ASSIREVI
Associazione Italiana Revisori Contabili

Il Presidente

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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*By e-mail:* baselcommittee@bis.org

We are pleased to have the opportunity to comment on the Consultative Document *"External audits of banks"* (the Document), issued by the Basel Committee on Banking Supervision (BCBS) in March 2013.

Assirevi is the association of Italian audit firms. Its member firms represent the majority of the audit firms under the oversight of CONSOB (*Commissione Nazionale per le Società e la Borsa*) and are responsible for the audit of almost all of the companies listed on the Italian stock exchange. Assirevi promotes technical research in the field of auditing and accounting and publishes technical guidelines for its members. It collaborates with Governmental bodies, CONSOB, the Italian accounting profession and other bodies in the development of auditing and accounting standards.

*General comments*

We support the BCBS's initiative to help improvement of quality of banks' audits and enhance the effectiveness of the prudential supervision.

We set out a number of recommendations below that are aimed at enhancing the level of relationship among supervisors, audit committees and auditors. Also, the Appendix to this letter includes our detailed comments to the Document.

*Reference to Internationally Accepted Auditing Standards (ISA)*

We appreciate the fact that the Document makes significant references to the ISAs and we believe that it is important that all stakeholders continue to support the IAASB in the activity of setting and improving internationally accepted standards for audit of financial statements.

However, we noted that, in some cases, the recommendations reported in the Document are going beyond the ISAs requests.

Furthermore, IAASB recently issued the Consultation Paper "*A Framework for Audit Quality*" that already deals with the interaction between auditors and regulators. In this respect, we believe that recommendation on improvement of the exchange of information between auditors and supervisors could be treated in that context.

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*Communication*

The Document emphasizes the need for the auditor to communicate facts and circumstances he or she may be aware of during the course of the audit to both supervisors and audit committees. We believe that, in order to improve audit quality, only a *two-way communication* between auditors and regulators and auditors and audit committees should be encouraged. We suggest to expand further the *"two-way communication"* in the final version of the Consultative Paper, also by making reference to the aforementioned Consultation Paper "*A Framework for Audit Quality*" which provides useful insights on how to achieve an improved *two-way communication* between auditors and regulators, particularly in the financial services sector.

*Regulatory information*

Some reference in the Document are given to activities to be performed by auditors on regulatory information. Please note that the level of audit of such kind of information may significantly vary among different jurisdictions. In this respect, we suggest to clearly identify additional work that Regulators may ask the auditors to perform, with a clear differentiation from the requirements of a financial statements audit performed in accordance with ISA.

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Should you wish to discuss our comments please do not hesitate to contact us.

Yours faithfully,

Mario Boella
*Chairman of Assirevi*

# COMMENTS ON THE BASEL COMMITTEE ON BANKING SUPERVISION'S CONSULTATIVE DOCUMENT

"External audits of banks"

(March 2013)

## Application

Paragraph 10 of the Consultative Document ("Document") provides that the Document is applicable to all banks: we believe that, as reported in paragraph 11, which establishes a principle of proportionality for the implementation of the principles set forth in the Document, some of them could be applicable only to larger banks and they could not be fully applicable to smaller banks. Also with reference to holding companies that own smaller banks and to holding companies with particular corporate governance schemes (i.e. banking foundations), we believe that the Document could not be fully applicable.

**Principle 1: The external auditor of a bank should have banking industry knowledge and competence sufficient to respond appropriately to the risks of material misstatement in the bank's financial statements and to properly meet any additional regulatory requirements that may be part of the statutory audit**

We believe that the industry knowledge and industry competence are necessary for audit of all entities. In this regard, ISQC1 (paragraphs 29-31) and ISA 220 (paragraph 14) already require auditors to have in place policies and procedures to assign to each engagement appropriate personnel (and any experts involved) with the adequate competence, skills and knowledge to perform that engagement in accordance with professional standards and applicable legal and regulatory requirements. Considering the above we do not recommend further specific guidance.

