Basel Committee
on Banking Supervision

External audit quality and banking supervision

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Executive summary

In recent years, there has been a change in banking supervisors' reliance on audited information and in the nature of the major external audit firms. Concerns about the risk of audit failures, the global expansion of the major audit firms, increased complexity of both accounting standards and financial instruments, and the challenges associated with fair value estimation processes, which have been amplified by the current market crisis, have reinforced bank supervisors' need to be confident of audit quality. This paper describes the Basel Committee on Banking Supervision's (the Committee) understanding of these circumstances and steps it intends to take regarding key findings.

The current market turmoil and demand for increased transparency suggests that reliable, clear financial information supported by quality audits are key elements in enhancing market confidence. Thus, continued involvement by the Committee to promote audit quality is warranted.

This paper summarises four key areas of the Committee's focus, including:

- Bankers' and supervisors' reliance on external auditors' expertise and judgments has increased
- High-quality audits enhance market confidence, particularly in times of severe market stress
- Most of the world's banking assets are audited, and supervisors are increasingly reliant on high-quality bank audits to complement supervisory processes
- Major external audit firms have globalised and, as a result, their structures are complex and governance within the firms lacks transparency

Building upon its ongoing efforts, the Committee intends to address these areas of focus. Actions include engaging with stakeholders who directly influence audit quality, promoting enhancement of sound audit guidance and practices and promoting clarity in international accounting and auditing standards. More detail regarding these actions is included at the end of the paper.

External audit quality and banking supervision

The need for bank supervisors to be confident of audit quality remains one of the keys to effective banking supervision; therefore, continued involvement by the Committee to support audit quality is warranted. Concerns about the risk of audit failures and a need for greater transparency surrounding the large globally active audit firms' overall governance and financial positions have prompted the Committee to evaluate its current involvement in efforts that support audit quality. Furthermore, in recent years, banking supervisors have come to rely more heavily upon the work of external auditors. At the same time, banking products and the accounting standards that define these products' recognition, measurement and associated revenue recognition have become more complex. The current market turmoil has further challenged external auditors' abilities to interpret these standards during the course of their audits. Furthermore, the Committee's involvement in audit quality also serves to respond to concerns raised by the Financial Stability Forum (FSF) about quality controls in place within global accounting firms and the concentration of audit services for large companies at the four largest audit firms.[1]

The objective of this paper is to describe the areas related to audits of banks that deserve the Committee's focus and the steps it intends to take regarding these areas.

Background

Audit quality, from the perspective of the audit profession, is about delivering an appropriate, independent professional opinion on financial statements that is supported by the necessary evidence and objective judgments. To achieve this objective, the auditor must comply not only with audit requirements but also with ethical requirements to ensure integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. [2]

Bank management has primary responsibility for the preparation and quality of financial statements and reports, valuations and risk disclosures and for the effectiveness of related internal controls. At the same time, sound audits provide a number of benefits to institutions, financial systems and supervisors. External audits performed in accordance with high-quality globally accepted audit and ethics standards are critical to the appropriate implementation of accounting standards. They help ensure that financial statements and reports are reliable, transparent and useful to the marketplace. This enhances market confidence and improves the quality of information relied on by banking supervisors. Sound audits may help to identify

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[1] See the FSF's Press Release issued on 6 September 2006. The FSF brings together senior representatives of national financial authorities (eg central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank.

[2] Currently, no tool exists to measure audit quality, but there are recent efforts to evaluate how to measure audit quality. For example, the International Forum of Independent Audit Regulators is evaluating this issue and the UK Financial Reporting Council (FRC) believes that the most appropriate approach is to define the key factors, called drivers, that determine whether a quality audit is undertaken and assess the way in which audit firms and individual audit teams perform against them. The drivers include: 1) the culture within the audit firm, 2) the skills and personal qualities of audit partners and staff, 3) the effectiveness of the audit process, 4) the reliability and usefulness of audit reporting and 5) some factors outside of the controls of the auditors. A copy of the FRC's February 2008 publication, *The Audit Quality Framework,* can be found at the following link: www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web.pdf

weaknesses in internal controls relating to financial reporting and risk management at banks and reinforce corrective measures, thus complementing supervisory efforts in contributing to safe and sound banking systems. Generally, auditors are not required to perform procedures solely for the purpose of identifying internal control deficiencies during a financial statement audit.[3]

In the past, the Committee has been involved with reforms in the international audit community.[4] The Committee also plays a continuing role in efforts to improve international auditing. For a graphic presentation of the Committee's involvement in bodies directly involved with audit quality, see the appendix.

