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

CONSULTATIVE DOCUMENT: *EXTERNAL AUDITS OF BANKS*

Ernst & Young Global Limited, the central coordinating entity of the Ernst & Young organization, welcomes the opportunity to offer its views on the Consultative Document: *External Audits of Banks*, issued by the Basel Committee on Banking Supervision (BCBS). We support the BCBS' efforts in this Consultative Document to bring further focus to the important topic of the external audits of banks and how to further improve the quality of those external audits and engagement with banking supervisory authorities. In addition, we appreciate the BCBS' outreach throughout this effort to the many stakeholders in the financial reporting chain of banks.

We recognize and embrace our role and responsibility to serve the public interest by providing quality audit services in an independent and objective manner. Fulfilling this obligation is fundamental to instilling confidence in and providing credibility to the financial reporting that is central to the efficient functioning of the capital markets around the world.

We broadly support the direction and goals of the Consultative Document to dialogue about and explore the ways in which the various participants in the external bank audit and bank supervisory roles can contribute to improving audit quality. As the demands on auditors and bank supervisors change over time, the expectations of stakeholders and how to best meet those expectations will also continue to further evolve. Meeting those changing demands is best met by engagement among the participants.

Our observations and comments are presented herein separated into:

- Overarching observations and comments and
- Observations and comments on specific principles (presented in Appendix 1 attached to this letter)

In addition, we broadly support the comments in the letter submitted on behalf of the Global Public Policy Committee (GPPC). In some instances within our letter, we express views similar to those contained in the GPPC letter.

Overarching observations and comments

Differing roles and responsibilities

We believe it relevant and important to understand and keep in mind that, while the roles and responsibilities of an external auditor of the financial statements of a bank and the banking supervisory authority are connected, they have different objectives and are governed by differing standards, requirements and regulations. The principal objective of financial statements prepared in accordance with an internationally accepted financial reporting framework (e.g., in accordance with International Financial Reporting Standards) is to provide decision-useful information for investors, and potential investors, in capital markets. The financial statements of banks are not prepared for nor provided to meet specific supervisory needs (stability of the banking system and the safety and soundness of individual banks), though certainly they contribute in this regard. These two differing, yet allied objectives should not be confused. The external audit of the financial statements and information discussed with an external auditor may aid in achieving supervisory objectives but it alone cannot meet them nor is it intended to do so. Clarity and understanding of the two purposes is central to each contributing to the public interest within its mandate.

Importance of international standards and standard setting

The Consultative Document acknowledges the importance of international standards, such as the International Standards on Auditing (ISAs) and the International Ethics Standard Board's (IESBA) Code of Ethics (the Code) and the work of their respective standard setting boards of the International Federation of Accountants. We believe effective international standard setting is critical to audit quality.

We are concerned that the Consultative Document is unclear about when it is simply referencing the ISAs and the Code, interpreting the ISAs and the Code, or establishing or appearing to establish expectations that exceed the ISAs and the Code. We have not identified each of these instances in this letter, but would be happy to further discuss should you desire.

We support the standard setting efforts of both the IAASB and IESBA and believe they should continue to establish internationally accepted standards applicable to the audits of all financial statements, including of banks. Because the ISAs and the Code are not specific to banks – and should in our view remain that way --it is important, as contemplated within the Consultative Document, that the BCBS engage in regular dialogue with the applicable standard setters to contribute to the on-going improvement of the standards and encourage, where applicable, interpretive guidance or other material useful to bank audits and bank auditors. We support this dialogue and desire to contribute to it in a positive and productive manner.

We suggest the Consultative Document consider a two prong approach which:

1) clearly references that auditors of banks comply with the applicable professional standards in the performance and conduct of the financial statement audit of banks (which may not be the ISAs or ethical standards of the IESBA in all instances, depending on the status of adoption of the ISA' or ethical standards in a given jurisdiction); and

2) addresses areas of additional interest to the supervisor including areas for other assurance or other work and/ or reporting that a supervisor could or should ask be performed, taking into account the circumstances and needs of the jurisdiction and its supervisory objectives. (see following section)

Supervisory expectations or needs beyond those of an external audit

The Consultative Document does not distinguish clearly proposals for potential additional work or reporting by the external auditor of banks from the discussion of the existing ISA requirements applicable to an external audit. In addition, Annex 1 of the Consultative Document provides guidance on the content of extended reports in certain jurisdictions. We believe the Committee should consider establishing a framework for supervisors to evaluate the need for additional work based on the following principles:

- Evaluate the need for additional work or reporting in the context of obtaining adequate assurance regarding institutions' compliance with relevant legal and regulatory requirements, including aspects of the Committee's Core Principles. Supervisors might obtain this assurance either by undertaking direct inspections or examinations of institutions or by engagement of the external auditor or another third party to undertake additional work.