**Principle 4: Audit firms undertaking bank audits should comply with the more stringent requirements on quality control applicable to listed entities in internationally accepted quality control standards, having due regard to the complexity of a bank audit**

As a general point, we support the Document's emphasis on audit quality; nevertheless we think that no direct correlation between the recent financial crisis which revealed weaknesses in risk management, control and governance processes at banks and the quality of external audits of banks should be reasonably identified.
All banks in Italy are considered PIEs (Public Interest Entities) by law; therefore auditors' quality control policies applicable to listed entities are already applied to banks.
Regarding the disposal of working papers documenting the engagement quality control review, Italian banks auditors are controlled in periodical inspections performed by the audit oversight body, which may include access to the auditor's working papers, and not by banking supervisor; therefore working papers could not be usually at disposal of banking supervisor.

**Principle 5: The external auditor of a bank should identify and assess the risks of material misstatement in the bank's financial statements, taking into consideration the complexities of banking activities and the need for banks to have a strong control environment**

In general terms we agree with the statement set out in Principle 5. However, we believe that International Standards on Auditing (ISA) already provide an appropriate framework and requirements to which the external auditor of an entity must comply with, according to, and consistently with, business sector, size, complexity, structure, economic and financial significance and risk profile of the entity being audited, whatever it is. According to ISA requirements, the external auditor of a bank should gain an understanding of business risk relevant to financial reporting objectives (ISA 315, paragraph 15(a)) and of the related control environment and internal controls designed by the bank and therefore perform test of controls over financial reporting with the extent deemed appropriate in order to rely on them.

Also, we agree that the assessment of the control activities over financial reporting required to the external auditor by the internationally accepted auditing standards is critical for the design on further audit procedures responsive to assessed risks. Nevertheless, we believe that the proposal, included in paragraph 69 of the Document, that the external auditor should communicate *in writing all matters* that are likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability goes beyond ISA requirements (ISA 265 and ISA 260) and carries the risk of resulting in an expectation gap about role and responsibilities of external auditors.

With reference to the concept of materiality and the use of it in evaluating identified misstatements, we agree that such assessment should not be based only on a mechanical and quantitative calculation so that individual misstatements below the level of materiality could be dismissed, but should involve professional judgment in light of surrounding facts and circumstances. For the same reasons we believe that, also in audit of banks, instances (account balances, classes of transactions or disclosures) in which the materiality level may be lower should be judged in light of all surrounding circumstances and relevant quantitative and qualitative factors, because an item that is material to an entity not need be material to another entity. Therefore we consider that a principle-based approach in assessing materiality, as defined in International Standards on Auditing, is adequate and it is not appropriate to define "a priori" which account balances, classes of transactions or disclosures in a bank's financial statements could be material.

**Principle 6: The external auditor of a bank should respond appropriately to the significant risks of material misstatement in the bank's financial statements**

We deem appropriate to remember that International Auditing and Assurance Standards Board (IAASB) carried out a project, so called ISA Clarified, according to which 36 auditing principles (plus ISQC1) have been redrafted or revised following a principle-based approach across all industries. Following to such a project, the existing IAPS (International Auditing Practice Statement) and in particular IAPS 1006 "Audit of financial statements of banks" have been considered not appropriate with the overall structure. More precisely, IAPS have been considered "unsatisfactory" and no substantive obligation to use the material contained in an IAPS exists. Therefore, the current trend in the definition of auditing standards does not consider appropriate the introduction of single principles industry driven, while it has been preferred an audit approach based on the analysis and the assessment of risks relating to the audited entity which encourages the use of auditor's professional judgment. For these reasons, we do not support the detailed declination of Principle 6 in paragraphs 78-98.

**Principle 7: The audit committee should have a robust process for approving, or recommending for approval, the appointment, reappointment, removal and remuneration of the external auditor**

**Principle 8: The audit committee should monitor and assess the independence of the external auditor**

**Principle 9: The audit committee should monitor and assess the effectiveness of the external audit**

The EU Draft Report on the Proposed Regulation on external audit (the "Barnier" proposal) is already addressing the role of the audit committee *vis à vis* the appointment, reappointment, and more in general the oversight of external auditors by the audit committee. In addition, in several legislations, and in particular in Italy, this is already addressed and specific rules are provided for banks which, as mentioned above, are all included within the PIEs notion. The same would apply with regard to paragraph 110 of the Document and Principle 7, where it is established the role of the audit committee in agreeing the terms of the engagement letter issued by the external auditor, which in Italy is a matter subject to the approval by the shareholders. Moreover, the length of audit mandate for banks is fixed in a nine-year period by local law.

