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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

By email: baselcommittee@bis.org

CONSULTATIVE DOCUMENT: *EXTERNAL AUDITS OF BANKS*

Dear Sir/Madam:

The International Federation of Accountants (IFAC) welcomes the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) consultative document, *External audit of banks* (the Document). Through its current membership of 173 professional accountancy bodies in 129 countries and jurisdictions, IFAC represents approximately 2.5 million accountants in public practice, industry and commerce, government, and education.

General Comments

IFAC recognizes the importance of high-quality auditing and acts to promote and enhance audit quality around the globe. This includes supporting the development, adoption, and implementation of high-quality, internationally accepted auditing and quality control standards; promoting the need for global regulatory convergence; and supporting the development of strong professional accountancy organizations and accountancy firms.

IFAC considers that the statement in paragraph one of the Document "*the recent financial crisis...highlighted the need to improve the quality of external audits of banks*" might be open to misinterpretation and misunderstanding, especially without describing and discussing the context within which such comment is made.

Several matters are pertinent to a discussion of audit quality with respect to external audits of banks.

(i) **Audit Quality—A Holistic View**. Recognizing that while the primary responsibility for performing quality audits rests with auditors, audit quality is best achieved in an environment where there is support from other participants in the financial reporting supply chain. Therefore, a holistic view of audit quality should be considered to determine the best means by which measures can be taken to improve it.

(ii) **Quality of Information**. Recognizing that the quality of information being reported by banks, and which is of critical interest to banking supervisory authorities, is a function of several factors besides the quality of the external audit, and includes the robustness of the reporting framework and the competence of those preparing the information.

(iii) **Expectations of Banking Supervisory Authorities**. The expectations of banking supervisory authorities and the best means by which to have those expectations met, including the role played by the external audit.

(iv) **Financial Reporting and Banking Supervision**. The different objectives of: a) financial reporting and the preparation of financial statements, and an audit thereof; and b) banking supervision reporting requirements and the extent to which an audit of financial statements assists in addressing these requirements.

(i) Audit Quality—A Holistic View

The Document notes that it aims to describe supervisory expectations regarding audit quality and how it relates to the external auditor's work in conducting an audit of a bank. However, any paper that aims to discuss ways in which audit quality can be improved must cover matters that extend well beyond what it is that the external auditor does, or is responsible for. It is a much broader concept than *"delivering an appropriate, independent professional opinion on the financial statements, in compliance with internationally accepted auditing standards"* (paragraph 15 of the Document).

In this regard, IFAC is encouraged that the BCBS has included references to the role and responsibilities of audit committees and regulators in the Document, as well the importance of key interactions between stakeholders, such as the external auditor and the audit committee. IFAC considers it important that the BCBS has chosen to include principles in the Document that are specifically directed toward the audit committee.

However, IFAC believes that the key factors impacting audit quality that go beyond the role and responsibilities of the external auditor could be discussed in more detail in a paper of this kind. For example, there are ways in which banking supervisory authorities can assist in enhancing audit quality, which may be considered for inclusion in this Document (see (iii) Expectations of Banking Supervisory Authorities).

To restrict the discussion to what is expected of the external auditor misses the opportunity to recognize that a more holistic approach to audit quality needs to be considered if real gains are to be made towards its enhancement. With this in mind, IFAC refers the BCBS to the recent Consultation Paper issued by the International Audit and Assurance Standards Board (IAASB). *A Framework for Audit Quality* describes the input and output factors that contribute to audit quality at the engagement, audit firm, and national levels. In addition it demonstrates the importance of appropriate interactions among stakeholders and the importance of various contextual factors, such as the applicable financial reporting framework, corporate governance arrangements, and broader cultural factors within the jurisdiction.

IFAC suggests that the BCBS might consider incorporating a fuller discussion of this range of factors in its Document. This might be done in the introductory paragraphs, as a way of providing greater context to the material that follows, and then in various sections as appropriate.

(ii) Quality of Information

In paragraphs five and six of the Document reference is made to the “complementary concerns” shared by the banking supervisory authorities and external auditors regarding the same matters, such as internal controls relating to financial reporting. While IFAC does not disagree with this comment, it stresses the point that the quality of the information provided in financial statements is a function of many factors that extend beyond the robustness and effectiveness of internal control arrangements and involve more that the audit. For example, the expertise and competence of financial preparers, senior management, and those charged with governance, including an audit committee, are important considerations.

