment portfolios resulting in accumulated provisions for unrealised losses at that date of Euro 95 million as required under rules of Bank of Portugal. Because a strategic agreement signed with PT group was re-assessed in October 2000 as having become effective as of 1 July 2000, the bank reversed to results of the fourth quarter of 2000 previous provisions of Euro 95 million. The basis for reversal of these provisions was that rules of Bank of Portugal permit long term strategic investments to be carried at cost of acquisition.

27 The usual international practice is for such transfers from short to long term portfolios to be made at market value at the date of the transfer. However, following detailed study of rules issued by the Bank of Portugal, we concluded that although transfers between trading and investments portfolios must be made at market value, there is no clear requirement for strategic investments to be carried at other than acquisition cost less, of course, any provision considered necessary for other-than-temporary impairment.

28 At 31 December 2000, the market value of long term investments in PT companies was Euro 321 million which was Euro 137 million lower than their cost of acquisition (and carrying value) of Euro 458 million. Under prescriptive rules of Bank of Portugal no provision is required to be made for such shortfalls in market value because the investee does not have a three year history of losses and is not considered insolvent or close to financial failure. Under US GAAP, the bank is obliged annually to consider whether any loss in value of the investment is other than temporary. This assessment is also required at any point in time that a major sustained fall in market value suggest a risk of possible impairment.

29 The board and executives of BES concluded that no provision is required for impairment under the Portuguese rules at 31 December 2000. For US purposes, in the case of the investment of Euro 226 million in PT, it was concluded that current research

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indicates that expected future price targets prepared by independent investment banks after the 2000 year end, exceed acquisition cost.

30 For Euro 157 million and Euro 74 million invested in PTM and in PTM.com respectively, recent cash flow projections by investment banks support a conclusion that for US purpose some of the unrealised losses require to be considered as other-than-temporary. Accordingly, having regard for the long period of time for which quoted prices of shares in PTM and in PTM.com have been substantially below their acquisition cost, impairment provisions were needed at 31 December 2000 for US GAAP purposes. US rules specifically preclude the use of held-to-maturity classifications for equity securities even when held for strategic purposes. We consider that equity accounting for shares in PT group companies would not be appropriate under the US standards because of the small percentage holdings and voting rights. Moreover, even if the interests could be equity accounted, the low net asset base of PTM and of PTM.com would give a very significant amount of goodwill which would have to be tested for impairment. Recent comprehensive financial forecasts to substantiate the fair value of the investment and of any theoretical goodwill support the substantial provisions proposed for impairment or value decline.

31 The board's attention is drawn to an SEC expectation that, in implementing applicable accounting standard for US purposes, there is an assumption that impairment is other than temporary *if the quoted market price of a security on an organised exchange of recognised depth and liquidity remains depressed for periods greater than about six months*. Exceptionally, we have accepted the boards arguments such that not all the marked-to-market loss is written off against earnings but only that amount of cost which exceeds reasonable fair value as evidenced and supported by detailed calculations made recently for the PT board. It should be recognised that the SEC could still question the basis for the relatively large difference between the fair value and the market value. Under the current circumstances, we recommend that during the year 2001 the board needs to maintain a very close watch over development in this situation to ensure that shareholders and markets in general are made aware on a timely basis of any continuing market conditions requiring the establishment of material provisions for impairment/decline, especially on a US basis of reporting.

32 In addition to direct investments in shares in PT group companies, the bank has executed total return equity swaps with four international investment banks to acquire the right but not the obligation to buy a further 29 million shares (2.41% of PT shares but increased in 2001 to 3.4%). Under the contracts, BES holds the short term right but not the obligation to exercise the votes of the foreign-owned shares underlying the swaps. The market was made aware of these voting rights through a public announcement.

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33 The bank has a further indirect market exposure to fluctuations in price of shares in PT group companies by virtue of its potential collateral interest in 2.4% of PT shares (28.8 million) the acquisition of which, together with other Portuguese equities (including BES shares), was funded by loans from BES to four off shore companies. Management has represented to us that it is satisfied that the beneficial owners of these companies are willing and able, if necessary, to reimburse BES for any realised shortfall between borrowings and related securities. The shortfall at 31 December 2000 between the loans and their underlying collateral is estimated by us to be in the region of Euro 120 million for which no provision was judged necessary by management because of the known (but undocumented) means of beneficial owners.

34 The bank is limited by capital adequacy rules in its ability to support larger investments in PT than those already carried. We also understand that, if BES's capital is increased, its investments in PT could be increased proportionately in future. The bank has not separately disclosed in its statutory financial presentation to the market at 31 December 2000 or at 31 March 2001 the nature of these swaps or its intention with respect thereto, or its other indirect exposures to PT risk. In our view, given the effective concentration of PT market risk to which BES group is exposed at 31 December 2000, the board needs to ensure on an ongoing basis that the extent of, and nature of changes in, the bank's exposures to PT are more fully communicated to the market.

#### *Future impact of International Accounting Standards on BES*

35 Attention is drawn to the potentially significant impacts for BES of the decision of IOSCO, the international body of capital market regulators, and of the European Community, to replace national accounting standards by International Accounting Standards for the presentation of consolidated financial statements for all quoted companies in Europe by the year 2005.

36 Because of the probable need to present in the financial statements the comparative amounts for two years previously, it will be necessary to commence the planning for these changes as soon as possible, even before the regulatory details are available. Consideration should be given to the human resource needs for this conversion given the shortage in the recruitment market of accounting personnel experienced in IAS matters.



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### **Difficulties encountered with the audit**

37 Occasionally, for certain confidential transactions, there is a tendency for top executives to restrict the flow of information to members of management on a “need to know” basis. A consequence of this policy is that directors and officers who require information to perform their duties properly will sometimes lack the necessary information.