Making reference to paragraph 107, we believe not appropriate that all findings of quality control activities should be shared with audit committee, since the goal of such activities is also to ensure consistency among different audit engagements within the auditing firm and the respect of firm's internal policies and procedures. In addition, with reference to paragraph 123, we do not support the sharing of the quality control reviewer's conclusions on significant accounting and auditing matters, since it could create a confusion of engagement partners' individual responsibilities and also could jeopardize the objectivity of quality control reviewer.

**Principle 10: The audit committee should have effective communication with the external auditor to enable the audit committee to carry out its oversight responsibilities and to enhance the quality of the audit**

**Principle 11: The audit committee should require the external auditor to report to it on all relevant matters to enable the audit committee to carry out its oversight responsibilities**

While recognizing the duties of the external auditors towards the audit committee, we would welcome a more explicit reference towards a "two-way" communication process between the external auditor and the audit committee, as a mean to improve the effectiveness of the external audit, which, as stated under Principle 9, is the common goal to be pursued. We believe that only reciprocal communications can contribute to improve audit quality and the Document could consider a Principle according to which the audit committee should inform the external auditor of all matters that are likely to be of material significance to the auditor's duties.

**Principle 12: The supervisor and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.**

**Principle 13: The external auditor should report to the supervisor matters that are likely to be of material significance to the functions of the supervisor.**

**Principle 14: There should be open, timely and regular communication between the banking supervisory authority, the audit firm and the accounting profession as a whole on key risks and systemic issues as well as a continuous exchange of views on appropriate accounting techniques and auditing issues.**

In general terms we welcome and support the proposal set out in the Document aimed to build and maintain an open and constructive relationship between supervisor and external auditor and to set out principles enabling regular communication of mutually useful information at the levels of supervised bank, the audit firm and accounting profession as a whole. However, we believe that some aspects of the proposed principles are worthy of consideration.

The recent Consultation Paper issued by the IAASB, titled *"A Framework for Audit Quality"*, in section *"Interactions between Auditors and Regulators"* including *"Prudential Regulators"*, provides useful insights on how to achieve an improved two-way communication between auditors and financial regulators *"particularly in the financial services sector"*. In particular, we bring to your attention the following comment included in Appendix 1 to the Consultation Paper: *"while it is recognized that the timely sharing of appropriate information between regulators and auditors can both enhance the regulatory process and contribute to audit quality, such information sharing is sometimes inhibited by timing and confidentiality issues. To improve information sharing clear criteria for what is to be communicated and the process for such communications need to be established either in law or by means of formal agreements or protocols"*.

We therefore believe that proposed principles should strongly encourage a dialog based on reciprocity and on an effective two-way communication process so that supervisors also alert external auditors regarding areas of particular concern or enabling the external auditor to access to the supervisor's communications to the bank and to other useful information such as supervisory risk assessments or other supervisory reviews (event not formalized in written form). We believe that only reciprocal communications can contribute to improve audit quality and that the Document should provide a more extensive guidance on communications from the supervisors to external auditors, especially for those matters that may have relevance to the conduct of the audit. In this context we also believe that appropriate communication protocols should be secured, addressing matters like confidentiality of information, guidance on matters to be reported and sharing of information that may be relevant also for market oversight bodies.

With particular reference to paragraph 166, we agree with the suggested approach to develop in local jurisdictions specific guidance so that terms, nature and scope of the communication are clear both to the supervisor and external auditor. In this context we also believe that matters in the scope of the external auditor's duty to report/alert should be clear and well defined. As a consequence we recommend a detailed and exhaustive list of matters in the scope and a clear set of principles instead of an illustrative list. Such matters and principles should be consistent with auditor's responsibilities in conducting an audit in accordance with applicable auditing standards.

Finally, with reference to Principle 14 we agree with the proposed approach to encourage exchange of views on accounting matters and auditing issues; in order to make it feasible we suggest a drafting change of wording from "continuous exchange" into "periodic exchange".