The Committee participates on the Monitoring Group, a group of key international regulatory bodies and international organisations that have a responsibility to protect and advance the public interest and are committed to strongly supporting the development of high-quality international auditing and assurance standards and related high-quality implementation practices by the international auditing profession.[5] The Committee is also involved in the proceedings of the Public Interest Oversight Board (PIOB), whose objective is to increase the confidence of investors and others that the activities of the international audit and ethics standards setters serve the public interest.[6]

To more directly participate in audit and ethics standard setting, the Committee is an active member of the International Federation of Accountants' (IFAC's) International Auditing and Assurance Standards Board's Consultative Advisory Group (IAASB's CAG)[7] and IFAC's International Ethics Standards Board for Accountants' Consultative Advisory Group (IESBA's CAG).[8]

The Committee participates in the proceedings of the International Forum of Independent Audit Regulators (IFIAR), a forum for national audit oversight authorities to share knowledge of the audit market environment and practical experience of independent audit regulatory activity, promote collaboration in regulatory activity and provide a focus for contacts with other international organisations that have an interest in audit quality.[9]

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3 In some jurisdictions, auditors are required to express a separate opinion on the entity's internal control over financial reporting.

4 In November 2003, the Council of the International Federation of Accountants (IFAC) approved reforms designed to increase confidence that its activities are properly responsive to the public interest and would lead to the establishment of high-quality standards and practices in auditing and assurance. The Committee, by encouraging this process and participating on the Monitoring Group and, ultimately, on the Public Interest Oversight Board, has helped to facilitate these reforms.

5 For additional information about the Monitoring Group see www.ifac.org.

6 For additional information about the PIOB visit www.ipiob.org.

7 For additional information about IAASB's CAG visit www.ifac.org/IAASB/ConsultativeAdvisoryGroup.php

8 For additional information about IESBA's CAG visit www.ifac.org/Ethics/ConsultativeAdvisoryGroup.php

9 For additional information about IFIAR visit www.ifiar.org

Key areas of interest to bank supervisors

1. Bankers' and supervisors' reliance on external auditors' expertise and judgments has increased

Management is responsible for the preparation and presentation of the financial statements and external auditors are responsible for expressing an opinion on the financial statements. Auditors and bankers exchange views at various points in the financial statement audit process and in various ways on such matters as changes to the bankers' assumptions related to estimates (eg fair values[10] and loan loss provisions), recognition of day-one gains, consolidation/derecognition/re-recognition of assets and disclosure content. Bankers and supervisors can benefit from the ability to rely upon the broad experience of the auditors. However, complexity of accounting standards themselves, extensive complex judgments in applying standards and a lack of specificity in auditing standards can affect audit quality.

Implementation of principles-based accounting standards and increased complexity of rules-based accounting standards have amplified reliance on auditor expertise and judgments and intensified auditor evaluation of management judgments.

Principles-based accounting standards focus on the substance of transactions and presume that similar transactions will be accounted for in a manner that is consistent with the accounting standard and consistent across firms. Since principles-based standards consist of broad concepts rather than detailed rules, increased professional judgment is needed for both management's implementation and auditors' interpretations of the standards. The reliance on auditor judgment will likely increase, as the international accounting standard setters have voiced a preference for greater adoption of principles-based standards.

Some countries rely upon rules-based accounting standards with guidance emanating from numerous pronouncements and sources. Auditors in these countries employ significant expertise and judgment to determine which of these various sources are most relevant and authoritative in auditing financial statements and disclosures.

Financial instruments and banking transactions are becoming increasingly complex, which poses challenges to auditors.

The Committee has observed that the creation of and investments in complex financial instruments has increased in recent years. Furthermore, there can be a large amount of uncertainty surrounding model-determined values of some complex instruments. This uncertainty can be exacerbated by: 1) the lack of industry consensus on how to model these values (eg exotic derivatives and synthetic collateralised debt obligations (CDOs) with asset-backed underlyings), 2) lack of observable input parameters (eg correlations in structured credit products and equity derivatives), 3) insufficient data histories (eg new products, new issues of asset-backed securities/mortgage-backed securities) and 4) non-traded or illiquid products (eg private equity, distressed debt and some corporate bonds).