38 In such cases, this restrictive practice is also applied to the availability of accounting registers, files and documentation needed by independent audit teams. As a result, our examination of the parent and its subsidiaries and associates becomes, for us and for top executives affected, a protracted exercise in prising relevant files and information out of a reluctant middle management. It is often unclear to us whether members of management, whom we would expect to possess relevant information, do in fact have the information. For example: certain important information made available to us in overseas branches, and known to have been sent to Lisbon head office, could not be made available in Lisbon purportedly because of “poor filing standards” by inexperienced officers. Areas most frequently affected by these difficulties are discretionary disintermediation, lending to off shore companies, credits parked in overseas units, investments in Brazil and credit exposures to ESIH.

39 A consequence of this practice within the BES group is that advertent or inadvertent misstatements of financial information made available to the executive committee and board for decision making purposes, or when published to the market, could pass undetected by the system of internal control for unreasonable periods of time. Additionally, there are unnecessary audit costs, unnecessary pressures on members of management during urgent reporting periods and major potential for delays in meeting deadlines.

### **Internal control - Areas for improvement**

40 The primary objective of independent examination of financial statements is the expression of an opinion concerning their fair presentation in accordance with the financial reporting framework established in Portugal by law and by industry/market regulators. The auditors report should not be interpreted as an assurance as to future viability of the banking group neither is it an opinion as to the efficiency and effectiveness with which management has conducted the affairs of the group since these are not the objectives of an audit.



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41 Audit procedures are designed to reduce, to an acceptably low level, the risk of issuing an inappropriate opinion when financial statements are materially misstated. An auditor assesses the inherent risk of material misstatement occurring and the risk that the entity's accounting and internal control systems will not prevent, or detect and correct, material misstatements on a timely basis. Accordingly, an auditors review of the system of internal control is carried out solely for the purpose of establishing the scope and extent of his audit procedures and not for any other purpose.

42 Generally accepted auditing standards require that as a result of our examination we bring to your attention reportable conditions, being matters coming to our attention that, in our judgement, should be communicated to the board or audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organisation's ability to record, process, summarise, and report financial data consistent with the assertions of management underlying the financial statements.

43 The banking group needs to consider the establishment of improved controls and alternative procedures in the following areas:

- Governance
- Organisation for credit control
- Financial function
- Credit exposures – companies of ESIH group
- Loans to off shore companies
- Related party assets, liabilities and transactions
- Discretionary asset management
- Pension responsibilities
- Angolan debt
- New products
- Confirmation and reconciliation procedures
- Long-lived assets and other than temporary impairment
- Other than temporary declines in values of securities.

#### **Summary recommendations**

44 We summarise below the key recommendations arising from our examination procedures for the year 2000 which included particular emphasis on significant related party credits and material loans transactions with off shore companies. Paragraphs

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numbered 45 through 55 inclusive are considered reportable conditions requiring urgent attention by management because of their future potential for non-detection of misstated financial information.

45 The bank should appoint a board audit committee (BAC) with responsibility to oversee management and internal and external auditors. A majority of its members should be independent of day to day management of the bank.

46 All credits originated by the bank, without exception, irrespective of the group units in which they carried, should be under the detailed control and regular review of the normal credit department and specialists of the bank. In particular, neither the Board Executive Committee (BEC) nor any other department of the bank should be involved in extending or renewing credits which are not subject to the normal controls and supervision of the specialists in the bank's credit department.

47 Important credit files in respect of significant loans and advances to off shore companies should be available at head office.

48 The quality and standard of credit file documentation maintained in overseas branches and subsidiaries in respect of credit approvals conceded from Lisbon, require substantial improvements. In particular, such documentation should include, amongst many other items, evidence of (a) requests and instructions received from ultimate beneficial owners regarding transactions with companies under their control and (b) the economic purpose of the owners in seeking off shore funding for securities portfolios.

49 The Chief Financial Accounting Officer of the bank should be present at all Executive Committee Meetings.

50 The Chief Financial Accounting Officer should not be dependent on decisions of the Head of Treasury for the reliability of accounting entries in respect of transactions originated in DFME.

51 Adequate credit files need to be prepared, and proper documentation put in place over credit limits, collateral security, terms of lending and repayment arrangements for all loans to non-financial subsidiaries of the ESIH group of companies and for other credit risks assumed with banks and investment companies of the ESFG group.

52 The amount and nature of significant direct and indirect credit exposures of BES group to non-financial companies of ESIH group should be included in monthly financial

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information packages prepared by DPC and made available to main board (and BAC in due course).

53 Main board (or BAC) should monitor progress in constituting the proper comprehensive documentation of these ESIH group risks and should examine the documentary evidence available in support of management's conclusion that no provisions are currently required against these exposures, meeting if necessary, the responsible ESR executive of each borrower.

54 The bank should establish and circulate, to all branches, subsidiaries and associates, clear and unequivocal instructions and guidelines for the definition of related parties for Portuguese and US purposes and for the identification and reporting of such transactions and related assets, liabilities, revenues and costs (including off balance sheet transactions/positions).

55 Special purpose entities abroad using funds provided to BES under mandates controlled by DFME should present, not less than quarterly, a proper balance sheet, statements income, of cash flows and of changes in residual interests drawn up using proper accounting principles consistent with those used by the bank, for portfolios of quoted securities held for trading, derivatives, revenue and cost recognition. These statements and should be independently audited not less than annually by a recognised international firm.

56 The board should arrange an independent review by a pension specialist of the basis on which pension charges in the statutory financial statements of the bank are being determined.

57 Although our audit procedures over the years have revealed no irregularities in the accounts, we recommend checks to ascertain the reasons why two Angolan banks have not replied to independent audit requests signed by the CEO of the bank asking for written confirmation of loan amounts and terms.

58 The board should evidence its approval of documentation in support of accounting principles to be applied to any new products of BES group or to any substantive change in interpretations of existing policies.