The BCBS notes “supervisors have a keen interest in the quality with which external auditors perform bank audits.” This is a significant point. However, IFAC notes that an audit aims to enhance the credibility of information provided by others (in this case, those charged with governance of the bank that is being audited) and that an audit, and auditor’s report, in and of itself does not have meaning when considered separately from the information being audited. High-quality financial information is developed in a financial reporting supply chain with many critical and inter-related components, only one of which is the external audit.

Therefore, IFAC considers it important for banking supervisory authorities to consider the manner in which they, as supervisors, might impact the quality of the information provided—and in turn the quality of the audit. For example, impacts are registered through supervisory requirements pertaining to the competence and skills of those involved in the financial statement preparation (e.g., within a bank’s finance department, on an audit committee), the communication and relationship between supervisors and banks, and banks’ governance arrangements.

Finally, while the banking supervisory authorities and external auditors may have concerns that could be considered complementary, it is clear that the objectives of financial reporting and banking (prudential) supervision are not identical and this distinction must always be kept in mind (see (iv) Financial Reporting and Banking Supervision).

(iii) Expectations of Banking Supervisory Authorities

Paragraph two of the Document lists the supervisory expectations of others, but does not detail what banking supervisory authorities might do to promote and enhance audit quality, other than to have an effective relationship with the external auditor and regular and effective dialogue with relevant audit oversight bodies.

However, IFAC believes that banking supervisory authorities can play a more significant role in promoting audit quality by:

- being more explicit about the information they expect auditors to assess and on which they expect them to communicate;
- recognizing that some of what they expect goes well beyond what is part of an audit of financial statements; and

- striving to create globally consistent arrangements related to the first two points.

Principle 12 of the Document, which is described in paragraphs 144-163, highlights a range of matters that banking supervisory authorities believe are important for an effective relationship with external auditors. For such a relationship to be truly effective it is important that the nature of the dialogue between the two parties be based on a balanced two-way process, respecting the roles of both the supervisory authorities and the external auditors. Any obligations imposed on both parties to communicate with each other should reflect such a balanced two-way process.

A number of the matters described in this section of the Document relate to an important ethical principle for all professional accountants, including auditors' confidentiality. IFAC is encouraged to note that the BCBS recognizes the need for safe harbors to be available to auditors (see paragraphs 160 and 161 in the Document) when there are expectations that they should breach this fundamental ethical principle. IFAC believes this is a key area where the BCBS should be ensuring there is global consistency and that all banking supervisory authorities are ensuring governments in their jurisdictions have appropriate safe harbor arrangements in place.

Paragraph 155 of the Document states that, "the contents of the external auditor's communication could cover all issues that the supervisor might consider relevant in carrying out its functions." As written, it implies that an external auditor is able to predict, foresee, and anticipate in advance the views and perspectives of a supervisor. Clearly, it is impractical to envisage that an external auditor should be able to know what a supervisor might consider relevant and might wish to know about, especially if the supervisor is not explicit about the work expected. The assumption in this section of the Document is that an auditor must second guess the supervisor, and then risk being reprimanded in hindsight for guessing incorrectly.

A fundamental element of an assurance engagement, which includes an engagement for an audit of financial statements, is the need for suitable criteria against which assurance can be provided. Such criteria should be relevant, complete, reliable, neutral, and understandable.[1] With this in mind, IFAC notes that the discussion in paragraphs 144-159 of the Document is not explicit about what criteria the BCBS expects the auditor to assess and examine. While some examples are provided, it is incumbent on the BCBS and banking supervisory authorities to be more explicit about reporting required by banks and the role expected of auditors.

Additionally, in the Document the BCBS recognizes that it expects the external auditor to address matters "outside the scope of" the audit. It also highlights the need for an effective relationship between the external auditor and the banking supervisory authority. IFAC believes it is critical for the BCBS to consider and explain how the expectation of addressing matters outside the scope of an audit and the relationship issue can effectively be achieved:

- given the role and responsibilities of an external auditor engaged to perform an audit of a bank's financial statements, by whom he/she is engaged, and to whom he/she is accountable; and

[1] Refer to the *International Framework for Assurance Engagements* from the International Audit and Assurance Standards Board.