[10] Some external audit firms have their own models, the outputs of which are used, at a minimum, to consider the reasonableness of the outputs of bank models.

Audit quality specific to bank accounting is influenced by the quality and complexity of accounting standards.

While many areas of financial reporting require significant judgments (ie by management when implementing the standards and auditors when interpreting the standards during the audit process), at least four areas are of particular importance to banking supervisors. These areas include: 1) loan loss provisioning and recognition of other impairments, 2) consolidation of and other involvements with off-balance sheet vehicles, 3) fair value estimates and related imprecision (eg illiquid or complex financial instruments) and 4) disclosures (eg valuation methodologies and exposure to risk).

Auditing and ethics standards are written for a broad range of audited companies and do not always include requirements that are specific to banking. This increases reliance on auditors' specialised expertise and emphasises the importance of the Committee's input into the audit standard setting process.

Committee representatives have assisted auditing and ethics standard setters in gaining a deeper understanding of banking industry specific issues that should be considered when developing standards and guidance. The Committee has provided well-received feedback to standard setters on proposals addressing auditing accounting estimates, including estimates of fair values,[11] communication concerning related parties of the audit client and independence rules for auditors who provide, on a concomitant basis, internal and external audit services.

2. High-quality audits enhance market confidence, particularly in times of severe market stress

External audits performed in accordance with high-quality auditing and ethics standards are an important element of enhancing market confidence. This is particularly the case with respect to valuations of financial instruments, including disclosures about the valuation methodologies, and the extent of off-balance sheet risks to which banks are exposed. The current market turmoil has shown the fundamental role that external auditors play in shaping financial reporting practice.

The market turmoil revealed valuation challenges in the audit of illiquid and/or complex financial instruments.

When liquidity evaporated in the financial markets for certain financial instruments, banks faced increasing challenges in valuing these instruments because sufficient or reliable market data were no longer available. The complexity of many of these financial products was not well understood by market participants, and the risks associated with these products were severely underestimated. Some banks responded by switching from valuation methods based on market data to methods based on models and internal inputs (often without the necessary historical data).

Audit firms have indicated that these circumstances placed extensive demands on auditors' ability to check the robustness of managements' processes for determining fair value estimates (notably for less liquid or illiquid financial products) and on auditors' use of

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[11] The Committee is participating on an IAASB-sponsored task force that has developed guidance on audits of fair value estimates: IAASB Audit Alert, which can be found at: web.ifac.org/download/Staff_Audit_Practice_Alert.pdf

professional judgment in evaluating key assumptions and inputs that bank management used in their valuations.

A perceived lack of transparent financial information from banks and across the financial system as a whole was a major factor of the current market crisis. It also has the potential to widen the expectations gap[12] for audits.

Investor confidence has been undermined by the lack of transparency in banks' valuation methodologies and risk exposures (eg credit, market and liquidity risks), particularly those related to structured products and off-balance sheet vehicles. Auditors played an important role in encouraging consistent and meaningful disclosures about valuation processes and the extent of off-balance sheet risks faced by banks, as enhanced transparency should increase market confidence. However, in many jurisdictions, enhanced disclosure standards were recently adopted and, without prior experience, auditors were challenged to determine how to audit the new disclosures. Additionally, the market stress revealed that disclosure standards should be further strengthened.[13]

Audit firms have mentioned that during times of severe market stress the expectations gap widens, which can further erode market confidence. For example, audit firms may appropriately provide a clean (ie unqualified) audit opinion on a bank's financial statements and in the next reporting period the bank could suffer additional losses due to further declines in the value of fair valued assets. Some market participants may believe that all potential losses should have been recognised in the initial reporting period so that no future impairment losses would need to be recognised.

Bank actions regarding off-balance sheet vehicles raised questions about existing guidance related to consolidation accounting. In addition, banks' treatment of such changes to the balance sheet may diminish market confidence in the audit process with regard to consolidation.

Market conditions and reputational risks led some banks to provide liquidity support and other credit enhancements to off-balance sheet vehicles. Existing accounting standards do not provide clear guidance for consolidation, de-recognition and re-consolidation of off-balance sheet vehicles, leading to inconsistent accounting practices and thus further eroding market confidence. Additionally, divergent international and US accounting standards in this area may confuse market participants, create potential competitive disadvantages and raise auditing challenges.[14]

When banks consolidate vehicles in response to stressed market conditions, market participants might perceive that the auditors inappropriately supported the original de-recognition or nonconsolidation, potentially diminishing market confidence.

