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Basel Committee on Banking Supervision
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Dear Ms Sucher

External Audit of Banks

Deloitte Touche Tohmatsu Limited (DTTL) is pleased to respond to the Basel Committee on Banking Supervision's (the Committee's) consultative document, 'External audit of banks' (the document). In developing our response, we have drawn on the views of certain member firms located in Europe, Asia and America. We value the opportunity to engage with the regulatory community on this and other matters of mutual interest, and welcome any questions you may have on our comments.

Our key points are set out below, followed by more detailed analysis of the document in the appendix. In common with our comments below, we concur with the views provided to you by the members of the Global Public Policy Committee.

Key Points

The external audit of financial statements is an important part of maintaining market confidence. Effective working relationships between banks, their regulators and auditors enable each of these parties to operate successfully; considering where there is scope for improvement is necessary and beneficial.

We support many of the ideas in the consultative document. It is good to see a principles-based approach being taken, and the principles themselves are developing in a direction we welcome as they propose more dialogue between auditors and regulators, and more engaged audit committees.

We are strongly supportive of the Committee's emphasis on quality. Audit quality is a priority for us. We have adopted robust policies to establish a consistently high level of audit quality throughout our network of member firms.

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We agree with the concerns expressed in the letter of March 21st from the Basel Committee chairman Stefan Ingves to Arnold Schilder, International Auditing and Assurance Standards Board (IAASB) chairman regarding the status of the Committee's guidance in so far as it relates to auditors. Standards and guidance for auditors should be issued by auditing standard setters, and compliance with standards considered as part of audit inspection. We believe principles 1-6 in the document would in particular be better placed as part of auditing standards and guidance. Standards and guidance should be developed by the IAASB in partnership as appropriate with the Basel Committee. The Committee should also work with IFIAR, the Independent Forum of Independent Audit Regulators. Some of the material in the document reads as if it is intended to be applied directly by auditors and other material repeats existing requirements of International Standards on Auditing (ISAs); this is a recipe for confusion. It would be helpful to distinguish between that which is a reminder to supervisors of what standards already require and that which reflects additional expectations that supervisors might wish to see introduced for bank auditors over and above the requirements of ISAs. There needs to be more clarity between the work auditors perform in relation to their statutory audit, and which assurance services are sought in addition to this to meet prudential regulatory requirements.

We agree that in some cases changes should be made to authoritative guidance by addition of requirements to IAASB standards. However, we believe that in many cases, appropriate application of existing requirements should be sufficient to deliver a quality audit, recognising that a 'one size fits all' approach may not deliver outcomes suitable for both a complex multinational investment bank and a small regional savings bank. We agree that to the extent that bank-specific guidance is required, this should be developed by the IAASB and we agree that the UK's Practice Note 19 provides a useful model of how such guidance could look. Useful guidance can also be found in the AICPA Audit Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies.*

We welcome the fact that in several major jurisdictions there has already been an improved degree of cooperation between bank supervisors and auditors. We are improving the way in which we share insights into potential systemic risks with supervisors. Bilateral meetings between supervisors and auditors and tripartite meetings which also involve the bank in question are an important way of sharing insight which will inform supervision activity; equally, given the systemic importance of the largest banks, auditors need to have good insight into the supervision of the audited entity. Regulators around the world should, as a matter of priority, be working to remove barriers to effective cooperation.

Yours sincerely

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Appendix – Response to Basel Committee's 'External Audit of Banks'

Comment on 'Structure' section of Consultative Document

1. We note that paragraph 16 of the consultation document states that internationally accepted auditing standards are applicable to all entities. Whilst International Standards on Auditing have been adopted directly in many jurisdictions, and indirectly (by adoption as national standards) in many more, there are some jurisdictions where these standards do not apply. Firms that are members of a network that is a member of the Forum of Firms will have committed to applying the requirements of the ISAs as a minimum but it is not necessarily a given that all banks will be audited by such firms.

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.

