COMPAGNIE NATIONALE DES COMMISSAIRES AUX COMPTES

Délégation Internationale
pour l'Audit et la Comptabilité

Secretariat of the Basel Committee on
Banking Supervision, Bank for International
Settlements, CH-4002 BASEL
SWITZERLAND

20 June 2013

YN.CE.CG.CB 20130503

Dear Sir ou Madam,

The Compagnie Nationale des commissaires aux comptes (CNCC), which represents the profession of statutory auditors in France is pleased to provide you with its comments on the Consultative document of the Basel Committee on the external audit of banks.

Our detailed comments are gathered in the attached letter. They have been prepared by our banking committee, with the help of our insurance committee, our financial market Department and with the support of our international affairs Department. We hope they will be helpful. Should you need any other information or precision, please do not hesitate to contact me.

Best regards.

Yves NICOLAS

President of the CNCC
Co-President of the DIPAC

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CONSULTATIVE DOCUMENT
EXTERNAL AUDITS OF BANKS
CNCC RESPONSE

June 18, 2013

The Compagnie Nationale des Commissaires aux Comptes (CNCC) welcomes the initiative of the Basel Committee on Banking Supervision (BCBS or the Committee) aimed at developing the relationships between the banking supervisory authorities and the external auditors to allow greater mutual understanding and cooperation and therefore improve the quality of external audits of banks. It also appreciates the opportunity to provide its comments on the BCBS consultative document.

First, as a preamble to our detailed responses, the CNCC would like to point out that it considers that a lot of the recommendations of this guidance are already applied in France, especially those relating to :

- Independence, with joint audit being required for a certain number of entities[1],
- Quality control,
- Communications between the supervisory authority and the oversight body of the profession.

During the crisis the banking system has been "shaken" all over the world. Even though "*French banks have shown significant resilience, during the global financial crisis*"[2], they "*face challenges*" and consequently, changes and evolutions have become necessary. In this context, the need for more market confidence in the quality of external audits of banks financial statements has increased.

The CNCC supports the idea that improving the quality of external audits of banks can be achieved through the development of closer relationships between the external auditors and the banking Supervisory authorities as well as the audit committees.

As a final preliminary comment, the CNCC considers that some proposals of this consultation are based on a "prerequisite" that :

- the external auditor, in addition to expressing an opinion on the financial statements also performs an in depth review of the prudential reporting of the bank,

- the role of audit committee is always extensive.

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[1] Joint audit is required in France for all entities preparing consolidated financial statements and for all Banks for which the total balance sheet is over a certain size.
[2] IMF Country report about France Financial System Stability Assessment/ December 2012 Report N° 12/341

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Reviewing the prudential reporting is not part of the auditor's role in France. The CNCC would strongly welcome an harmonization and extension of the role of the external auditor with respect to the prudential reporting of the banks but this would need prior evolution of the French regulatory framework before being effective. Implementing some of the new BCBS proposals with regard to the external auditor's role will only be possible if proposals regarding the role of audit committees are also effectively implemented.

Our main detailed comments are summarized hereafter :

We consider that putting forward proposals relating to auditing standards creates confusion

The CNCC notes that the Basel Committee wrote to the IAASB to express its demand for improvement of the auditing standards on a number of topics which they consider as not being sufficiently addressed in the ISA. The letter[3] addressed to IAASB explains clearly the reasons and the objectives of such recommendations. Consistent with that letter, the CNCC considers that the Basel Committee guidance should not, at this stage, include recommendations that would be better placed in the auditing standards.

We do consider that additional requirements regarding independence, competency or quality review standards should be adapted for smaller and less risky Banks

The BCBS Consultative Document suggests strengthening the current requirement applicable to external auditors in many areas like industry knowledge and competence **(Principle 1)**, independence standards **(Principle 2 and 4)** or quality reviews (**Principle 2 and 4**). Although such proposed evolutions are appropriate for important banks which are so-called "systemic", the CNCC considers that they should remain proportionate to the size, complexity and risk profile of the bank. Similarly, to mirror that position, supervisory expectations with regards to banks audit committees should also, in the same way, be proportionate to the size, complexity and risk profile of the bank.

There should also be some room for adapting such requirements to national regulation when certain local regulations have similar objectives. It is for instance the case with the joint audit in France which already reinforces the independence of external auditors.

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[3] Letter from the Basel Committee on Banking Supervision to Mr Arnold Schilder Chairman of the International Auditing and Assurance Standards Board (21 March 2013)

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We consider that the external auditors' role in respect to regulatory reporting needs to be clarified and harmonized ; such an extension of the audit of prudential regulatory reporting would be very positive in light of the public interest at stake.