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[12] The expectations gap refers to the gap between an auditor's required standard of performance during a financial statement audit and public expectations of the auditor's performance during the audit. Some examples include the mistaken expectations that: 1) auditors should accept primary responsibility for the financial statements, 2) a *clean* or unqualified opinion <u>guarantees</u> the accuracy of financial statements, 3) auditors check all transactions, 4) auditors must provide early warnings about the possibility of business failure and 5) auditors have a responsibility to detect all fraud.

[13] The Committee participated on an Expert Panel sponsored by the International Accounting Standards Board (IASB) that developed valuation and disclosure guidance for valuations in illiquid markets. The IASB staff released the guidance, which can be found at www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf

[14] In September 2008, the IASB and the US accounting standard-setter published an updated Memorandum of Understanding that establishes a goal of completing joint projects on major topics by 2011.

3. Most of the world’s banking assets are audited, and supervisors are increasingly reliant on high-quality audits to complement supervisory processes

Supervisors rely upon financial information to evaluate the condition of banks and to determine sufficiency of regulatory capital. Accurate and reliable valuation of a bank’s loans, securities and other assets has a direct bearing on the determination of regulatory capital. Supervisors expect management to have sound processes in place to properly value assets and can potentially place greater reliance on valuations contained in financial statements that have been subject to external audit. The increased use of fair value heightens the importance of reliable valuations and the audits of these values. The components of regulatory capital are reported in the financial statements and serve as the foundation for determining regulatory capital. Bank supervisors rely on the reported amounts of these components and their attributes (eg degree of subordination), which are audited in large internationally-active banks.

As most of the world’s banking assets are audited, high-quality audits contribute to a sound banking system and financial stability.

High-quality, internationally accepted audit and ethics standards and a robust audit oversight function are imperative in developing and maintaining sound external audit processes. The Committee’s past contributions to develop sound audit and ethics standards and support enhanced audit oversight serve to advance the achievement of these goals.

Auditors can provide an early warning on issues of supervisory concern.

There are many circumstances in which external auditors become aware of important information that may be relevant to, or may require urgent action by the supervisor. In many countries, it is expected or required that these circumstances should be reported on a timely basis to the supervisory authorities. These actions are consistent with guidance issued by the Committee.[15]

Audited financial information is among the sources of information used in the risk-focused supervision process, which contributes to increased efficiency in banking supervision.

To varying degrees, bank supervisors may reduce some on-site or off-site supervision tasks by relying upon audit work performed by the external auditors.[16] High-quality audits complement supervisory processes and increase supervisory efficiency. Thus, high-quality audits are of increasing importance, particularly with broader global acceptance of risk-focused supervision techniques.

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[15] Clear requirements concerning the auditor's communication to banking supervisors are already established in many countries either by law, by supervisory agreement or by formal agreement or protocol. This is of mutual interest for both auditors and banking supervisors and is consistent with the Committee’s Core Principles for Banking Supervision, Core Principles Methodology (issued in October 2006), Principle 21, Essential criterion 11, which states “The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.”

[16] There may be circumstances where bank supervisors will limit the extent of their reliance on audited information (eg areas audited but not to the extent that the supervisor deems sufficient for supervisory purposes).

4. Major external audit firms have globalised and, as a result, their structures are complex and governance within the firms lacks transparency

The largest internationally active accounting firms have a global presence but most are currently not managed globally. While the head office or global leadership can influence member firms in different countries (ie predominantly through moral suasion backed-up with a threat of dropping the firm relationship), they do not commonly have direct authority over them. The structure of global network firms is influenced by national regulation and legislation relevant to audit firms.[17] However, the firms stress the importance of having a strong *tone at the top* and state that they have robust commitments to audit quality. For example, recently, audit firm partner remuneration has reportedly become more closely aligned with audit quality.

Transparency is lacking about global network firm corporate governance and their world-wide financial positions.

The large globally active firms do not provide sufficient public information about how the firms are managed on a global basis, how audit quality is assured at the global level, or about their world-wide overall financial condition and profitability.