59 Regulatory returns submitted by the bank, particularly those relating to large risks, should be made available to the members of the Board of Directors not less than quarterly.

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60 The foregoing recommendations and our comments on risks associated with the underlying condition are discussed in more detail in Appendix A attached to this memorandum. The foregoing recommendations should be read in conjunction with the appendix.

**Unadjusted differences**

61 The results of the unadjusted differences are summarised as follows (AAA to insert the summary)

**Closing remarks**

62 We shall be pleased to discuss with representatives of the board and management any matters relating to the contents of this report.

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**INTERNAL CONTROL RECOMMENDATIONS**

This appendix is to be read in conjunction with the attached Board Audit Report dated May 20, 2001.

**Governance*****Recommendations:***

- 1 The significance of the bank's exposures to ESIH group requires the Board to give serious and urgent consideration to the need to establish a formal BAC. We suggest that it should comprise not less than three members, two of whom should be non-executive directors of the bank with significant financial management and accountancy expertise. Ideally, the third member of the BAC should also be a non-executive director. Increased regulatory emphasis on operational risk indicates that risk management should be represented on the BAC.
- 2 The audit committee must oversee management which has and must accept the primary responsibility for the financial statements, the external auditors on whom investors rely to provide an unbiased, robust examination of the numbers to ensure their credibility and integrity, and where they exist, internal auditors who provide a source of advice and information on the processes and safeguards that exist. This oversight role should be timely, robust, diligent and probing.
- 3 The internal auditor should have an unobstructed and clear communication channel to the audit committee.
- 4 The internal auditor should evaluate and report to the audit committee on the adequacy and effectiveness of a company's internal controls.
- 5 There should be independent communication with and information flow between the audit committee and the outside auditors. The audit committee should adopt additional voluntary measures to ensure outside auditors' objectivity.
- 6 There should be *candid* discussions by the audit committee with management, the internal auditor, and outside auditors regarding issues implicating judgement and impacting quality.
- 7 The Head of the Internal Audit Department should be responsible directly to the BAC for approving the scope and extent of the work of the internal audit department which would be agreed, after due consultation over operational developments and risks with members of the Executive Board and other key officers.

**Risks:**

- 8 Members of ESIH on the Board(s) of BES group companies will not be viewed by third parties to be independent and objective with respect to any decisions concerning credit extended directly or indirectly to the ESFG and ESIH groups using third party funds taken by the bank. Deficiencies in the quality of loan documentation for the ESIH exposures reinforce this perception. Accordingly, credit losses requiring provisions will not necessarily be detected on a timely basis by the existing systems of the bank.

**Discussion:**

- 9 The bank is controlled by ESIH but the majority of the economic interest in its performance is sourced by third parties. Accordingly, management is obliged to be attentive to the periodic potential conflicts of interest inherent in this situation. Adoption of the recommendation will provide an improved level of independence and transparency into the management decisions affecting such matters. There is an increasing requirement from the capital markets for greater emphasis by boards on monitoring the quality and effectiveness of internal control systems. A BAC will add balance to that process and serve to improve market confidence in the institution.
- 10 The role of the BAC would be to ensure high-quality financial reporting, risk management and internal control. Areas of focus include accounting and financial reporting with emphasis on understanding high risk areas for reporting manipulation, gaining a better grasp of industry and business issues impacting the bank's reports. BAC members should also focus on group-wide risk management by developing a detailed understanding of the management processes by which risk is identified and managed.
- 11 We have already provided the main board, separately, in February 2001, with information about the role of the proposed audit committee.

**Organisation for credit control**

**Recommendations:**

- 12 Consideration should be given to ensuring that all important credit exposures are kept under review by the credit department at Head Office irrespective of their geographic location. The involvement of the International department in credit transactions abroad, while justified, should not diminish the effectiveness of the credit control procedures.
- 13 Employees should be explicitly precluded in writing from accepting responsibility to exercise powers of attorney from customers to operate their accounts. Employees should not accept to represent customers for the purpose of enabling the bank or



others to serve legal notice of non-performance or foreclosure etc. If customer relations oblige exceptions to this policy then the bank should establish special control structures and procedures to ensure that the conflicts of interest inherent in the dual role of the officer are not abused. Accordingly, a register should be maintained centrally for all customers providing the bank with a power of attorney to operate their accounts. All such acceptances of delegations of power should be approved by the Executive Committee and made available to the Internal Audit Services for periodic examination.

- 14 The Internal Audit Department should regularly test the sound functioning of the delegated powers using procedures designed to ensure that conflicts inherent in the arrangements are not subject to abuse or negligence.

***Risks:***

- 15 The standards of credit control may be subjugated when responsibility is exercised outside of the experience and knowledge of the credit services such that any under-provisioning for possible losses may not be detected by the bank's regular systems on a timely basis.
- 16 Employees with conflicts of interest between the business of the bank and of the customer will be assumed to be acting primarily for the bank and not necessarily in the best interests of the customer thus risking subversion of the effectiveness of elements of the system of internal control of the bank. Loan loss risk increases.

***Discussion:***

- 17 Presently, the effectiveness of the credit control function is diminished by a lack of clarity concerning responsibilities for credits awarded by head office but parked in overseas branches and subsidiaries under instruction from the International Department of the head office. Head office retains the primary responsibility for the approval granting and monitoring of the related credit risk. Branches and subsidiaries have complained to us that their requests for information and documentation about such credits, which is necessary for them to comply with their national regulatory responsibilities, are not actioned, or are actioned too late or incompletely. At the same time, efforts by our audit teams to obtain from head office the information and documentation on behalf of the overseas offices indicate, in many cases, that the available information and documentation is either non-existent, is mislaid or is too sparse for its intended purposes. Our examination has identified a serious deterioration in the extent and quality of the information available on the credit files for these overseas credits. We are particularly concerned about significant exposures to off certain shore companies where there appears to be a complete absence of credit files in Lisbon.