2. We agree that the teams that audit banks should collectively have an appropriate level of experience. We note that junior members of the team, or more senior auditors new to auditing banks, may not have accrued much industry-specific knowledge. This should not act as a barrier to them contributing to a bank audit, and acquiring the necessary knowledge and skills, through working alongside others with appropriate experience. IT, tax or financial reporting specialists may also have limited knowledge about some aspects of the industry, but still make a valuable contribution to the audit. Requiring specific experience for each individual on the team would reduce the diversity of perspectives brought to bear by those with other backgrounds. A prescriptive approach could also create practical difficulties around developing experience in junior staff. In this regard, paragraphs 29-31 of International Standard on Quality Control 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and other Assurance and Related Services Engagements* already require audit firms to have in place policies to allocate partners and staff to engagements with the competence, capabilities and authority to perform the role, and paragraph 14 of ISA 220 *Quality Control for an Audit of Financial Statements* already requires the audit engagement partner to be satisfied that the team, which includes specialists, has such competence and expertise. In principle the knowledge and competency requirements for bank audits are not different in nature to those raised by the audit of other entities; we are unconvinced that further specific guidance is required. We note that as banks vary in complexity and size the competency criteria for bank auditors will likewise vary.

Principle 2: The external auditor of a bank should be objective and independent in fact and appearance with respect to the bank, consistent with the more stringent requirements applicable to public interest entities in internationally accepted ethical standards.

3. We agree that objectivity and independence are critically important for auditors. Our member firms have a range of processes to support an independent and objective approach, including client and engagement acceptance procedures, audit review processes, and questions for our audit teams to consider to establish whether we can provide an objective and independent audit. Moreover, Deloitte member firms comply with well-established policies and implement appropriate procedures to help safeguard their objectivity and the independence of the organisation and their people. These policies and procedures help ensure that the member firms and audit engagement teams do not have any financial, personal, business or other relationships with audited entities that would compromise

Deloitte's independence. The effectiveness of and compliance with our quality controls over independence are carefully monitored. We would be happy to provide more detail on our member firms' activities around objectivity and independence if this would be of interest to you.

4. As you are aware, the International Ethics Standards Board for Accountants (IESBA) has developed a 'Code of Ethics for Professional Accountants' (the IESBA Code); we think this is the appropriate standard in this area. The more stringent requirements applicable to public interest entities will not always be appropriate for every bank, as there are significant differences in the types and public exposure of banks in today's market.

5. Rather than treat all banks as public interest entities for audit purposes, bank regulators in each jurisdiction should understand their own financial markets and the differences between the banks operating there and classify them accordingly. Regulators should have responsibility for this analysis and classification. A logical starting point would be 'A framework for dealing with domestic systemically important banks' developed by the Basel Committee. In some jurisdictions there are already specific requirements for major banks. For example, in the US the Federal Deposit Insurance Corporation (FDIC) Improvement Act requires the use of SEC, AICPA and PCAOB rules when performing audits of insured banks with assets in excess of $500 million.

6. Paragraph 45 includes a requirement for auditors to comply with the independence requirements of both the home jurisdiction and the overseas regulatory authority where the bank is regulated by an overseas authority. We are not sure what the words 'when applicable' and 'ultimately' are intended to mean here. We are unconvinced that this proposal is necessary. It will increase complexity and we would expect to see the costs and benefits associated with this proposed change more clearly set out for consultation. If this paragraph simply means that the audit engagement team members, the firm and network should comply with all applicable independence requirements, we would be comfortable with that.

7. The paper refers at paragraph 40 to 'conflicts of interest'. This often gets confused with independence and objectivity but is different. This paragraph should instead be worded along the lines of: . . . the external auditor is not affected by influences that compromise professional judgment. This language is aligned with what is in the IESBA Code on the definition of independence of mind.

8. Paragraphs 41 and 46 refer to a 'reasonably informed third party'. This formulation is similar to the reasonable and informed third party in the IESBA Code but could have a different meaning; we draw this to your attention in case the difference is not intentional. Paragraph 42 indicates that all banks should comply with the Public Interest Entity requirements, but it appears that only listed PIEs are required to include related entities. Again, we highlight this in case it is not intentional. In paragraph 46 what the word 'significant' means in the context of non-audit services could be clearer. The reference 'to the bank being audited' could be interpreted to exclude related entities.

