



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

**Via e-mail**

Mr Arnold Schilder  
Chairman  
International Auditing and Assurance Standards Board  
529 Fifth Avenue, 6th Floor  
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United States

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**Exposure Drafts: Proposed International Standard on Quality Management (ISQM) 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements; Proposed ISQM 2, Engagement Quality Reviews; and proposed International Standard on Auditing (ISA) 220 (Revised), Quality Management for an Audit of Financial Statements (the exposure drafts).**

Dear Mr Schilder

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the IAASB's Quality Management exposure drafts. The Committee has a strong interest in promoting high-quality auditing and ethical standards for auditors and is supportive of the work of the IAASB to promote such standards.

Overall, we are supportive of the IAASB's initiatives to enhance quality management at the level of both the audit firm and the individual engagement.

Given our keen interest in the quality of banks' audits, we previously provided letters to the IAASB Invitation to Comment: Enhancing Audit Quality in the Public Interest - A Focus on Professional Skepticism, Quality Control and Group Audits in 2016<sup>1</sup> and to various ongoing projects, including International Standard on Quality Control 1 and ISA 220, in 2013<sup>2</sup>. We are pleased to note that several of our recommendations have been reflected in the exposure drafts. However, we believe the exposure drafts can be enhanced, including in relation to quality management at an audit firm network level and the scope of the Engagement Quality Review (EQR). This letter reiterates the comments we previously made and also includes the Committee's main comments on the consultation documents. Other comments are provided in the Annex to this letter.

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<sup>1</sup> [www.bis.org/bcbs/commentletters/ifac51.pdf](http://www.bis.org/bcbs/commentletters/ifac51.pdf)

<sup>2</sup> [www.bis.org/bcbs/commentletters/ifac45.pdf](http://www.bis.org/bcbs/commentletters/ifac45.pdf)

## Overall comments

The Committee is supportive of the IAASB's approach and, in particular, of the following features:

- That the “purpose of a system of quality management is to support the consistent performance of quality engagements” (Exposure Draft (ED)-ISQM1 paragraph 7)). The Committee notes that the International Forum of Independent Audit Regulators (IFIAR's) 2017 inspection findings report said that “the global networks must continue in their efforts to strengthen their systems of quality control and drive consistent execution of high quality audits throughout the world”. Consistent, high-quality audits are very much in the public interest, particularly for banks.
- The Committee supports a principles - and risk - based approach to quality management. Nevertheless, we encourage the IAASB to ensure that such an approach can be subject to effective oversight by audit regulators and that enforcement action can be taken if appropriate. For example, the level of assurance for the quality management system appears to be left to the professional judgements of the audit firm (see *ED-ISQM1: The firm's system of quality management and acceptable level of risk* below). This heightens the risk that the level of assurance provided is designed to a different risk tolerance than that of the audit firm's stakeholders, and it is unclear whether audit regulators would be able to require change in those circumstances. Additional guidance on the application of the audit firms' judgement would therefore be helpful in this regard.
- A focus on an audit firm's governance and leadership, including accountability and an objective recognising the audit firm's role in serving the public interest (ED-ISQM1 paragraph 23).
- Monitoring and remediation, requiring audit firms to establish policies to investigate and respond to the root causes of deficiencies (ED-ISQM1 paragraph 48).
- Strengthened requirements for the appointment and eligibility of EQ reviewers (ED-ISQM2 paragraphs 15-20).
- Recognising the importance of professional scepticism to audit quality.

## Quality management at an audit firm network level

We note that the proposals apply at the individual audit firm level and that compliance with the network requirements shall not contravene the requirements of ISQM1 for the audit firm (ED-ISQM1 paragraph 58). The IAASB states that the individual audit firm remains responsible for the audit and for its system of quality management. It added the requirement for an individual audit firm to understand and respond to the network requirements as a result of criticisms that audit firms place too much reliance on network requirements or services. It also expects the proposals to have some impact on the network as well as on individual audit firms within the network.

We are supportive of the IAASB's proposals to require the individual firms within the network to understand network requirements and services. We also understand the problems identified in paragraph 79 of the explanatory memorandum in applying requirements at the network level. However, audits of internationally active banks

are performed primarily by the largest networks of firms and, as the supervisors for these banks, we are very much interested in the quality management established at the network level and disseminated to member firms. The Committee believes that network firms should be expected to uniformly apply the requirements set forth in the auditing and ethical standards across the network and that the network systems and processes ensure that this is the case. In addition, the Committee's view is that the quality management systems and processes established at the network level should be within the scope of audit inspections to ensure that there is accountability for them. The Committee believes that this is an important public interest issue.