- Additional work or reporting should be clearly differentiated from the requirements of a financial statement audit performed in accordance with ISAs or other applicable professional standards. It should be understood by the bank and its audit committee and management why additional assurance or reporting is required by the supervisor.

- Ensure any requirements for additional work or reporting by auditors are clearly understood in their respective jurisdictions. Any additional procedures or engagements, including terms of reference, should be understood by and agreed between the relevant parties to avoid misunderstanding or not meeting expectations.

- Engage in discussion with the auditing profession about any proposed additional engagements or reporting to ensure that they are capable of being performed in accordance with relevant professional standards, including any threats to the auditor's independence and objectivity depending on the nature of the engagement.

Specifically on reporting, there is considerable dialogue under way on the "auditor's report" itself. The IAASB and the US PCAOB, just as examples, have consultations or efforts underway to enhance and modify the auditor's report, and the UK FRC has recently issued new reporting standards. In addition, other initiatives focus on improving company reporting, for example, the International Integrated Reporting Council's efforts to promote an Integrated Report and the Financial Stability Board's Enhanced Disclosure Task Force which is focused on various aspects of enhancing bank disclosures. Supervisors can add meaningfully to these dialogues, based on their experience. This could include not just the auditor's report but also potential enhancements in corporate reporting, such as separate reporting by management about going concern or forward-looking risk information which may contribute to supervisory objectives and provide additional subject matter on which auditors could be engaged to report. Supervisors should also consider the extent to which requiring auditors to report on additional

information s – e.g. on regulatory capital calculations – could enhance transparency and public confidence in regulated institutions.

Recognition of jurisdictional differences and the effects thereon

The Consultative Document acknowledges in paragraphs 12 and 13 that significant differences exist in national, institutional, legislative and regulatory frameworks and that the principles in the Consultative Document should be applied in accordance with national legislation and corporate governance structures in each country.

These jurisdictional differences will impact a number of the principles and how they will and can be implemented. In some jurisdictions, changes may be necessary to allow for the type of communications the Consultative Document envisages between the external auditor and the supervisor.

Importance of open, transparent two-way communication

We support the objective of enhancing effective two-way communication between external auditors and supervisors beyond the statutory duty of an auditor to report certain matters which is in place in a number of jurisdictions. We recognize that during the conduct of a financial audit an auditor may identify matters that are of interest to a supervisor. The principles and guidance as drafted appear more focused on information to be provided by the auditor to the supervisor. We believe that the guidance should clarify that dialogue is expected to be two-way, and the supervisor should provide information to the external auditor that is relevant to the conduct of the external audit which might include information such as the supervisor's views on the bank's solvency, risk governance and compliance framework, internal controls or its view on the loan loss provisioning as compared to other institutions on an unnamed basis, just to mention a few. We believe information supplied by the supervisor would make a direct contribution to enhancing audit quality. It speaks to the complementary nature of the work of both parties.

Supervisors will need to establish and implement communication protocols to support enhanced and robust dialogue with the external auditor. The protocols should remove or alleviate potential barriers to effective communication faced by all relevant parties including external auditors, supervisors, audit oversight bodies, and those charged with governance and management. The matters that should be considered in such a protocol include the following:

- *Confidentiality:* The Document establishes, in Principle 16, confidentiality requirements for the supervisor and the audit oversight body when sharing information. While the Document acknowledges that external auditors are required to comply with the duty of confidentiality in the IESBA Code, protocols are required in order to address potential conflicts with this duty, in particular relating to information reported by the external auditor to the banking supervisor or audit oversight body.

- *Safe harbour:* While the Consultative Document acknowledges the effect on communication of the availability of a safe harbour to an external auditor, we believe greater emphasis should be placed on the importance of jurisdictions working towards achieving a safe harbour, if not already in place. Without a safe harbour, the ability of auditors to communicate frankly is curtailed.