9. In summary, we agree that objectivity and independence are of paramount importance, and consider that existing ethical standards are sufficient for banks that pose no domestic or international systemic risks; our preferred approach would be proportionate to the risk posed.

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Principle 3: The external auditor should exercise professional scepticism when planning and performing the audit of a bank, having due regard to the specific challenges in auditing a bank.

10. We strongly agree that bank auditors should exercise professional scepticism. Our member firms are aware of the importance of scepticism and have a range of policies to support a sceptical approach.

11. Since the financial crisis there has been an increased focus on auditor scepticism. Of particular relevance to banks are the changes made in 2010 to the clarified ISA 540 *Audit of Accounting Estimates*, *including Fair Value Accounting Estimates, and Related Disclosures*. These introduced several new requirements to challenge fair values produced by management – for example the challenge to valuation bias included in paragraph 51 of the consultation document. We think these changes will support the Basel Committee's objectives to increase the focus on financial instruments valuations.

12. Scepticism is difficult to measure objectively, unlike many audit processes and procedures, and instead must be embedded and established as an integral part of audit behaviour. For a more detailed consideration of audit scepticism, we refer you to our UK member firm's response to the Financial Reporting Council's discussion paper, 'Auditor scepticism: raising the bar'.

13. On a drafting point, the reference in paragraph 48 to 'actively considering whether there are alternative accounting treatments that are preferable' could be reworded so that it is restricted to those which are allowable in the context of the relevant accounting framework; we assume it is not an invitation to adopt non-GAAP approaches.

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.

14. As a general point, we are strongly supportive of the Committee's emphasis on quality. We strive for quality in all the work we do and have robust internal processes to help us maintain high standards, across all of our audits.

15. However, we do not support this principle for the reasons outlined in our response to Principle 2. Whilst some bank audits – including those of global systemically important banks – are highly complex, the same cannot be said of the world's smaller banks. It would be disproportionate to treat all banks for audit purposes as though they were listed entities.

16. As we indicated in our covering letter, our preference is to see audit standard-setting bodies lead developments around audit requirements, and this includes in relation to quality control. Moreover, we are not persuaded that industry-specific audit quality requirements are necessary or helpful.

17. Paragraph 53 states that where a quality control standard 'is more restrictive than a corresponding rule in the other quality control' standard the more restrictive one should be followed. Different quality control standards may not be directly comparable in the manner this paragraph implies, so this proposal may be impractical.

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.

18. The application of materiality is explained in section B of the consultative document, and is central to audit methodologies. If the subsection on materiality remains in the document, it needs to be clarified that it has general applicability to auditors' work and is not limited in application to Principle 5.

19. We agree that bank audits will almost always involve controls testing for the reasons set out in paragraph 60. However, we do not think that all of the material in later paragraphs necessarily follows from this. For example, we do not agree that the external auditor should 'determine whether the control environment extends to all types of operations and service offerings and encompasses all subsidiaries and branches of the banking group' (paragraph 66). The auditor's understanding of risk will include business risks relevant to financial reporting objectives (paragraph 15(a) of ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*) and therefore of related control activities. However, it will not necessarily include business risks that do not affect financial reporting and it will not be as comprehensive as the work outlined in paragraph 66. Indeed, such a scope increase would be expensive and, in the context of an audit report on financial statements, could not be justified.

20. We appreciate that banks' regulators have a particular interest in metrics used for capital and liquidity purposes (paragraphs 64, 74). Where assurance over regulatory ratios (including the leverage, liquidity or capital adequacy ratio) is specifically required because a high level of confidence in the quality of the information is needed, we would recommend that the supervisor performs or commissions assurance procedures specifically designed for these metrics.

21. The wording used in paragraph 69 refers to the auditor communicating in writing "all matters" that are likely to be significant to the responsibilities of those charged with governance; for the avoidance of doubt, we would propose a drafting change and add that these will be all significant matters that the auditor becomes aware of in the course of the audit. Further we note that the requirement to communicate significant deficiencies in internal control is already embedded in professional literature (see ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*).