- 18 In connection with an off shore credit exposure, we noted a branch employee in London had agreed in writing to serve as legal representative of a bank customer for the service of due legal process under the English legal system. Such action constitutes a serious breach of legal and regulatory rules governing the conduct of bank accounts. Branch employees should be responsible for servicing only their employer's interests unless specific controls are put in place as for example with mandates for discretionary fund investments by head office.

### Financial function

#### *Recommendation:*

- 19 The Chief Financial Officer of the bank, who is not a board member, has a non-voting presence at all board meetings meetings. This presence should also extend to all meetings of the board executive committee (BEC) since he should receive no less detailed information about proposed business transactions than any other BEC member to ensure that he is fully informed about the bank's affairs for reporting purposes. Unless this action is taken it will continue to be possible for vital information to be withheld from an officer responsible for the effectiveness and reliability of the bank's accounting system and for the preparation of published financial information to the market.
- 20 The Chief Executive Officer of the bank group should delegate to the Chief Financial Officer all the financial reporting responsibilities, restricting himself to monitoring the process.
- 21 Given the increasing dimension of the group, and the complex inter-relationships amongst its components, the BES group needs to appoint, formally, a BES Group Chief Financial Officer. To the extent that he is not a board member of autonomous subsidiaries, he should have the group's authority to be copied with the agendas and presentations made available for board meetings of all subsidiaries and to elect to be a non-voting presence to the extent that he deems it consistent with his responsibilities as a group CFO. Consideration should be given to extending his normal financial responsibilities to include a watching brief over consolidated fiscal efficiency and effectiveness.
- 22 The resources of the DPC at BES need to be reinforced, qualitatively and quantitatively, as they are less than adequate for the responsibilities involved.
- 23 Procedures should be put in place to ensure that Departamento de Planeamento e Contabilidade (DPC) is furnished with more complete and comprehensive information to support transactions and decisions concerning their accounting treatment.

- 24 Top management of each group subsidiary and associate should be required to provide written representations to group management as to their satisfaction with the integrity, reliability and appropriateness of the information bases used in the submissions made for consolidation purposes.
- 25 The back office accounting control function over disintermediation activities at DFME is presently supervised from within DFME. Accordingly, the function is executed by persons who are also responsible for customer-related transactions while also being involved with strategy, transaction initiation, and transaction confirmations and their documentation. To overcome this inadequate segregation of duties and responsibilities, this accounting control function over the investment activity should be transferred to DPC.
- 26 Consideration should be given to reminding senior officials of the bank, its branches and group companies, in writing, that capital markets expect informative disclosures of significant oral agreements entered into by empowered officials even when such agreements may not be legally enforceable.

*Risks:*

- 27 Inadequate segregation of duties resulting in the effectiveness of the chief financial officers in acting as a counterbalance to the judgements of the Chief Executive Officer being seriously diminished.
- 28 Financial information known to board members may not be made available to the financial officers responsible for making important accounting decisions at an individual and consolidated level.
- 29 The required involvement of officers of DPC in the design, implementation and monitoring of important general accounting controls (like review of reconciliations and of major reconciling items) is seriously prejudiced by the resource constraints of the department.
- 30 Board members and senior executives of subsidiaries and associates are not sufficiently involved in ensuring the adequacy and reliability of the information submitted for BES group consolidation purposes resulting in attitudes of indifference prejudicial to the quality and reliability of the information submitted. Staff tend to think that it is not a responsibility to be taken seriously senior management are not involved in reviewing their work. The risk is that misleading information could be used for management decisions and publication.
- 31 Lack of segregation of duties results in DFME being in a position to manipulate the bank's results without the knowledge of the accounting services responsible for preparing the financial information made available to the board.

*Discussion:*

- 32 The Chief Executive Officer should be independent of the financial accounting and reporting function. Market pressures from analysts to achieve certain results creates conflicts of interest for any CEO which conflicts should be seen to have been subject to detailed independent executive assessment.
- 33 DPC is responsible for maintaining the primary books of account for the bank and for compiling significant elements of financial management information for use by officers, executives, board members, regulators and others. Notwithstanding the critical nature of this role DPC is frequently required to make accounting decisions without adequate details of contracts and other evidence relevant to understanding the transactions and properly accounting for them. Often the evidential data is simply retained by board members or representatives of other departments. Withholding key data from DPC increases the risk of mis-reporting in financial statements and board reports to shareholders and the public and imposes an unnecessary additional responsibility on the Chief Executive Officer and auditors.
- 34 Presently, DPC is responsible for compilation of periodic financial statements of BES group for use by management, shareholders, regulators and capital markets. The consolidation process is carried out by DPC officials at BES. It is not a simple arithmetic sum of data from subsidiaries and associates. It requires an in-depth knowledge of the affairs of the entities being consolidated and, frequently, additional detailed information about key transactions and business decisions. Our examination work reveals that this knowledge and information is frequently not made available to DPC or is incomplete. In cases, the accounting services of the subsidiary units are themselves unaware of the key transaction details.
- 35 While the boards of directors of subsidiaries are closely involved in the review and approval of the annual reports and financial statements, they are not sufficiently involved in ensuring the reliability and appropriateness of the financial information submitted for BES group consolidation purposes. The process tends to take place between the respective accounting services with, in our view, insufficient review and supervision by board members. Consequently, subsidiary staff tend to regard the process as incidental to their primary responsibilities and, because top executives are not seen to be involved in the process, the related work procedures tend to be performed less diligently. These deficiencies of process become more acute when dealing with information for the ESFG consolidation. The amount of time spent by us as auditors, and by DPC officials, in pressing subsidiary officials to provide adequate considered evidence in support of important accounting presentations is excessively time-consuming. More importantly, because the DPC is seriously under-resourced in relation to its responsibilities, its present processes cannot ensure that significant errors will not arise. Only better supervision of the process by top officials throughout the group will ensure the required qualitative risk improvements.