In many respects, the BCBS Consultative Document emphasizes the numerous interactions between the accounting and the regulatory information. It also stresses how regulatory constraints can influence accounting treatments and the need for auditors to precisely understand and assess such situations.

The Committee also acknowledges the significant differences that exist in national institutional, legislative and regulatory frameworks amongst jurisdictions, in particular in respect of the external auditor's role on matters such as regulatory reporting.

The CNCC does believe that such situation may create an expectation gap regarding the auditor's role. It would therefore welcome more clarification and international harmonization in this area and, more particularly, regarding the verification of regulatory ratios calculation.

The CNCC also stresses the fact that in jurisdictions such as France, where the external auditors have no role regarding regulatory reporting, it adds to the difficulty for them to identify potential bias or inconsistencies in financial information disclosures.

We agree with the importance of effective interactions between external auditors and audit committees

The CNCC agrees with the need for more effective communication between audit committees and external auditors. It particularly welcomes the proposal that external auditors be invited to attend audit committee meetings, even if there are no items explicitly relevant to the external audit on the agenda (**Principle 10 §130**).

Risk functions have taken an increasing importance for banks and it is particularly important that external auditors attend all presentations that are being made in this area to audit committees. Similarly presentations on regulatory information are of interest for the external auditors and should be made in their presence.

However, we disagree with some comments, such as the proposal to share with the audit committee the differences of views raised as part of the internal quality review process or the link that seems to be made between independence, audit quality and audit firm rotation.

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We believe an effective and <u>reciprocal</u> relationship between the Supervisor and the banks external auditor is key to improve the quality of external audits of banks

The CNCC strongly agrees with the idea that the Supervisor and the banks external auditors have complementary concerns regarding the same matters. This is the reason why it welcomes the idea expressed in **Principle 12** that the Supervisor and the external auditors should have an effective relationship, that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.

This is particularly important given the unique position that the Supervisor has, to observe, on a regular basis, the liquidity and solvency situations of banks. Having regular, timely and transparent communication of information with the Regulator is to a large extent one of the most appropriate way for the external auditor to adequately assess a bank solvency or liquidity situation, considering also how quickly market confidence can be lost and how rapidly a bank can be faced with liquidity issues in such circumstances.

It is essential for the CNCC that these exchanges are based on the principle of reciprocity and equality between the parties, notably with regard to deciding the nature of the information which could be shared with the other party.

The CNCC strongly recommends that **Principle 13** should define a reciprocal requirement for supervisors to tell auditors of matters that are likely to be of material significance to the audit.

The CNCC also emphasizes that it is important that the terms and scope of the relations between the Supervisor and the external auditor's professional body be clearly and jointly defined and understood. This could be achieved through regular and effective exchanges between such parties.

Detailed comments on BCBS Consultative Document

Principle 2

- **§42** : *"...the external auditor of a bank should comply with the more stringent independence standards for public interest entities...."* Such requirement goes beyond the IESBA code and French regulation.

The CNCC does consider that such an extension is unnecessary. In France, although they are considered as PIE's, the banks which are not listed bear less constraints, for example on the rotation of engagement partners. More stringent independence standards on these banks would not bring more global financial stability but could create unnecessary constraints, inefficiency and audit costs.

- **§45 :** *"The audit engagement team members, the audit firm and when applicable network audit firms should comply with the independence requirements of both the home jurisdiction and the overseas regulatory authority… ".*

  The CNCC considers that such requirement, if implemented, might lead to a lot of inappropriate complexity (and possible confusion) and that the strict respect of the code of ethics of the International Ethics Standards Board for Accountants (IESBA) should be considered sufficient and appropriate.

Principle 2 and Principle 4 - Quality controls

- **§27 :** *"…Similarly, the external auditor of a bank should also follow the most stringent standards on quality control at the engagement level.* **"***and* **§53 "** *… should comply with the more stringent requirements on quality control applicable to listed companies in internationally accepted quality standards… ".*

  Again, the CNCC considers that regulation in this area should be tailored to the size and risk profile of the bank and adapted to local regulation when appropriate.

Principle 4 and 7 – Quality review evidence

- **§57 :** *"…Any significant discussions between the engagement quality reviewer and the audit engagement team, particularly in areas where views may have differed and as to how conclusions were reached, should be fully documented in the audit working papers."* **and §123** *"The audit committee should obtain an understanding of the rationale behind the final conclusions drawn by the audit engagement partner on significant accounting and auditing matters, particularly in those circumstances where the audit engagement partner's conclusions differed from those of the engagement quality control reviewer… ".*

ISA 230 A4 mentions that " *the auditor need not include in audit documentation superseded drafts of working papers,..., notes that reflect incomplete or preliminary thinking*". ISA 220 § 25 also states that "*the reviewer should document that he is not aware of any unresolved matters that would cause him to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate*".