The Committee urges the IAASB to give further consideration as to whether requirements can realistically be imposed (and inspected) at the network level (including across network member audit firms). This would encourage consistent application and make the network accountable. The IAASB should also consider whether, if there are no legal obligations for the network, the firms in the same network, eg using the same brand, could be made collectively responsible for network requirements, services and resources. Regarding accountability, the IAASB should also clarify in ISQM1 that any network requirements, services and resources used by an individual audit firm are part of the individual audit firm's quality management processes and therefore within the scope of any inspections of the individual audit firm.

### **Component auditors**

The Committee would welcome further guidance on the application of the requirements to component auditors, as we find the current exposures drafts unclear. Additional material that sets out the interaction of the group and component auditor regarding quality management would also be helpful.

The firm responsible for the group engagement and the firm responsible for the component audit will each have their own quality risk management process. This is in the case, applying ED-ISQM1, the two firms are in the same network.

The Committee believes that the group auditor should be responsible for quality management in respect of the entire group audit, including any relevant component auditors. The exposure drafts do not appear to deal with this point, and no amendments are proposed to ISA 600<sup>3</sup> to specifically describe this situation. Moreover, parts of the text read as if there is a boundary between the group and component parts, such that the group auditor's responses to risks may not be implemented at the component level. Similarly, the engagement quality review may not extend into and sufficiently cover the risks in the component. The risk that the group auditor may not consider themselves responsible for quality management throughout the group audit seems heightened for group audit firms that are part of a network, where the group auditor may look to place reliance on the network's requirements regarding the quality management of the component auditor.

It is also unclear whether there is any requirement stating that the group auditor should have regard to the quality management processes of the component auditor and the risks to which the component auditor identifies and responds. These are very relevant considerations for the group auditor, both in relation to specific aspects

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<sup>3</sup> ISA 600 The Audit Of Group Financial Statements

of the group audit and as part of the assessment of the competence and capabilities of the component auditor.

### **Scope of the EQR**

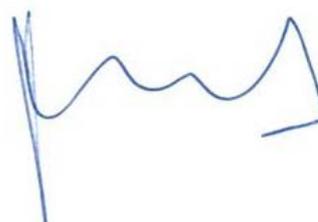
In our 2013 letter, we requested that banks be subject to an EQR, in line with the EQR requirement for audits of financial statements of listed entities. This has not been addressed in the ED-ISQM1.

The Committee notes that the IAASB has proposed strengthened requirements for audit firms to consider which entities should be subject to an EQR, but that it has not mandated that EQRs are carried out for the audits of internationally active banks. Rather, it is for the audit firm to determine the public interest entities that are within the scope of a review (ED-ISQM1 paragraph 37(e)(ii)). We note that the application material indicates public interest entities may include certain banks. We also note the IAASB's argument in section 3G of the covering memorandum as to why EQRs are not being proposed as mandatory for all public interest entities.

Nevertheless, the Committee remains of the view that internationally active banks should be subject to a mandatory EQR. It is in the public interest that internationally active banks are subject to high-quality audits, which includes an EQR. In addition, the application guidance should be strengthened by requiring consideration of economic importance, complexity, and activity in relation to whether other banks should be subject to EQR. Banks play a key role in the financial system and their audits are subject to particular risks and complexity.

We hope you find our comments constructive and helpful. This letter has been prepared by the Committee's Accounting Experts Group, chaired by Fernando Vargas Bahamonde, Associate Director General of the Bank of Spain. If you have any questions regarding these comments, please contact Mr Vargas (+34 913 38 61 04), Michael Gaull, chair of the Committee's Audit Subgroup (+44 20 3461 5781), or Masaya Hatoma at the Basel Committee Secretariat (+41 61 280 8577).

Yours sincerely



Pablo Hernández de Cos

# Annex

## Other matters raised in previous letters from the Committee

### *Communication of the results of the EQR to those charged with governance*

We believe that the results of the EQR should be communicated to those charged with governance at the audited entity. This is because the Committee believes that EQR results are an important piece of information that those charged with governance can use in order to assess the quality of the audit. The conforming amendments proposed to ISA 260<sup>4</sup> would seem to leave it to the auditor to determine whether to communicate to those charged with governance.

### *Pre-issuance technical reviews of banks' financial statements*

We note that some audit firms perform pre-issuance technical reviews of banks' financial statements. Given banks' central role in contributing to financial stability and providing financial resources to the economy, we believe that all bank audits should be subject to a pre-issuance technical review. Paragraphs 36 and 37 of ED-ISQM 1 could be enhanced by including an additional requirement in this respect.

## Other matters in relation to the current consultation

### *ED-ISQM 1: culture*

The draft standard applies to audit firms performing audits or reviews of the financial statements or other assurance or related services (paragraph 4). "Audit firms" are often multi-disciplinary firms, where ISQM 1 services form a minority of the total fees and where partners who are not auditors may be leaders.

It would seem relevant when looking at aspects of culture and leadership, for example, to consider how the culture in relation to audit services might be impacted by the culture of the firm as a whole, and how that might be addressed. There is no guidance for these circumstances.