- 36 Pursuant to decisions of the Executive Committee (BEC), it appears also that DPC at BES, and the equivalent services at subsidiaries and associates throughout the group, will shortly be required to implement International Accounting Standards (IAS) throughout the group for statutory and regulatory reporting purposes. In considering the need for reinforcement of the group's financial accounting resources it should be recognised that more than 7,000 major European companies are expected to make this conversion to IAS. Soon there will be a scramble to secure financial accountants with the knowledge and experience necessary to accompany the process with the minimum disruption. This is a factor to be taken into account in re-considering the qualitative and quantitative resources of DPC.
- 37 The results of activities of the DFME are advised to DPC without supporting evidence of their validity, applicability and relevance. In our view, there is insufficient segregation of duties and responsibilities at the top of DFME to ensure that accountability for transactions is not influenced by operational responsibilities for their initiation, execution, evaluation and supervision. Accordingly, the back office function should be under the control and supervision of the DPC.
- 38 The principle of disclosing significant oral agreements arises by virtue of the significance which the market attaches to contingent risks arising from such undertakings by top officials.

**Credit exposures - companies of ESIH group**

***Recommendations:***

- 39 The bank should ensure that as part of its credit control (including control over the setting of counterparty limits) each of the individual ESIH companies borrowing from the bank and its subsidiaries should provide, not less than annually, meaningful details of monthly budgets, forecasts, and cash flows for the coming year and expected forecasts for activities in the medium term.
- 40 The bank should require ESIH to present annual audited financial statements for each significant exposure and annual audited consolidated accounts for the ESIH group as a whole. The consolidation should respect recognised accounting bases and not be a statement of assets and liabilities at valuation.
- 41 The bank should possess detailed plans provided by each borrower from the ESR group as to the expected form of realisation of its principal assets, including estimated future funding needs and their expected sources.
- 42 In view of the extent of the borrowings and the need of the ESIH group to be able, if necessary, to demonstrate that it does not put its own interest before those of the minority shareholders of BES, serious consideration should be given to providing



BES bank with either a charge over selected assets of ESR for each entity's borrowing or a formal financial guarantee from the ESIH group, or both.

- 43 The overall direct and indirect exposures of the BES group to the ESIH group should be analysed in detail by the non-executive members of the Board (or, shortly, the BAC) who should be required to opine, not less than annually, as to the quality of the loan and credit documentation and the acceptability or otherwise of the levels of credit and solvency risks assumed.
- 44 The monthly financial management information given to BES main board members should include details of the nature and extent of the direct and indirect exposures to the ESIH group together with the opinion of the BAC and details of the strategy for reducing the amount of the exposure of the BES group to comply by the end of 2001 with the capital adequacy limits required by the Bank of Portugal.
- 45 The parent and each company of the ESR group should have a proper credit file.

*Risks:*

- 46 Major potential for inappropriate award or extension of credits with consequential risk of understatement of credit loss provisions on a timely basis.

*Discussion:*

- 47 The financial management information package given to the main board excludes any information about the nature and extent of the direct and indirect exposures of BES to ESIH. The ESR group, a part of the ESIH group, comprises the largest single effective consolidated exposure risk of the BES group (being some Euro 800 million at 31 December 2000) but the nature and extent of that risk is not separately disclosed in the annual accounts nor even in the management information package distributed monthly to members of the BES Executive and Board Committees.
- 48 In addition to direct lending to ESR companies, the bank is exposed indirectly to substantial risks with ESR companies through placements made with companies of the ESFG group such as BESIL and ESFIL and which, in turn, are substantially lent on to other companies of the ESR group.
- 49 There are no adequate procedures or standards of documentation specified for the preparation and maintenance of credit files in support of lending to BESIL, ESFIL and, directly and indirectly, to ESR related parties. In BES and within companies of the BES group, related party files are seriously inadequate for their purposes, and even, in cases, non-existent. There is negligible information made available to credit officers or board members of the bank with which to assess the prospects of recoverability of the loans granted. Loans are rolled over frequently without additional information or part payments.



- 50 Potential conflicts are inherent in any relationship between an owning group and its other shareholders and the depositors of the lending bank. The nature of related party transactions requires the credit files of the bank and bank group to be better and more carefully maintained than those of normal customers, a requirement specified by the Bank for International Settlements and emphasised recently in a circular from the Bank of Portugal regarding internal control standards and credit risk. Presently the related party credit exposures are almost wholly unsecured. Neither asset collaterals nor other forms of guarantee have been provided to BES by BESIL, ESFIL and ESR entities concerned. ESIH has not provided any overall guarantee to BES that it will use its assets to facilitate recovery of any amounts due by directly or indirectly by individual ESR companies.
- 51 There are no proper consolidated financial statements prepared and audited for the ESIH or ESR groups of companies. Where financial statements have been made available by certain subsidiaries of the ESR group in previous years these have not been supported by proper board reports and notes sufficient to facilitate a responsible evaluation of the associated investment risk. Analysis of a preliminary statement of assets and liabilities of ESIH group as at June 30, 2000 indicates that, while BES has been increasing its aggregate exposure to the ESR sub-group, ESR's accumulated losses now exceed Euro 1 billion.
- 52 Because nobody is delegated clear responsibility at a BES group level to keep up-to-date the lists of consolidated subsidiaries and associates and details of related parties, the information about large risks provided by BES to ESFG for submission to the Bank of Portugal in connection with consolidated supervision at 31 December 2000 excluded reference to Investel which is clearly an ESR credit risk.