Consistent interpretation of accounting, auditing and ethics standards within a global firm poses challenges.

Consistent interpretation of accounting standards is challenging because there may be influence by national accounting traditions or weak communication within a global firm. Firms attempt to resolve these challenges through centralised knowledge bases, enhanced communication networks and training programs.

Consistent interpretation of auditing and ethics standards can be challenging when firms are not managed on a global basis, particularly when a firm does not have firm-wide quality control policies or programs. Audit quality on a national level can also present challenges; however, firms attempt to mitigate these challenges. For example, smaller local offices may have to go through an approval process before being allowed to accept an audit in a specialised field. Additionally, before allowing some smaller offices to accept an engagement with a "one-off" client in a specialised field, they may be required to have specialised training, join forces with a more experienced office, or have audit processes reviewed by more seasoned partners from other offices.

Next steps

The Committee intends to engage in the following actions, which should serve to address areas of focus described above:

- Enhance promotion of sound auditing guidance and practices in areas of specific interest to banking supervisors, notably through an *increased* focus on:
    - auditing fair value estimates derived through models,

[17] Suggestions for enhancing governance in the network firms are being evaluated by some national authorities (eg appointing outside directors to the audit firms).

- auditing disclosures (eg risks, fair value estimates and methodologies and uncertainty surrounding estimates),
- auditing loan-loss provisions, day-one gain recognition and own credit risk adjustments reflected in fair value estimates,
- auditing consolidation of and other involvement with off-balance sheet vehicles and
- auditors' responsibilities related to internal controls over fair value and other accounting estimates.

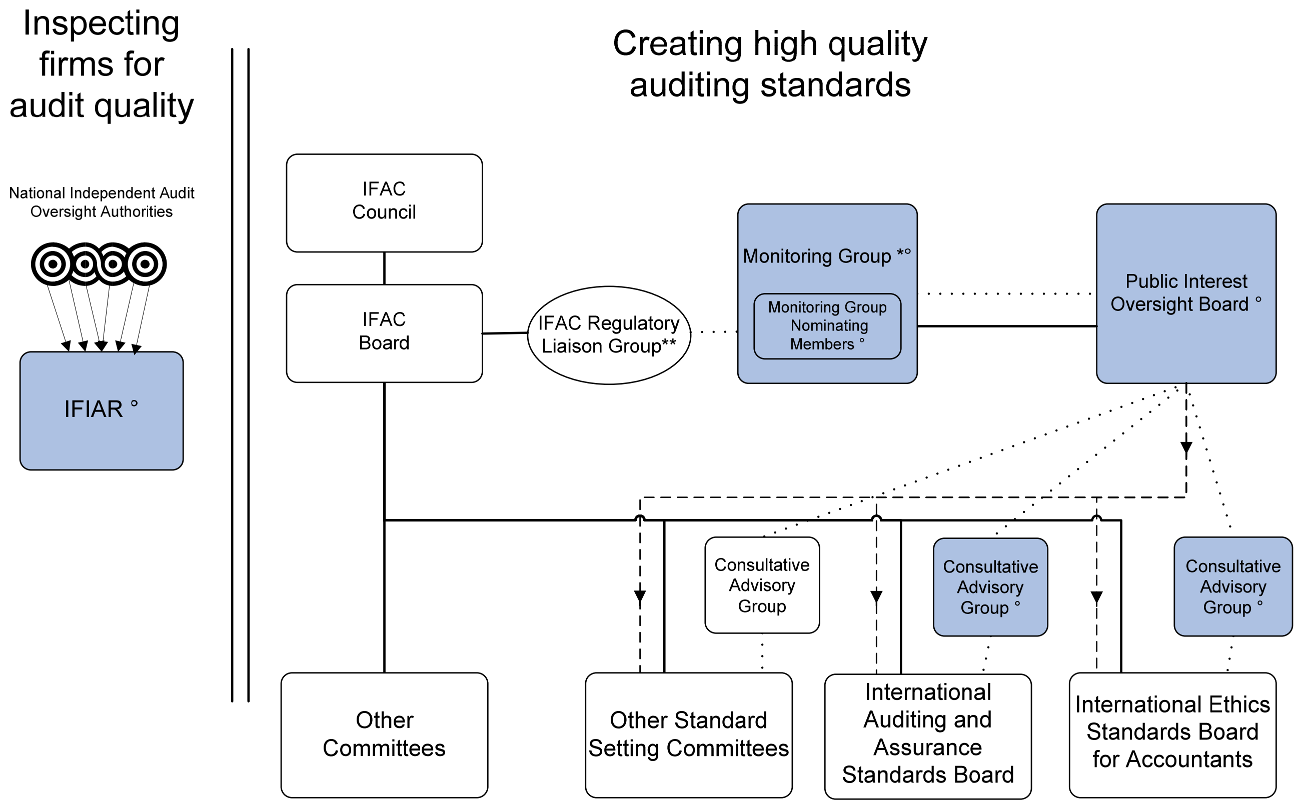
- Enhance audit quality by encouraging clarification of accounting principles in areas of specific interest to banking supervisors, such as valuations, consolidation, impairment and other areas that could be improved by relying on lessons learned from the current market turmoil.
- Encourage dialogue within and among audit firms to prepare for and address processes that should be conducted during future times of financial stress.
- Enhance engagement with independent audit oversight authorities.
- Encourage greater transparency of the corporate governance structures and the financial position of the global network firms.
- Encourage dialogue within and among the global network firms and other relevant bodies about the challenges that the firms face with respect to audit quality in audits of banks. In particular, the firms could identify impediments to their ability to consistently apply, on a global basis, accounting and auditing standards or internally developed guidance.
- Participate with the IAASB when it redrafts/updates International Auditing Practice Statement (IAPS) 1004, *The Relationship Between Banking Supervisors and Banks' External Auditors*, January 2002[18] and IAPS 1006, *Audits of the Financial Statements of Banks,* October 2001.[19]
- Continue to support audit quality by:
  - participating in groups involved with audit and ethics standard setting and auditor oversight,
  - monitoring and responding to emerging issues related to international auditing and accounting that may affect audit quality, such as developments in the area of auditor liability and
  - responding to requests for comment by the audit and ethics standard setters.