In this area, the CNCC strongly believes that ISAs requirements regarding documentation of audit quality reviews are fully appropriate and that there would be no benefit in asking for more documentation of preliminary and potentially incomplete views. This could possibly lead to misinterpretation. It should rather be suggested that the external auditors should formally present to the audit committees any possible alternative views and the reason why they have accepted the view chosen by the bank management.

Principle 5

- **§60** : this paragraph suggests that the auditor should always perform "*extensive tests of controls*" and does not refer to the possibility to rely on certain second level internal controls properly tested, or on the work of the internal audit function as permitted under ISA 610 for instance. In this area, the CNCC believes that ISAs requirements should be strictly referred to, in order to avoid any misunderstanding regarding the external auditors' obligations.

- **§69** : "*The Committee believes that the external auditor should communicate all matters that are likely to be significant to the responsibilities of those charged with governance....*" The CNCC considers that the sentence "*identified during the audit and not necessarily all matters that additional procedures might have revealed*" should be added after "all matters".

Principle 6

- **§79 (f)** : "*Disclosures should enable users to assess the loan loss provisioning methodology applied by the bank regarding.... and how it compares with methodologies applied across the banking sector*".

  This point should be primarily addressed to banks instead of their external auditors.

  The CNCC considers that such proposition towards bank financial statements preparers might be difficult to apply, given the lack of a common and agreed framework for risks reporting.

- **§98 (b)** : this paragraph should explicitly explain how the external auditor could or should be informed of any situations where the Supervisor has requested additional regulatory capital on certain complex securisations.

Principle 7

- **§106 :** seems to consider that the audit committee responsibility is distinct from the Board responsibility, which goes against the generally admitted principle of collective Board responsibility.

Principle 8

- **§114 :** *"...The policy should also call for the audit committee to consider periodically whether there should be a limit to the length of the external auditor's tenure... given the potential impact of audit firm rotation on independence and audit quality".*

  The CNCC strongly disagrees with the view that there might be a correlation between the length of the external auditor's tenure and independence or quality of the audit. Rotation of the key audit partners appears adapted and proportionate to preserve independence. Audit firms have also put in place others procedures to avoid a risk of familiarity (such as independent review, quality control, etc). We therefore suggest that the above sentence be deleted.

Principle 9

- **§121 :** *"...The audit Committee should understand the nature and extent of audit work that the external auditor intends to rely upon where the audit work is performed by network firm personnel or other audit firms."*

  The CNCC considers that there is no need to distinguish between the external auditor and its network firms, given the existence of network quality control procedures in place. We therefore suggest deleting the end of the sentence *" where the audit work is performed....or other audit firm*".

- **§124 :** *" The audit Committee should also discuss with the external auditor the audit representation letters before signature by the board of directors/senior management...".*

The CNCC agrees with the fact that the external auditor informs the audit committee on specifics subjects of the representation letter, but considers that the proposition is too formal and might be difficult to apply for practical reasons and should not be suggested in all circumstances.

- **§127** :"*The audit committee should seek to obtain information from the external auditor on the main findings of audit quality reviews of the bank's audit and the audit firm's quality control system by audit oversight bodies*".

  In France, the quality review performed by the oversight body is not limited to only one controlled field. So the conclusions, which report on many entities, cannot be communicated under the rules of professional secrecy. Moreover, in France, the supervisor obtains these conclusions directly from the oversight body.

  Finally, French legislation defines the subjects to be discussed with the audit committee: the conclusions of the quality review is not listed.

Principle 12

- **§147** :"*The terms, nature and scope of this relationship can be determined in individual jurisdictions and should be clear to both the supervisor and the external auditor – for example, through guidance issued by the banking supervisory authority*".

  The CNCC considers that guidelines which set out the framework for the relationship between auditors and regulators should be prepared **<u>jointly</u>** by the Supervisor and the auditor's professional body in order to ensure a consensus and a balance between the parties regarding the means, the form and the scope of this relationship.

- **§154** : "*The communication channels described in paragraphs 150-153, can be a helpful source of information for the Supervisor about matters that are outside the scope of the external auditor's duty to report/ alert discussed in Principle 13 and <u>on which the supervisors can reasonably expect the auditors to form a view</u> in the course of their audit of the banks financial statements*".

  §155 : "*The contents of the external auditor's communication could cover all issues that <u>the supervisor might consider relevant in carrying out its function</u>. Such issues may include current, emerging and thematic issues, entity-specific and sector-wide issues. The external auditor should remain alert to the fact that these issues may also fall within the scope of the external auditor's duty to report/alert.*"

The current drafting could give the impression that the supervisor could have a different view than the auditor regarding the matters covered in the course of an audit. Furthermore, the CNCC notes a difference of expression compared with paragraph 162.

