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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Via Email to baselcommittee@bis.org

Re: External audits of banks - consultative document

Dear Committee Members:

Grant Thornton International Ltd appreciates the opportunity to comment on the Basel Committee on Banking Supervision's *Consultative Document - External audits of banks* (Consultative Document). We welcome the Committee's efforts and recommendations to improve the quality of external audits of banks and communications between supervisors and auditors. We agree that improving audit quality is an important component in market confidence in banks and that external auditors, supervisors (regulators), and audit committees (or others charged with governance) all have important roles.

We support many of the principles and commentary in the Consultative Document, although we do have some specific comments on the Consultative Document as set forth below.

Supervisory expectations

The document outlines various supervisory expectations of auditors and audit committees (or others charged with governance). However, the document is unclear as to its exact status or intended role in the improvement in the external audit of banks, and we believe that the final document should clearly indicate whether it is an enforceable, authoritative document or only suggestions that may or may not be adopted. Further we believe it should clearly articulate whether auditors and audit committees are expected to comply with this document upon final issuance. We believe that auditing standards should continue to be set by auditing standard setters such as the International Auditing and Assurance Standards Board (IAASB).

We also note that the document defines Supervisors as "[T]he group of supervisory personnel at a banking supervisory authority who are directly involved with the supervision/examination of a specific institution." Paragraph 12 indicates that "Supervisors should clearly communicate the recommendations contained herein to the banks they supervise and their respective external auditors, and articulate the measures banks and external auditors should undertake to meet these best practices, where possible." We believe that the communication of the recommendation in the Consultative Document should be communicated by the applicable

"Banking supervisory authority,"[1] (rather than the Supervisors) to the banks they supervise and their respective external auditors and that the legal status of these recommendations should be made clear in that communication.

We note that in certain jurisdictions, the principles included in the Consultative Document are already implemented. We recommend that the document clearly distinguish between currently existing audit requirements and the supplemental recommendations of the Committee. Additionally, we believe it would be important for the Committee (or respective local Banking Supervisory Authorities as appropriate) to identify to the relevant audit standard setter where enhancements to current auditing standards are needed versus situations in which the Committee's principles are more of a reminder about existing auditing standards.

Working with auditing standard setters

We believe that the Committee's recommendations related to auditing would be best implemented by the continued collaboration with the IAASB.

Responsibilities of the audit committee or others charged with governance

We agree that audit committees are important in the oversight of the external audit function. The consultative document includes various recommendations, which we support, for audit committees or others charged with governance to improve their oversight of the external auditor. However we do not believe that this document is sufficiently known by those important constituents and recommend that the Committee separately expose the principles and related guidance for audit committees and/or consider issuing a consultative document that updates the October 2010 paper on *Principles for enhancing corporate governance.*

Working together

Paragraph 155 indicates that "[T]he contents of the external auditor's communication could cover **all issues** that the supervisor might consider relevant in carrying out its functions." However, Principle 13 indicates that the "The external auditor should report to the supervisor matters that are likely to be of **material significance** to the functions of the supervisor." We believe that requiring communication of all issues or those that are of material significance to the supervisor is overly broad and auditors are unlikely to know all issues that the supervisor might consider relevant (especially with hindsight). Therefore, it is not reasonable to create the expectation that the auditor can do so unless (i) the supervisor communicates to the auditor the matter of interest; and (ii) defines key terms, such as "material significance," in order to have a common understanding of the supervisor's expectations.

We also believe that the interests of the public would be better served by requiring a two-way dialogue between the auditor and the supervisor. For example, Principle 13 could and should also apply equally to the supervisor such that there is a two-way dialogue between the external

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[1] Banking supervisory authority is defined in the Consultative Document as "The body responsible for promoting the safety and soundness of banks and the banking system in a particular jurisdiction, including the persons who are involved with supervisory policy setting and policy issues, including policies regarding accounting and auditing."

auditor and the supervisor on matters that are likely to be of material significance to the functions of the external auditor.

