

RESPONSE OF THE SIX LARGEST GLOBAL AUDIT NETWORKS TO THE BASEL COMMITTEE ON BANKING SUPERVISION CONSULTATIVE DOCUMENT- “EXTERNAL AUDITS OF BANKS

We appreciate the opportunity to comment on the Basel Committee on Banking Supervision's (the Committee) consultative document on 'External audits of banks' (the Document).

This response is prepared by the six largest global audit networks (the members of the Global Public Policy Committee (GPPC)) and presents a summary of the key observations that the networks share. These observations may also be reflected in the separate submissions of individual networks which also include additional observations by members of the network concerned. The members of the GPPC are referred to as “we” throughout this document.

We support the establishment of principles to guide the interactions between external auditors, audit committees and supervisors of banks with the objectives of enhancing audit quality, stability of the banking system and fostering the safety and soundness of individual banks. In doing so, we acknowledge the importance of the banking sector to the global economy. We believe that the implementation of appropriate principles, tailored to reflect the significant differences in national institutional, legislative and regulatory frameworks, and designed with sufficient flexibility to respond to the diversity in size, complexity, structure, economic significance and risk profile of different banks, can assist in achieving those objectives.

We welcome the Committee's inclusion of a section on Audit Committees as we believe they play a very valuable role in supporting and promoting the quality of financial reporting, the control environment and audit quality.

Similarly we see the inclusion of the section on the relationship between the supervisor and the external auditor as fundamentally important. The need to develop open and effective communication between auditors and supervisors is one of the lessons from the financial crisis.

We support many of the principles outlined in the Document and much of the supporting guidance. There are, however, areas in the Document which we believe could lead to misunderstanding, could result in unnecessary work effort in some circumstances, or that may be impracticable. Much of this concern stems from the way the guidance is structured rather than necessarily its content. We address each of the areas below.

If you have any questions on the content of this memorandum please contact either John Hitchins of PwC (+44 20 78042497, john.hitchins@uk.pwc.com) or Mark Rhys of Deloitte (+44 20 73032914, mrhys@deloitte.co.uk) who co-chair the GPPC Bank group.

Section 1: Principal Comments

We have grouped our principal concerns under two headings:

Comingling of ISA and IESBA requirements and the Committee's expectations

We have concerns with how the Document presents the Committee's expectations of an external auditor of a bank. The Document comingles the Committee's recommendations – which go beyond internationally accepted auditing and ethical standards – with selected portions of and interpretation of those standards.

Since the financial crisis, there has been an increased focus on audit quality by audit oversight regulators and professional bodies around the world and we support those activities. The Committee has demonstrated its concern with audit quality by incorporating in the Document selected parts of, and commentary on, International Standards on Auditing (ISAs) and the Code of Ethics issued by the International Ethics Standards Board for Accountants (IESBA Code). However, the way in which these existing requirements are comingled with the Committee's recommendations results in the Document being unclear as to what are actual requirements of those standards and what are the Committee's incremental recommendations.

We believe standards and guidance for audits of financial statements should be issued by auditing standard setters and that therefore the subject matter of principles 1-6 in the Document would be better placed as part of auditing standards and guidance. This guidance should clearly distinguish between the specific requirement of an ISA and guidance on applying the ISA requirement in the context of a bank. The UK Auditing Practice Note 19 is an example of guidance of this nature. We believe it would be preferable for such guidance to be issued by the International Auditing and Assurance Standards Board (IAASB), or, given the previous guidance on external audit was issued jointly by BCBS and the IAASB, to be a joint document or formally endorsed by the IAASB if joint issuance is not practical.

The guidance makes extensive use of the word 'should' throughout which may lead to misunderstanding between auditors, audit committees and supervisors. The "Clarity project" to revise ISAs, undertaken by the IAASB, established certain conventions to enhance the consistency of application of ISAs around the world. Specifically that project concluded that the word 'should' is ambiguous, and could be interpreted as implying best practice rather than mandating an action by the auditor. As such, this word was eliminated from ISAs, replaced instead with the use of the word 'shall' when an auditor was required to perform an action and the use of the word 'may' when actions were conditional or recommended best practice. Since users of the Document will be familiar with the language used in ISAs we recommend that in restructuring the Document, as we suggest above, the word 'should' be replaced with 'shall' or 'may' as appropriate. Further as we understand from the Document that the Committee intends for the principles to establish best practices and be applied with appropriate flexibility by different jurisdictions, we therefore believe that in most cases a change to use of the word 'may' will be appropriate.