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Appendix – Response to Basel Committee's 'External Audit of Banks'

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

Loan loss provisioning

22. The factors the document lists for auditors to consider include how the 'estimation techniques used to compute provisions vary among' banks (79(a)). To the extent that such benchmarking information is publicly available, this is possible. However, if the intention is that information that is not publicly available would be used to achieve this comparison, we note that many audit teams may only audit one bank, particularly if it is large, and that within an audit firm steps are taken to keep information confidential to each bank audit team, with only limited information being shared across bank audit teams. Indeed, confidentiality considerations (including legal ones) would not allow sharing of certain client-specific information. Even across a firm, information will be limited to a subset of the banking market. So although audit teams will be informed about provisioning approaches being taken in the industry in general, exactly how one bank's provisions may compare to peers with similar instruments will not always be evident to the audit team, nor where in the range one bank sits. Regulators potentially have access to more complete benchmarking information. We note that regulator perspectives (79 d) are specifically referred to – the document should be expanded to state that supervisors can assist auditors in this by sharing their insights, for example, into valuation techniques gained across the market.

Going concern assessment

23. We think this section should be expanded to refer to the role supervisors can play. As the document correctly states, the bank supervisory authority sets liquidity and capital requirements for banks. Where these requirements change they may affect a bank's ability to continue as a going concern. Accordingly, material facts known to the regulator and relevant to the audit should be communicated to the auditor. Were an incorrect opinion to be given because regulators withheld such information, this would reduce market confidence: an outcome clearly contrary to the objectives of the Basel Committee. We suggest that the approach in the UK Financial Reporting Council's Supplement for Banks (in the Sharman Implementation proposals) may be helpful in this regard.

Securitisations – SPEs

24. We note that interconnectivity is cited as a reason for activities requiring 'special consideration by the external auditor' but would challenge this (paragraph 98). How interconnectivity may affect financial stability is outside the scope of a financial statements audit. As you are aware, we are keen to support the Financial Stability Board's work in increasing financial stability. Where we can help identify areas of interconnectedness that may impact financial stability, we will share this with the Financial Stability Board (FSB), including through the Global Public Policy Committee. On any specific audit, however, how global systemic risk is potentially increased (98 c) is not within the scope of work.

Appendix – Response to Basel Committee's 'External Audit of Banks'

Principles 7 to 11

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.
8: The audit committee should monitor and assess the independence of the external auditor.
9: The audit committee should monitor and assess the effectiveness of the external audit.
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.
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.

25. We welcome an engaged audit committee and support these principles. We have a number of detailed observations about the text as drafted, which we set out below.

26. At paragraph 105 the document states that the audit committee is to include 'supporting information on the tenure of the incumbent auditor' in the annual report. It is unclear what this means.

27. The proposal at paragraph 106 that the board of directors explains why it has taken a different position would undermine the important principle of collective responsibility and we think this paragraph should be removed. We suspect that the circumstances described are extremely rare even where there are separate management and supervisory boards.

28. We disagree with the suggestion that the audit committee should consider 'whether there should be a limit to the length of an external auditor's tenure as the bank's external auditor given the potential impact of audit firm rotation on independence and audit quality.' This implies there is a direct correlation between length of tenure and independence and quality: we reject this idea. Independence is the outcome of many factors, and length of tenure is not one. We recognise that audit rotation is a matter that is of interest to a range of stakeholders, including regulators, but do not consider that it should be addressed by Basel in this document as other initiatives are already underway in this area. Accordingly, we recommend you delete paragraphs 113 and 114.

29. We agree it is important that the audit committee understand and take ownership of their bank's financial reports, and our member firms share insights gained from the audit with members of the audit committee. ISA 260 *Communication with those Charged with Governance* guides our member firms' communications with the audit committee. This is an area where we are not persuaded that industry-specific requirements would be necessary or helpful.

30. However, we disagree that issues raised as part of the engagement quality control review process should automatically be shared with the audit committee (paragraph 123). The audit of the financial statements is there to provide assurance on the reliability of the reported information and the engagement quality control review is to ensure quality and consistency within and across a firm's audits. To provide the audited entity with information arising from the engagement quality control review confuses these roles. The engagement quality control review is not designed to ensure the audit committee receives the information they need to consider accounting judgments, and sharing issues raised from the review process is not the appropriate route to that end. In our view, reducing

confidentiality around engagement quality control review conversations will not support effective quality assurance processes and would be likely to inhibit them.

