

Basel Committee on Banking Supervision
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Chris Barnard
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06 June 2013

**Your Ref: Comment letter on Consultative Document
- External audits of banks**

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative document on: External audits of banks. You are issuing this consultative document to help improve audit quality at banks. The document proposes 16 principles along with extensive explanatory guidance, and sets out supervisory expectations of how:

- external auditors can discharge their responsibilities more effectively
- audit committees can contribute to audit quality in their oversight of the external audit
- an effective relationship between the external auditor and the supervisor can improve communication of mutually useful information
- regular dialogue between the banking supervisory authorities and audit oversight bodies can enhance the quality of bank audits.

In general I support the proposed 16 principles. They are reasonable and complete, and will help to improve the quality of bank audits and enhance the effectiveness of prudential supervision. This will improve confidence in the banking system and will promote financial stability. I will comment on the interaction of the external auditor with the internal audit function, and a bank's audit committee and its relationship with the external auditor.

Interaction of the external auditor with the internal audit function

I have already commented on the internal audit function in banks.¹ Principle 5 in the current consultative document covers the risk of material misstatements, and paragraphs 70-72

¹ See consultative document on The internal audit function in banks, BCBS, June 2012, and my comment letter thereon.

discuss the internal audit function. Greater communication and understanding between the internal audit function and the external auditor can improve audit quality, as internal auditors can bring significant matters that may affect the audit to the external auditor's attention. Furthermore, the external auditor may be able to use the work of a bank's internal audit function. In this case, when determining whether the work of the internal audit function can be used for purposes of the audit, the external auditor should always:

- evaluate the degree of independence and the level of competence of the internal audit function (function based)
- evaluate whether the internal audit function applies a systematic and disciplined approach, including quality control (process based)
- evaluate the extent of judgements (to be) used by the internal audit function, and the level of materiality for the financial statements (responsibility based).

This will help the external auditor to plan the use of the work of the internal audit function. It will also enable the external auditor's observations on the internal audit function, which may be of interest to the audit committee.

The bank's audit committee

Principle 8 states that the audit committee should monitor and assess the independence of the external auditor. I agree with this. Paragraphs 113-115 discuss audit firm rotation and auditor rotation in more detail. I believe that audit rotation would improve audit quality by enhancing auditor independence, objectivity and professional scepticism. There is clearly a learning curve; however I do not believe that this learning curve implies that auditors are not effective at the same time. The learning curve is greater for more complex banks and their businesses. This would be mitigated by the fact that there are sufficient audit firms with greater experience of such complex audit cases that would be well-prepared to take them on. There are very few (niche) banking cases where there would be a lack of audit firm capacity that would be appropriate to audit them. Clearly, the outgoing auditor should provide the incoming auditor with a written report outlining audit risks and other important information about the bank. This should further enhance auditor professionalism, independence, objectivity and professional scepticism.

Principle 10 states that the audit committee should have effective communication with the external auditor. Paragraphs 132-133 discuss the significant issues in more detail. I would support that communications between the external auditor and the audit committee should always encompass the following:

- any outstanding matters of material significance, including misstatements
- suspected bias in critical accounting estimates, and significant sensitivities thereon
- disagreements with management
- any judged shortfalls in processes or personnel in critical functions including governance, compliance, internal audit, risk management and legal, whether currently material or not.

I also agree with paragraph 134 that the audit committee has a duty to communicate to the external auditor matters that are likely to be of significant influence on the audit. This communication should be regular and timely.

Principle 11 also covers communication with the external auditor. I strongly support this principle, as effective, two-way communication between the audit committee and the external auditor will enhance both the quality of the audit and the ability of the audit committee to carry out its oversight responsibilities.

Yours faithfully

A handwritten signature in blue ink that reads "C.R. Barnard". The signature is written in a cursive, slightly slanted style.

Chris Barnard