**Loans to off shore companies**

***Recommendations:***

- 53 The contents of credit files, maintained abroad in respect of companies whose credit is recorded in the books of overseas branches and subsidiaries at the request of the head office in Lisbon, require significant improvement to ensure they comply with proper banking standards.
- 54 Credit files should document the underlying economic purpose of the equity acquisitions of the ultimate beneficial owner in seeking the loans through an off shore.
- 55 Evidence of the beneficial owners requests for loans, drawdowns, re-assignment of credits to other locations etc should be available on credit files.

- 56 Loans should be restricted to 70% / 80% of the market value of the equity shares acquired to enhance credit risk protection in the event of adverse fluctuations in market prices of the securities financed. Terms of the loans should include the provision of additional collateral by the borrower or ultimate beneficial owner in the event of a decline in the market value of the portfolios funded.
- 57 Where management is relying on the name and reputation of the beneficial owner of an off shore company for recovery of shortfalls between loans and the value of equity collaterals, it should hold on file evidence of the financial capacity and willingness of the beneficial owner to make good any deficiency.
- 58 Senior officials of overseas units of the group need to be formally instructed regarding the changes which have taken place in global industry standards for documentation of customer relationships as a result of the global "know-your-customer" rules, the rules governing account documentation in the European Community and Portugal particularly with respect to beneficial ownership of nominee, trust and off shore accounts.

*Risks:*

- 59 Credit may be extended inappropriately with consequent increase in risk that credit loss provisions may not be recognised early enough.
- 60 Regulators may impose fines for non-compliance with documentary standards.
- 61 Money laundering may pass undetected.

*Discussion:*

- 62 Negligible information could be presented to us from branch and subsidiary files presented in support of loans made during the year 2000 to six off shore companies in amounts aggregating Euro 785 million and used to facilitate the acquisition of shares in the bank, in companies of the ESIH group and in other Portuguese equities.
- 63 Although required by EC and Portuguese law, such files as existed contained no evidence of the ultimate beneficial ownership of these off shore companies at the date of our audit visits. Similarly, the economic purposes for which the customers required these very substantial loans have not been evidenced on any of the files or documents made available to us.
- 64 In numerous respects, the terms of these off shore loan contracts are not consistent with normal bank lending practices. For example: loan interest payments dates were not consistent with expected cash flow timings from the investment securities. In other cases, Portuguese law attributes the voting rights of securities to the registered owner but files and agreements contained no written evidence of arrangements

regarding the exercise of voting rights for securities held as collateral for loans, some of which were voted by the bank even though no evidence was available on file of the borrowers approval.

- 65 The collateral value of the share portfolios securing the loans at the year end had fallen below the amount of the loans but no evidence is available on file to show how the bank's credit committee satisfied itself that that the ultimate beneficial owners are willing and able to settle any realised shortfalls between the loans and the share portfolios.
- 66 Many of the letters and other communications on the file are not signed by the responsible officials and there is negligible tangible evidence available on file of any requests by the ultimate beneficiaries for the loans and their draw downs.

#### **Related party assets, liabilities and transactions**

##### ***Recommendations:***

- 67 To ensure the integrity of the consolidation process and to preclude risk of inadvertent misrepresentation of net assets and earnings through non-elimination of inter-company transactions, the bank needs to formalise regularly its list of consolidated entities of the BES and of the ESFG and ESIH groups. The list needs to be updated quarterly and distributed to branches, subsidiaries and associates.
- 68 Additionally, as a publicly quoted entity with significant borrowings in global capital markets, the bank is also expected to report in its periodic consolidated financial statements and related publications its assets, liabilities and transactions with related parties. Given the complexity of the ESIH group, it is essential for the bank to take the necessary to action to put in place systems and procedures in place to ensure the reliability of the information which it publishes.
- 69 In the absence of responsible guidance from the regulator in Portugal, the Board should decide what policy it should pursue for related party disclosures in its statutory and regulatory reporting. Because the bank is obliged to follow US GAAP rules on related party reporting, we suggest that consideration be given to adopting the same practices for Portuguese purposes.

##### ***Risks:***

- 70 The bank's obligations to inform the capital market adequately about the risks it assumes and the management controls used to monitor those risks will not be appropriately disclosed leading to risk of mandatory restatement of periodic regulatory returns, financial statements and related information with consequential loss of reputation and possible fines.

**Discussion:**

- 71 Presently, the Portuguese authorities responsible for setting the accounting and reporting structure for the market have all failed to specify any national standard for the comprehensive identification and disclosure of related party transactions. Notwithstanding this omission on the part of the Bank of Portugal, it is clear that under the CMVM and SEC rules their existence is a relevant fact which needs to be disclosed.
- 72 The bank has adopted a responsible attitude in reporting voluntarily for statutory purposes certain information about related party business. Nevertheless, its disclosures in Portugal fall short of global standards. In the absence of properly defined standards and regular compilation procedures, the identification of related party business remains a hit and miss process, dependent for its accuracy, not on top management knowledge, but largely on incomplete knowledge of the group structure held by staff in central accounting services. Few if any of these staff know much about personal relationship which might exist between board members or officers and other counterparties to underlying operational activities of the bank and its subsidiaries. Accordingly, they cannot ensure the integrity of the disclosures made.
- 73 Because the bank is obliged to comply with the complex and very detailed US requirement for related party reporting, it makes no sense to have any other lesser standard for the Portuguese shareholders.
- 74 In our letter dated January 30, 2001 (as amended on 8 March 2001), we summarised for the bank the definitions applicable under the relevant US reporting standards and offered guidance regarding their implementation. This document should be used as a basis for the complete formalisation of the necessary revised reporting system for all reporting purposes.