The Document also incorporates portions and paraphrases of the IESBA Code; however, we believe these requirements are better expressed in the IESBA Code itself and that additional interpretive guidance from the Committee in this area may add confusion rather than clarity.

There are a number of instances in the Document where the extent of regard to regulatory requirements that is suggested appear to us to go well beyond meeting an ISA requirement and instead appear to address supervisory objectives. Various jurisdictions already have requirements or practices in place for external auditors to perform additional procedures that go beyond the scope of an ISA audit. We believe such requirements should continue to be decided on a jurisdiction basis as part of a separate regulatory audit requirement that national supervisors might agree with national audit professional bodies. A 'one size fits all' approach is not the most efficient or effective approach – what is appropriate will vary with the different circumstances and practices of individual jurisdictions and institutions. Therefore, instead of setting detailed requirements we believe the Committee should establish a clear framework for supervisors. In particular, we believe the Committee should make clear the following principles:

- Supervisors should 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 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. It would be helpful for the Committee and supervisors to explain the objectives of requests for additional assurance or reporting.
- Supervisors should ensure that any requirements for additional work or reporting by auditors are clearly communicated in their respective jurisdictions, including guidance on the basis and form of reporting to be provided. Any additional procedures or engagements, including terms of reference, should be understood by and agreed between the relevant parties.
- Supervisors should 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 that any threats to the auditor's independence and objectivity are considered.

Open and effective two way communications

We fully support the objective of fostering 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. However the principles and guidance as drafted are focused primarily on information to be provided by the auditor to the supervisor. We believe the guidance should be more balanced in order to foster a robust discussion and, therefore, we recommend the inclusion of an additional principle that the supervisor should provide information that is relevant to the conduct of the external audit to the external auditor. We believe information supplied by the supervisor would make a direct contribution to audit quality through assisting auditors in making judgments on risk.

In order for improved dialogue to occur, it is necessary for supervisors to secure the establishment of appropriate communication protocols. The protocols should remove or alleviate potential barriers to effective communication faced by all relevant parties including external auditors, supervisors, audit oversight bodies, those charged with governance and management. Matters we believe should be addressed 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 and, in some jurisdictions, legal restrictions, 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 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 Document establishes expectations regarding communications from the external auditor to the supervisor but provides limited guidance to enable the auditor to determine what would be of interest to the supervisor. Given the different current practices in this area around the world, there is a strong likelihood of an expectations gap developing between the supervisors and the external auditors. To address this we recommend that either the 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. For example we are aware that the Bank of England's Prudential Regulation Authority issued such a code of practice framework in April 2013 providing greater clarity around such communications with respect to banks under their 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 to ensure the participation of external auditors at an appropriate point in the process so there is a full understanding of the different perspectives.

Section 2: Other areas where we believe clarification is needed

The designation of all Banks as Public Interest Entities

The Document applies the Public Interest Entity ("PIE") designation to all banks regardless of the size, complexity, structure, economic significance or risk profile of the bank. Footnote 28 to the Document notes that a PIE is defined by the IESBA Code of ethics and that definition allows for a relevant regulator to make such a designation. It does not automatically make all banks PIEs. In practice the use of the PIE designation leads to a significant increase in the extent of quality control and independence compliance requirements that must be applied by the external auditor. For small or narrow purpose banks we believe the requirements should be proportionate to the risks of the institution and therefore do not believe the extra cost involved is always justified.