- *Reporting:* The Consultative Document establishes expectations regarding communications from the external auditor to the supervisor but does not provide a great deal of guidance to enable the auditor to determine what would be of greatest interest to the supervisor. Given the different practices around the world currently in this regard, it seems likely there could be a misunderstanding or unmet expectations between the supervisors and the external auditors. We recommend either the Consultative Document provide criteria with which the external auditor and supervisor can evaluate what is expected to be communicated, or indicate the importance of establishing such criteria at a jurisdictional level. An example is the Bank of England's Prudential Regulation Authority's recently issued code of practice framework providing greater clarity around such communications with respect to banks under its jurisdiction.

- *Communication with audit oversight bodies:* We believe protocols between the banking regulator and relevant audit oversight body should be established that address what information would be shared between the parties and the manner in which the information would be shared. We also think it is important that external auditors participate in these dialogues, where appropriate, so there is a full understanding of the different perspectives.

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We would be pleased to discuss our comments with the BCBS and/or the working group of the Consultative Document. If you have any questions, please contact Karen M. Golz, Global Vice Chair, Professional Practice at 44 (0) 207 980 0004 or via email at karen.golz@eyg.ey.com or William Schlich, Global Banking and Capital Markets Leader at 212-773-3233 or via email at William.schlich@ey.com.

Yours sincerely,

Ernst & Young Global Limited

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Appendix 1

Observations and comments on specific principles

- **Supervisory expectations relevant to the external auditor and the external audit of the financial statements**

  A. The supervisor's expectations of the external auditor of a bank (Principles 1 through 4)

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 agree industry knowledge and competence is important and necessary for designing and executing effective audits. However, we have concerns that paragraph 33, in particular, may suggest more than is currently required under the IESBA Code on professional competence and due care, the ISAs and the International Standard on Quality Control (ISQC 1) as regards professional competence and skills**.** The potential extension is aligned to one of our overarching observations.

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

We agree fully that the external auditor of a bank should be objective and independent in fact and appearance and comply with applicable ethical or independence standards. We do not agree this means the requirements applicable to public interest entities (PIEs) should be applied universally to all banks. While the globally systemically important banks (G-SIBs) are without question PIEs and in many jurisdictions, generally banks are PIEs, it is not always the case. Some countries may have very small institutions with little interaction with the general public and we see no reason, to deem them to be PIEs if the jurisdiction itself has not. These would likely be non deposit taking institutions.

The IESBA's Code of Ethics provides that a jurisdiction may determine what constitutes a PIE. The Code of Ethics is developed in accordance with robust due process and public interest oversight and it is our suggestion that its approach to the PIE definition be followed.

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

We fully agree that the exercise of professional skepticism throughout the audit is necessary and, of course, required by the ISAs. Paragraph 52 discusses that the extent of professional skepticism should be "demonstrable and understandable" through the audit documentation. It is not clear if this is intended to require more documentation

than the ISAs currently require. We believe if changes are necessary to enhance international professional standards and, thereby, audit quality, those suggested changes are best made directly to the international standard setting boards to take up in due course.

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

We have concerns about this principle for the same reasons as articulated in Principle 2 above. This principle appears to take a single approach for all banks, regardless of size or significance or how they are viewed in their own jurisdictions. We believe ISQC 1 is the operative standard and it should be followed and not be supplemented by additional requirements as appear to be contemplated herein.

B. Supervisory expectations of the audit of a bank's financial statements (Principles 5 through 6)

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 internal control environment.

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

We believe the content of Principles 5 and 6 are generally required by the ISA's. We did note paragraph 74 appears to have a significant amount of regulatory content that may not fall within the scope of the audit of the financial statements and, therefore, may be required to be addressed in a separate regulatory requirement or engagement.

We also note with respect to Principle 6 and its detailed comments that an auditor would benefit from two-way communication with the supervisor in considering and identifying the significant risks of material misstatement.

- **Supervisory expectations with regard to a bank's audit committee and its relationship with the external auditor (Principles 7 through 11)**

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.

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.

We welcome initiatives around strengthening the effective working of audit committees and many of the comments in Principles 7 to 11 to support such efforts. We believe strong audit committees and governance are important ingredients to enhancing audit quality.