**Discretionary asset management****Recommendations:**

- 75 Funds removed from the bank's balance sheet as part of the discretionary asset management activities performed under mandates given by private banking customers should be subject to more rigorous fiduciary standards.
- 76 In particular, off shore entities, for which important functions are outsourced to parties related to the ESFG group, into which clients money is invested, should be required to produce, *not less than quarterly*, comprehensive financial statements in support of their financial positions including detailed cash flow information distinguishing clearly between third party sources and applications of funds and operational earnings flows.

- 77 The annual financial statements of the foregoing off shore entities should, where these operations are significant to the income and exposures they generate for the bank, be subject to full examination. Their affairs should also be covered by periodic review and examination by the bank's internal auditors as and when they deem it necessary.
- 78 These financial statements should be reviewed not less than semi-annually by the board of the bank.
- 79 The accounting principles used in their preparation should be conformed wholly with those of the Portuguese financial services sector.

***Risks:***

- 80 The bank's potential business exposure to unrecognised losses on off balance sheet activities is not brought to the attention of the board or executive committee.
- 81 Possible misuse of any unremitted off shore earnings of investors would not come to the attention of the executive committee, board or management.
- 82 DPC as preparers of the financial information used for regulatory and US purposes are not aware of the existence of structured products which may need to be considered under FAS 140 for possible consolidation.

***Discussions:***

- 83 Presently, the fiduciary standards by which these operations are conducted are not evidenced to show their review and approval by the BES board of directors neither are they documented for the use of officers concerned. As a result, the record keeping for the operations is late, inappropriate and unreliable as a basis for ensuring the proper and transparent accountability for the conduct of these activities and to ensure that they are not being used to manage the bank's reported earnings.
- 84 The officers responsible for these operations, when asked to present financial statements demonstrating that stewardship of the customers funds has been appropriate, offer merely a Statement of Portfolio Assets at their current market or estimated valuations. Such limited management reporting would not reveal the amounts of any earnings which might have been applied to other, possibly questionable, purposes or even distributed to parties other than the customers.
- 85 These concerns have been discussed many times in prior periods with the Chief Executive Officer and DFME representatives who have promised that comprehensive audited accounts would be made available for these companies, without action being taken. Accordingly, the board and management of the bank need to satisfy



themselves that there are no occult reasons why proper controls are still not being put in place over these activities.

- 86 The accounting policies of the off shore entities are not consistent with those of the bank resulting at 31 December 2000 in unrecorded losses estimated by us at Euro 15 million. If certain derivatives written by the bank and held in these portfolios were evaluated on the same bases as they are at the bank, the market value of the net assets of the funds would be lower by Euro 15 million than the customers funds applied. From a legal point of view this loss would legally fall on the private banking customers of the bank but the bank would presumably consider itself to have a business exposure (under civil laws relating to due care and attention) to pick up the loss to protect its future business. No provision was made against this loss at 31 December 2000 in the books of BES.
- 87 The entities attributed responsibility for the maintenance of the accounting and administrative records of these and other off shore companies with which BES is involved include Gestar SA and Eurofin Services SA, companies which by their concentration of services to group related companies appear to be under the effective economic control or significant influence of the ESIH group. Because of the high level of outsourced involvement of these entities with the group, there financial position, commercial status, and business affairs should be under the periodic review and supervision of the bank board and the internal audit department.

**Pension responsibilities**

***Recommendations:***

- 88 Because the bank is responsible for any insufficiency in the pension funds of employees, the board needs to evidence that it maintains an adequate level of supervision over the composition and value of the assets and operations of the fund.
- 89 The financial statements of the pension fund should be prepared, and presented to the Board of Directors of the bank for minuted-review, quarterly, using a comprehensive reporting model and related disclosures.
- 90 The basis for determining the annual contribution of the bank to the fund requires amendment.
- 91 The financial statements of the pension fund should be subject to a full scope examination under recognised auditing standards.

***Risks:***

- 92 Undervaluations of the pension fund assets, if any, would not be known to the executive committee and board on a timely basis.



- 93 Charges against earnings for past service may continue to be understated leading to future need for material adjustments as the errors involved accumulate over time.
- 94 Transactions between the fund and the bank and with related parties will not necessarily be within the purview of the board.

*Discussion:*

- 95 The Bank of Portugal has not prepared pension accounting rules which are sufficiently detailed for the purposes. In particular, no guidance is given as to how actuarial variations and experience adjustments are to be accounted. Accordingly, bank officials have necessarily developed their own method of determining how these adjustments and variations affect the determination of the annual contribution and related pensions costs. One of the methods chosen is inconsistent with international pension accounting theory in that the amount of pensions paid each year to former employees cannot be considered a reduction of current net periodic pension costs for charge against future earnings over the next 15 years. It follows that the amount contributed each year to the fund is also misstated. We believe that this error in the treatment of the paid pension cost is not only inconsistent with international practice but is also contrary to the understandings implicit in the rules of the Bank of Portugal. The amount by which the pension charge is understated in 1999 and 2000, being Euro 43 million and Euro 48 million respectively, is reduced by another compensating error amounting to approximately Euro 30 million each year in the treatment of the effect of the fund earnings on the determination of the pension contribution to be expensed. As a result of this questionable practice, the bank has misstated its annual pension cost in 1999 and 2000, and under-contributed to the pension fund each year, by Euro 13 million and Euro 18 million respectively on a pre-tax basis. Unless the present practice is clarified with the regulator, the amount of this possible understatement will continue to accumulate in future until it reaches an amount which could require adverse reference in the annual auditors report.
- 96 The Board of Directors should review and approve the securities and other assets comprising the fund and should take steps to obtain comfort that the future yields and maturity recoveries are in line with market performance and expectations. Specific approval should also be sought for all investments made in or transacted with parties related to BES, ESFG and ESIH.
- 97 The bank board's review is important not least because the pension fund is managed by a wholly-owned subsidiary of the bank banking. Moreover, it is regulated by the insurance regulator who may not be as aware as the banking regulator of all the related party relationships involving the fund.
- 98 The regulatory audit of the pension fund falls short of a normal examination.