We believe that in most cases such designation is best applied on a national jurisdictional basis where its application can be tailored to the specifics of the industry in that country, in particular to the size and complexity of the banks. Where an auditor believes a bank does not warrant designation as a PIE this is something that can be usefully discussed between auditor and supervisor

External Audit firm re-tendering

Paragraph 114 proposes that audit committees should have a policy that stipulates the frequency with which there should be a tender for the external audit. We believe such a requirement is too prescriptive and might be interpreted as a mandatory tendering requirement. Application of too rigid a policy may also create operational risks if an audit committee felt obliged to run a tender process in a period of significant change. Instead, we believe audit committees should be required to reassess regularly the auditor's effectiveness, including with respect to independence and objectivity. Considerations would include the possible impact of a change in auditor on audit quality as well as the safeguards that the current auditor has in place to mitigate self-review and familiarity threats, such as quality controls and rotation of members of the audit engagement team. This assessment should be made transparent to shareholders. In addition, if the audit is submitted to tender, it should be made clear that the audit committee should apply the same rigour in assessing quality and independence for all those tendering.

We also believe it would be premature for this Document to impose more rigid recommendations while these issues are still being debated in a number of other international forums.

The paragraph could also be read as asserting that there is an audit quality issue with the long tenure of an external auditor. We would point out that there is no evidence to support this assertion and suggest that the paragraph should be reworded.

Knowledge, competence & training

Section 130 of the IESBA Code on professional competence and due care imposes obligations on audit firms to maintain professional knowledge and skill at the level required to ensure that clients receive competent professional service and to act diligently in accordance with applicable technical and professional standards when providing professional services. We believe it is appropriate to stress in Principle 1 the importance of giving consideration to specialised industry knowledge and experience; however, we do not agree with the detailed recommendations in the Document specifying how and what should be done and which do not appear to be necessary in order to comply with the ISAs and the IESBA Code.

For example paragraph 33 introduces a concept of proficiency in the context of knowledge and competency but it is not clear what is meant by this. If it is intended to repeat the existing ISA and IESBA requirements then we believe it is confusing and should be deleted. If something additional is proposed then this needs to be clearer. Similarly in paragraphs 35 & 36 while we agree that the overall engagement team should have the necessary skills and competency required for the specific bank audit, the Document should reflect that the application of

competency requirements to individual members of the engagement team will vary according to their role. Similarly the audits of different banks may require different skills depending on the nature of their businesses.

Role of the Engagement Quality Control Reviewer (EQCR)

The Document introduces a requirement that differences of opinion between the EQCR and the engagement leader be communicated to the audit committee. External auditors have established formal internal processes for resolving differences of opinion between engagement team members and the engagement leader, and between the EQCR and the engagement leader which ultimately result in the audit firm forming one collective opinion. Such protocols are already rigorous when there is any difference of opinion between the engagement leader and the EQCR. ISA 220 requires each audit firm to have a process for resolving differences of opinion and effectively prohibits the issue of an opinion while an unresolved difference between the engagement leader and the EQCR exists. While we believe it is important for the audit committee to be made aware of alternative treatments regarding complex or significant accounting judgements we do not agree that it is necessary to attribute these views to individual members of the engagement team. We recommend that the Document remove all implicit and explicit requirements along these lines.

Interaction between the External Auditor and Board Committees

Consistent with the fact that the external auditor is already required by ISAs to communicate various matters to the audit committee (or others charged with governance oversight of that relationship), the Document provides extensive discussion of how such communications could be enhanced. In addition paragraph 130 of the Document states that 'Further, to enhance audit quality, the audit committee should consider, if necessary, assisting the external auditor to gain access to any other committee meetings that the external auditor determines to be relevant for the auditor's work.' We welcome the inclusion of this sentence but are concerned that it may not be worded commensurate with the significant importance of the key Board Committees. Rather than stating that the audit committee "should consider" the two actions described in the paragraph, we believe that the Document could usefully clarify that such access, particularly to risk committees, should be expected. More fundamentally, the Document should state that management shall provide the external auditor with full co-operation and access to all information necessary to perform the audit.

Collective Board responsibility

We consider that there is a long established practice regarding the importance of collective responsibility by the Board and that this is necessary to clarify the fiduciary and legal obligations of Board members. Paragraph 106 requires differences of opinion between the members of the audit committee and the rest of the members of the Board regarding the appointment of the external auditor to be publicly disclosed. Such disclosure is inconsistent with the notion of collective responsibility and we do not believe that it will enhance the quality of the process of appointing the external auditor.