- without having explicitly defined suitable criteria against which assurance might be provided (see preceding paragraph).

Global Consistency

As the ongoing global financial and sovereign crises have demonstrated, the economies of countries around the globe are very much interconnected. Major events in one or more jurisdictions can have tremendous impacts in other jurisdictions. Regulatory responses to issues arising from the crises recognize the existence of globally significant financial institutions. Therefore, it is imperative that global solutions are predicated on globally consistent standards, requirements, and supervisory arrangements.

IFAC believes it is incumbent on the BCBS and at the very least, G-20 countries to strive for and implement consistency in banking supervisory arrangements.

In the Document the BCBS notes that there are differences in supervisory requirements and techniques. For example, the BCBS recognizes that there may be differences in the requirements of a “home jurisdiction” and an “overseas regulatory authority.” IFAC believes it is important to recognize the extent to which these differences might have an impact on the quality of bank audits.

(iv) Financial Reporting and Banking Supervision

The primary objective of financial statements prepared in accordance with an internationally accepted financial reporting framework and standards (e.g., in accordance with International Financial Reporting Standards) is the provision of decision-useful information for investors, and potential investors, in capital markets. The Document notes that banking supervisory authorities are “primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks” (see paragraph five).

This distinction is important. It means that the financial information reported by banks in financial statements is not purporting to meet overarching supervisory ideals. IFAC observes that this has led to some confusion, and much debate in some countries, about the suitability of financial reporting standards for supervisory purposes.

Likewise, an auditor who is enhancing the credibility of the information presented in financial statements is not explicitly undertaking an audit with banking supervisory requirements in mind, except where they are specifically detailed and mandated. Banking supervisory authorities need to remain cognizant of this fact when assessing audit quality and before making assertions with respect to audit quality. This is particularly important when considering the relationship between the banking supervisory authority and the external auditor, as well as the expectation that an external auditor will report matters of significance to the supervisory authority.

IFAC believes it is important for the BCBS to ensure that banking supervisory authorities understand this point and do not rely unduly on the information in audited financial statements to achieve supervisory objectives. Additional supervisory reporting and assurance requirements are typically very important components of robust prudential supervisory arrangements, and can most effectively be developed through open, timely and regular communication with audit firms and the profession (refer Open, Timely, and Regular Communication).

Engagement between the Banking Supervisory Authority and the Audit Oversight Body

IFAC welcomes the notion of greater engagement between the banking supervisory authority and the audit oversight body. However, consistent with the discussion in the preceding paragraphs, it is important for there to be clarity about objectives of, and differences between, the two parties in order to minimize misinterpretations and misunderstanding. For example, usually an audit oversight body will administer an inspection program utilizing a risk-based approach, which aims to focus on those audits that are perceived to have the highest potential concerns. Furthermore, inspections are typically spread across a broad range of industry sectors, and do not solely focus on audits in the banking sector. Therefore, the specific applicability of the outcomes of the audit oversight body's inspection program to audits of banks will need to be assessed with this in mind.

Open, Timely, and Regular Communication

IFAC supports the view of the BCBS that there should be open, timely, and regular communication between the banking supervisory authority, the audit firm, and the accountancy profession as a whole on key risks and systemic issues. IFAC recognizes that such communication is important at various levels: internationally, nationally, and regionally, where appropriate. This means that while communication between the banking supervisory authority, the audit firm, and the accountancy profession at the national level is crucial, there is, of course, important dialogue that needs to take place at an international level between the three equivalent types of organizations—namely the BCBS, the global networks, and IFAC.

Wording in the Document

IFAC notes that words such as "should" and "must" are used throughout the Document to describe what is expected of external auditors. Use of these imperatives implies that requirements are being placed on the external auditor beyond those described in International Standards on Auditing (ISAs). Potentially, this may lead to some uncertainty and confusion on the part of external auditors, banking supervisory authorities, and audit oversight bodies about the requirements with which auditors need to comply in conducting an audit. Additionally, the use of imperatives in the circumstances indicated in the Document may not appropriately take into account the specific circumstances of the audit. IFAC believes that the BCBS should clarify its intention for the Document and consider whether the purpose of the Document is reflected by the use of these words.

Please do not hesitate to contact us should you wish to discuss any of the matters raised in this letter, or require any further information.

Sincerely,

Fayezul Choudhury
Chief Executive Officer