Principles 12 and 13: 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.

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

31. We strongly support the Committee's proposals around the need for effective working relationships between supervisors and auditors which include regular dialogue. We are pleased that working relationships have already improved in many jurisdictions in recent years and look forward to contributing to even more effective relationships in future. We agree that the objective of an effective relationship for supervisors is to enhance the effectiveness of their supervision; however, as the relationship must be a reciprocal the auditor's objective to give the appropriate opinion should also be included in paragraph 141.

32. We refer to our comments above on Principle 6 on going concern and valuation, as examples of matters on which supervisors should usefully share information with auditors; these are not specifically mentioned at paragraph 143 but are specific instances of how the relationships could be more effective and should be included in the document.

33. We welcome Principle 12, with the focus on the exchange of information relevant to the duties of both supervisors and auditors. With Principle 12 in mind, Principle 13 is incomplete: consistent with 12, there must be a requirement for the supervisor to report to the external auditor matters that are likely to be of material significance to the auditor.

34. Nevertheless, we are aware that there are a number of barriers which exist to a more open relationship; these vary by jurisdiction and will require further analysis to see how they can best be overcome. National laws may prohibit or limit communications by the external auditor to third parties. Some illustrations of this are laws governing client confidentiality, data privacy, bank secrecy or state secrecy, among others.

35. On the issue of safe harbours, the wording at paragraph 161 does not provide an adequate protocol for auditors to disclose information, for example it does not consider what happens where the bank withholds consent. Footnote 81 suggests that supervisors may be in a position to achieve a safe harbour for auditor communications, however, in many cases we believe that legislation may be required to create such a safe harbour.

36. In general in this section of the consultative document there is a lack of balance between the situations where auditors should disclose, and those when supervisors should; we would expect a more balanced and reciprocal engagement. Paragraph 163 states that supervisors "should carefully consider how sensitive the information is and the extent to which disclosing the information to the external auditor would support the supervisor in discharging their duties." We think a better test of when information should be disclosed would be the likely importance of the information known to the supervisor to the auditor's conclusion. This is consistent with our earlier point about market confidence being damaged if auditors are kept in the dark about information known to supervisors and relevant to (for example) a bank's ability to continue as a going concern in the short term.

37. Many of the barriers to communication are surmountable, although policy statements or legislative changes may be needed to overcome them. These will be different for each jurisdiction. We recognise that there is scope for this relationship to develop further, particularly as supervisors could commit more fully to providing auditors with information material to the audit.

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.

38. We wholeheartedly support the principle of open communication on risk and systemic issues. DTTL member firms across the world actively engage with banking supervisory authorities, professional accounting bodies, standard-setters and legislators and share their insights with these groups. We participate in the Global Public Policy Committee's work, including its engagement with the Financial Stability Board. Mark Rhys co-chairs the GPPC's banking audit advisory group which aims to deliver insights from the six largest global audit networks to the FSB. We are willing to provide more examples of our engagement if this is of interest to you.

39. One drafting point: a literally 'continuous exchange' of views would be setting the bar rather high, and a 'frequent exchange' would be preferable.

Principles 15 and 16: There should be regular and effective dialogue between the banking supervisory authority and the relevant audit oversight body.
The banking supervisory authority and the audit oversight body should observe appropriate confidentiality requirements when sharing information.

40. We support dialogue and information sharing between the banking supervisory authority and relevant oversight body, providing the respective responsibilities of each are clearly defined along with the objectives and benefits of the information sharing and governed by protocols that maintain confidentiality and applicable legal privileges.

41. It would make sense for the audit firm to be included in the discussions, or kept apprised of them so they can provide their perspective and hear any relevant feedback on their work.

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Annexes 1 and 2

42. We are unclear as to the purpose of the information at Annexes 1 and 2 so have limited our observations to the two points below.

43. There should be more emphasis on two-way communication – that is, reference to matters of audit interest on which supervisors can reasonably be expected to form views should be made, alongside matters of supervisory interest on which external auditors can reasonably be expected to form views.

44. It would be appropriate to refer to barriers that exist around sharing information, and how supervisors can help reduce these.