### *ED-ISQM1: the firm's system of quality management and acceptable level of risk*

ED-ISQM1 paragraph A3 explains reasonable assurance is obtained when the firm's system of quality management reduces risk to an acceptably low level. It is not clear who decides what is an acceptably low level or on what basis the decision is made.

The Committee believes that the audit firm should consider its stakeholders when making this assessment. We think the ED could be strengthened by clarifying that the acceptable low level of risk should be determined by the audit firm having regard to the public interest and the interests of the various stakeholders in the firm and, in particular, of audit, securities and financial services regulators.

### *ED-ISQM 1: governance and leadership*

Paragraph 24(b) requires the firm to establish policies and procedures for the periodic performance of individuals. It does not set out minimum requirements that should be included in those policies and procedures. Paragraph A40 indicates the policies and procedures may

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<sup>4</sup> ISA 260 Communication with those charged with governance.

include the results of monitoring activities and the action taken by individuals in response to identified deficiencies relating to the responsibility of that individual.

We believe the matters in paragraph A40 should be elevated to be requirements in the standard, as they are necessary to promote audit quality, and so should be included in paragraph 24(b).

#### *ED-ISQM 1: identifying quality risks*

The quality risks the firm identifies are those that have a reasonable probability of occurring (paragraph 28), which means when the likelihood is more than remote (paragraph A55).

We believe the standard could be strengthened by also requiring a consideration of those quality risks that might be remote, but nevertheless the impact, if they were to occur, could be highly significant. This is not to suggest that the firm should design a response. But we believe the audit firm should be required to consider whether it needs to design a response.

#### *ED-ISQM 2: limitations on the EQ reviewer*

The EQ reviewer cannot previously have been the audit's engagement partner (paragraph 16). However, there appears to be no explicit prohibition where the reviewer served in some other capacity on the engagement team; nor is there a similar limitation on other persons assisting with the EQR but who are not the EQ reviewer. As a result, the following two scenarios seem possible, and although paragraphs 16 and 17 may lead to them not being compliant with ED-ISMQ 2, the Committee would like the IAASB to clarify whether such scenarios would be prohibited:

- An EQ reviewer may have previously occupied a senior role in the audit team despite not being the engagement partner (eg in developing the strategy or playing a significant role in supporting the engagement partner's judgements), such that their objectivity could be seen to be threatened in a similar way to that of the partner.
- A person assisting but not leading the EQR may have previously been the engagement partner.

#### *ED-ISQM2: nature of the EQ reviewer*

The EQ reviewer is required to understand the engagement and discuss significant matters with the engagement partner. They are then required to identify areas involving significant judgements.

We believe it would be beneficial to clarify that the EQ reviewer has to form their own view of what are significant judgements – ie they are not only assessing those judgements that have been determined to be significant by the audit team. The EQ reviewer should be assessing all judgements that, in their view, are significant.

#### *ED-ISA220: audit delivery models (ADMs)*

We are supportive of the IAASB's objective to modernise ISA 220 for an evolving environment, including changes in ADMs. As the expression ADM is intended to cover terms such as "firm shared service centers", "centers of excellence", "on-shoring", "offshoring" or "outsourcing", the approaches to oversight of these evolving models can vary significantly across firms.

Concerns have been expressed about the quality control in relation to ADMs, in particular about how an engagement partner addresses requirements for retaining responsibility for the direction, supervision, performance and review of the works performed by ADMs.

The approach of ED-220 is to define ADMs as a part of the engagement team (paragraph 10(d)). We understand that the IAASB wants to maintain the flexibility of the standard as the nature and extent of use of ADMs will change, but we are not convinced that this response will help to eliminate the concerns identified. We believe that more clarification around this issue is needed, in particular the need for policies and procedures to safeguard against the inappropriate use of ADMs.

We would also recommend an initiative for more transparency around the use of ADMs. The concerns about quality expressed by stakeholders might result from the fact that for many users of financial statements, the use of ADMs is obscure and non-transparent.

*ED-ISA220: professional skepticism*

The application material (paragraphs A27-A29) in the standard is helpful in setting out examples of impediments, biases and actions in regard to professional skepticism. We believe it could be strengthened by adding the following examples:

- Budget constraints may discourage the use of sufficiently experienced or technically qualified resources (including specialists). This may be particularly relevant for audits of entities such as banks, where there is a need for the audit team to have, or access, sufficient technical and specialist skills, to ensure effective understanding, assessment of and responses to risks and challenge (relevant to paragraph A27).
- Familiarity and/or trust are additional biases that can be common. These can arise in relation to the staff and processes at the audited entity, but also in respect of prior year audit papers and procedures. As a result, there may be insufficient challenges or considerations of potential risks (relevant to paragraph A28).