In paragraph 162, it is stated that the supervisor "may decide to communicate" whereas in paragraphs 154 and 155 it is stated that the content of the communication of the auditors could cover any subject that the supervisor may consider useful in the exercise of his functions. This difference produces de facto a breach in the balance between the parties.

Moreover, the CNCC considers that the wording of these paragraphs 154/155 may be source of misunderstandings as the external auditors may not necessarily either anticipate nor identify all issues that the Supervisor may consider useful. Moreover, the external auditor would only be able to communicate those aspects identified during the course of the audit.

Finally the CNCC considers that the above underlined sentences be replaced in both cases by "which the auditor might consider of interest for the supervisor".

- **§156** : "*In addition to discussing with the supervisor areas where there is often a significant risk of material misstatement in the financial statements, Section 4 includes examples of areas where matters of interest to the supervisor may be identified by the external auditor in the course of the financial statement audit and therefore are relevant for communication to the supervisor. Examples of these matters are :*

  □ *Where a bank undertakes transactions to achieve a particular accounting or regulatory outcome such that the accounting treatment is technically acceptable, but it obscures the substance of the transaction.*

  □ *Where a bank consistently utilises valuations which are at the extreme ends of a range of acceptable valuations or there are other indications of possible management bias.*

  □ *Significant deficiencies in internal control processes and their observations on matters that are 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. This may include, where relevant, their observations on the effectiveness of the internal audit function, the risk management function and the compliance function (where not already required by statute).*

 Actual or suspected breaches of prudential regulations noted in the course of the audit.80.

 Indications that disclosures in financial statements are not consistent with published prudential information if noted in the course of the audit".

The CNCC considers that this development could be considered as hidden requirements. Moreover, since the verification of prudential reporting is not part of the auditors' assignment in certain countries, some examples do not seem appropriate.

Furthermore, on the basis of the examples given, the CNCC understands that this information relates particularly to the areas of significant estimates and management judgment and therefore will have been the subject of communications to the various levels of governance (audit committee, board of directors, executive board and supervisory board). The CNCC therefore suggests a recommendation to discuss the content of these communications, at the supervisor request, instead of a proposing a list of examples, which can create confusion and can appear as setting requirements.

- **§ 157** :"*Annex 2 to this document provides guidance on the timing and examples of the potential content of the meetings between the supervisor and the external auditor, as circumstances may dictate*".

  The CNCC considers that this annex should be completed with the information that the supervisor could provide to the auditors in order to achieve a proper balance between the two parties. Such items could be for example :

  - Themes which could have an impact on the accounts,
  - Correspondence between the supervisor and the bank management, certain notes and instructions and minutes of meetings,
  - Information about derogative regulatory treatment to reflect the view formed by the supervisor on particular operation,…

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

  The CNCC suggests an alternative wording which better takes into consideration the necessary reciprocal relationship between Supervisors and banks external auditors : **Supervisors and auditors should share all information relevant to carrying out their respective statutory duties** : the auditor should communicate to the supervisor, any information or opinion on a matter that he (the auditor) reasonably believes is relevant to the Supervisor. Similarly, the Supervisor discloses information to the auditor that it judges relevant to the external auditor.

- **§168** :*"To assist in effective supervision of banks, it is important to identify system-wide, macro-prudential risks which may have an impact on banks. In the course of their work, the banking supervisory authority and* ***external audit firms*** *obtain information which, when reviewed in its entirety, can assist in identifying changing and emerging key trends and developments that may be indicative of emerging systemic risk."*
  Given the central role of the professional body in those industry specific discussions, the CNCC suggests adding "or the professional body of external auditors" after **external audit firms.**

- **§169** :*"Audit firms may also identify emerging issues over inconsistent or inappropriate application of accounting standards which, if identified early, permit external auditors and supervisors to take timely remedial action"*.

  Similarly, "the professional body of external auditors" could also be added after **external audit firms.**

  Principle 14 : ***"There should be open, timely and regular communication between the banking supervisory authority, the audit firms 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".***

- **§170 :** "*The banking supervisory authority and external audit firms* or the professional body of external auditors when it exist *should have regular discussions on existing and emerging key risks and systemic issues at the national level, as the exchange of such information is mutually beneficial. The communication should be open and in an environment that allows a frank exchange of views and ideas. If circumstances dictate, ad hoc meetings should be held to discuss matters requiring urgent action to allow each party to take appropriate action in a timely manner"*.

As mentioned above, "the professional body of external auditors" could also be added after **external audit firms.**