We are concerned that the extent of the information in paragraphs 103 to 139 may imply additional requirements or effort on the part of the audit committee (and potentially the auditor) and a need for an audit committee to have enhanced documentation over what it might otherwise have obtained to achieve its purpose and objectives. It is not clear if this is what is intended or would be required. We believe audit committees will be interested to understand if this is intended and how they might best achieve these intended objectives.

As noted in the main body of our response, we believe certain points relative to communication with the audit committee exceed those currently contained within the relevant ISAs. If these are useful to an audit committee, it would likely not be limited to banks and we recommend these be considered by the IAASB for potential standard setting.

We do not agree with paragraph 114 regarding re-tendering policies and tenure related considerations. Several proposals are under consideration around the world for either mandatory rotation or mandatory re-tendering. We believe the conclusions and recommendations of the Canadian Audit Quality Initiative should be considered as an interesting and thoughtful alternative. The key recommendation of this effort is for audit committees to conduct a comprehensive review of the auditor at least every five years and report to the shareholders on this review. This would be as an alternative to mandatory firm rotation or mandatory re-tendering. This review would focus heavily on the quality of the external auditor's work as well as its objectivity and independence, and would be transparent to shareholders. The report, released 30 May 2013 concludes a) that the mandatory rotation of audit firms or mandatory retendering of the audit would not contribute to the enhancement of audit quality, b) that having the audit committee perform a periodic comprehensive review of the audit firm at least every five years, resulting in a recommendation to retain or replace the audit firm, is a preferred approach to address any institutional familiarity threats potentially created by audit firm tenure and to focus on audit quality and c) that a report summarizing the results, findings and conclusions of the comprehensive review should be included in an entity's public disclosures in the year the comprehensive review is carried out.

This potential approach as put forth in the Enhancing Audit Quality: Conclusions and Recommendations report of the Canadian Public Accountability Board would potentially touch on and address much of what is contemplated by Principles 7 through 10.

Further, given the report would be included in the entity's public disclosure there is transparency to the audit committee's evaluation and process.

- **The relationship between the supervisor and the external auditor (Principles 12 through 14)**

A. Effective relationship at the supervised bank level

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.

We support dialogue between the external auditor and the supervisor as a means to enhance audit quality. This is subject to creating the necessary structure and protocols in jurisdictions which may have barriers such as legal, regulatory, confidentiality and so forth. We would not want this to be interpreted as an additional requirement for established written reporting to the supervisor where such does not already exist, but rather, remain as a means for a robust two-way dialogue of industry specific and institution matters of significance. We believe the current reporting by the external auditor to the audit committee or those charged with governance as well as the supervisor (where already in place) could form the basis for this dialogue.

There is an important role for management of the institution, as well, to fulfill in these dialogues. Some dialogues may be best served to be tripartite—management of the institution, supervisor and the external auditor.

In addition, in various places in Principles 12 and 13, there are broad comments which are open to interpretation and could create unclear expectations. For example, paragraph 155 says, "The contents of the external auditor's communication could cover **all** issues that the supervisor **might consider relevant** in carrying out its functions." We believe wording such as "all" and "might consider relevant" are vague and open to interpretation and both sides would benefit from greater clarity about the expectations of the dialogue.

B. Effective relationship at the levels of the audit firm and the accounting profession as a whole

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.

We strongly support this principle and welcome the opportunity to have open, timely and regular communication on key risks and systemic issues and to engage in formal and informal discussions. We believe such communication aids all parties and is most effective when the dialogue is two-way and reflects a "give and take" by all participants.

Where possible, these dialogues can be informed by members from the profession with specialization in banking, risk, valuation, accounting and auditing.

As a network, we are already engaging, along with others in the profession, in outreach and dialogue with other participants and we look forward to continuing to do so.

- **The relationship between the banking supervisory authority and the audit oversight body (Principles 15 through 16)**

Principle 15: There should be regular and effective dialogue between the banking supervisory authority and the relevant audit oversight body.

Principle 16: The banking supervisory authority and the audit oversight body should observe appropriate confidentiality requirements when sharing information.

We believe such interactions may vary based on the jurisdiction and regulatory and legal requirements and enabling changes may be required. We believe protocols between the banking regulator and relevant audit oversight body should be established that address what information would be shared between the parties and the manner in which the information would be shared. We think it is important that external auditors participate in these dialogues, where appropriate, so there is a full understanding of the different perspectives.