[18] This IAPS was prepared by the predecessor of the International Auditing and Assurance Standards Board in association with the Committee.

[19] This IAPS was prepared by a bank audit sub-committee (which included observers from the Committee) of the predecessor of the International Auditing and Assurance Standards Board.

Appendix 1

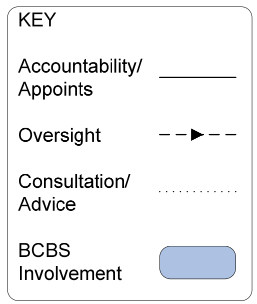
Bodies directly involved in audit quality and the Basel Committee on Banking Supervision (BCBS) presence in these bodies



* The Monitoring Group monitors the implementation of the 2003 IFAC Reforms in general. It monitors how the PIOB is carrying out its public interest role in the reform process with particular regard to the PIOB's oversight of the standard setting process. The Monitoring Group also has an ongoing relationship of consultation and advice with the PIOB.

° Participants include members from the International Organization of Securities Commissions, the World Bank, the International Association of Insurance Supervisors, the BCBS and the European Commission. (The CAGs' members also include representatives from the auditing profession, financial statement users and financial statement preparers.)

** Comprised of leadership from IFAC and its relevant Committees. Monitoring Group meets with the IFAC Regulatory Liaison Group to discuss the recent activities of IFAC and the PIOB, progress in implementing reforms and the Monitoring Group's views on regulatory developments, audit quality issues and other matters of mutual interest.



Appendix 2

Members of the Accounting Task Force's Audit Subgroup

Chair: Mr Marc Pickeur, Commission Bancaire, Financière et des Assurances, Brussels
Mr Gerald Edwards, Senior Advisor on Accounting and Auditing Policy, ATF

Brazil	Mr Amaro Luiz de Oliveira Gomes
Canada	Mr Lonny McPherson
France	Ms Fabienne Lasserre
Germany	Mr Raoul Nägele
Italy	Mr Michele Lanotte
Japan	Mr Tetsushi Miyaji Mr Hiroshi Ohata (until July 2008) Mr Minoru Aosaki (since July 2008)
Luxembourg	Ms Ana Bela Ferreira
Spain	Ms Bárbara Olivares Alvaro
United Kingdom	Ms Patricia Sucher
United States	Mr Terrill Garrison Mr Robert Riordan Mr Robert Storch
Basel Committee Secretariat	Ms Linda Ditchkus