**Angolan debt**

***Recommendation:***

- 99 Internal audit services should secure comprehensive bank confirmations from the Angolan bank counterparties.

***Risks:***

- 100 Assets may be carried at overstated amounts in relation to the customer perception of its obligations.

***Discussion:***

- 101 Requests despatched by us, with the bank's authority, asking for independent confirmations of balances and other information to be sent directly to us in our capacity as independent auditors, produced no replies in spite of the fact that they were signed by the Chief Executive Officer of BES and were addressed to the Presidents of each counter party bank in Angola. This omission to respond should be followed up by BES management with procedures designed to secure the necessary reply and also to ascertain if there are any unsatisfactory reasons why such important counterparties failed to respond.

**New product accounting**

***Recommendation:***

- 102 The DFME should formally propose to, and receive the approval of, the board of directors as to the terms and conditions of new products negotiated by or with the bank and, in particular, the accounting treatment to be afforded such transactions.

***Risks:***

- 103 Management may account for new products in a manner which is inappropriate in relation to the risks. The board will not be aware of factors affecting the bank's earnings recognition.

***Discussion:***

- 104 In 1999, the bank introduced a securitisation product for which there were no recognised accounting rules in Portugal. The accounting involved important matters of judgement and valuation for which the board carries an important responsibility to ensure that it is appropriate, is in line with industry practice and does not front end results.

- 105 In year 2000, the bank executed a number of total return equity swap options under which it acquired significant additional voting rights in relation to PT shares. Given that neither the Bank of Portugal nor any other recognised authority in Portugal has pronounced as how such products should be accounted one would expect the bank to ensure that its board minutes formally evidence approval of the new accounting treatment to be adopted.

### **Confirmations and reconciliation procedures**

#### ***Recommendations:***

- 106 The board should issue formal written instructions obliging officials to prepare or secure in respect of its nostro/vostro accounts, regular reconciliations, for review and approval by independent officials. The instructions should clearly specify the officers and responsibilities attributed to each of them.
- 107 For group related companies the board should issue a formal instruction as part of its quarterly group reporting procedures requiring the debtor party to secure from the creditor party a confirmation of all intra-group accounts. The creditor party should be obliged to inform the debtor party of the date and nature of the major reconciling items and explain why they are outstanding at the period end.

#### ***Risks:***

- 108 Unauthorised, unusual or irregular transactions would pass undetected for long periods
- 109 Significant assets would be misclassified.
- 110 Revenues and costs may be incorrectly deferred.
- 111 The substance of transactions may be hidden.
- 112 Transfers may be instructed against non-existent balances resulting in penalty interest.
- 113 Counterparties form a poor image of the bank's control systems.
- 114 Duplicated accounting for the same transaction would not be detected

#### ***Discussion:***

- 115 As part of its internal control system, the bank has established procedures for identifying open transactions with counterparties in the normal course of its business. This benefits of this process are seriously prejudiced because there is no formal

procedure by which officials are obliged to prepare periodic reconciliations and to follow up unusual reconciling items. Clearly, open transactions initiated by the bank but not yet recorded in the bank's registers indicate system process problems and would require more urgent follow up than recent transactions not yet booked by a correspondent bank. Major outstanding transactions need to be followed up urgently if frauds or other reporting irregularities are to be detected on a timely basis. The recommendations apply irrespective of issues as to which department might be responsible for the account.

**Long-lived assets and other than temporary impairment**

***Recommendation:***

- 116 The board needs to define, for the financial and accounting services, a single set of criteria by which asset impairments, which are other than temporary, are to be determined.
- 117 For US purposes, the bank needs to issue to each major subsidiary instructions for the methodology to be used to evidence annually management's assessment of the recoverability of goodwill. The determination of impairment and related conclusions are the responsibility of each subsidiary board and should be evidenced and approved by the subsidiary board before submission to the parent for consolidation purposes. The main board of BES should approve the overall consolidation conclusions on whether any impairment requires accounting recognition for US reporting purposes.

***Risks:***

- 118 Required provisions for impairment may be omitted or recognised later than necessary with risk that filings may need to be restated with fines levied by regulators.

***Discussion:***

- 119 The Bank of Portugal defines the conditions which must exist for an assessment of impairment to be made and accounted. It does not specify any methodology for the determination. Meanwhile, the bank is also obliged for US reporting purposes to make an assessment of impairment not less than annually in accordance with methodologies which are clearly specified in formal pronouncements. In commercial terms, there is no difference in the objectives of these two requirements. Accordingly, it is not consistent with the bank's image for management to try to assert different provision needs for the same objective based solely on differences of prescriptive methodology.
- 120 Quarterly, the bank is obliged to consider the amount, if any, of provisions needed for impairments of long-term fixed assets/investments. In principle, such provisions

require to be set aside when management judges that an impairment in the estimated recoverable value of the asset is other than temporary. The process must be documented not less than six monthly.

- 121 The assessment must be made in relation to, amongst other items, any long-term investments which are not consolidated (e.g. investments in PT GROUP and IASA), any goodwill arising on consolidation for US purposes, and any other material intangible assets.

**Regulatory returns**

***Recommendation:***

- 122 The members of the board of directors should receive copies of the more important regulator returns submitted by the bank and by its principal subsidiaries to the regulatory authorities.

***Risks:***

- 123 The board members cannot protect the interest of shareholders if they are unable to fulfil their statutory responsibilities in relation to knowledge of the detailed information made available to the regulatory authorities.

***Comments:***

- 124 The returns are an important source of information for the board members and the knowledge of the board members is an important counter-check on the completeness and reliability of the returns themselves.
- 125 The nature and frequency of the returns to be made available for review and periodic approval should be determined by the board in conjunction with management but should include the large credit risk details.

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