In order to establish effective communication channels between auditors and supervisors, we believe that it is important that each party clearly understands the concerns and issues the other party is considering with respect to the specific bank, such that both parties know what likely would be of material significance to the function of the auditor or supervisor. Further, understanding the current concerns and issues of each party with respect to the specific bank would help ensure that nothing important is excluded in the respective roles of both parties. However, we do not intend to suggest that either party should use the work of the other as a substitute for its own work.

We realize there may be jurisdictional barriers in achieving better collaboration between auditors and supervisors, however we believe solidifying this as a principle will be an important step in overcoming those barriers.

Retendering

Paragraph 113 highlights some important positive and negative considerations in changing an auditor, and paragraph 114 presents an approach to retendering that appropriately involves the audit committee.

In our responses to other consultations, we have supported the adoption of measures, such as retendering or firm rotation, which could serve to prevent complacency by audit firms in a market where audit tenures are excessively long and which may bring about improvements in choice, innovation, and quality through increased competition. The implementation of measures such as tendering and rotation could also have the beneficial effect of addressing the concerns of those investors who believe more frequent changes of auditor would take away perceptions of potential loss of independence which arise when an audit firm is in place for too long. Other jurisdictions and regulators – such as the European Co-legislators, the UK's Financial Reporting Council, and the UK Competition Commission – are considering retendering and firm rotation, and we believe that the Committee should likewise consider these. We note, however, that the retendering or rotation period must be sufficiently long so that any benefits are not outweighed by the costs, and that retendering or rotation must be accompanied by additional provisions designed to prevent the unintended consequence of increasing market concentration in the hands of the dominant audit firms.

Alongside retendering and rotation is the important issue of the day-to-day exercise of independence and skepticism by audit engagement teams as they interact with management and evaluate audit evidence. For this reason we believe the concern of supervisors and other stakeholders should also focus on pressures on auditors over being dismissed and whether there are safeguards regarding inappropriate dismissal of an auditor for exercising appropriate independence and skepticism.

In addition, we believe that the Committee should provide guidance to audit committees and supervisors that helps empower them in their important oversight of the external auditor. We

believe this could be best accomplished through providing audit committees and supervisors with guidance as to how to evaluate external auditor's knowledge, competence, objectivity, independence, professional skepticism, and effectiveness. Further, the Committee should recommend measures that can be taken by the audit committee and supervisor to monitor the pressures the audit engagement team feels to conform to management's desires and expectations as well as the existence of any issues that the auditor believes may endanger their tenure. Supervisors should also interview audit committees and auditors whenever the auditor is dismissed or resigns to gain a full understanding of the causes.

Going concern

Paragraph 96 indicates that "…if the external auditor considers referring to the going concern issue in the audit report, the external auditor should promptly communicate this fact to the supervisors." We believe the Consultative Document would be enhanced by clarifying what should trigger the auditor to communicate with the supervisor on material uncertainties that could bear on management's "going concern" determination. We also believe that the supervisor should communicate to the auditor whether they have any significant information and concerns relevant to the auditors going concern evaluation.

Audit committee's evaluation of the audit approach

Paragraph 120 indicates that "At the start of each audit, the audit committee should consider whether the audit approach is appropriate, including considerations on the audit scope, the level of materiality, areas of focus and whether planned audit procedures address the areas of significant risk for the bank…" We believe this language may be interpreted as placing a greater responsibility on the audit committee than they have the expertise and information to reasonably satisfy. We suggest that it be reworded to ask the audit committee to "obtain an understanding of the audit approach, scope, level of planning materiality, areas of focus and how the planned audit procedures address the areas of significant financial reporting risk for the bank."

We also note that management's materiality threshold for preparation of financial statements should be understood by the audit committee and that the auditor's planning materiality may be different from the auditor's consideration of identified errors and disclosure deficiencies at the conclusion of the audit. As discussed in paragraph 62, "The determination of what is material to the financial statements as a whole is a matter for the external auditor's professional judgment about misstatements that could reasonably be expected to influence economic decisions of users taken on the basis of the financial statements." We also note that the auditor may change its materiality after the planning phase in response to changes in expectations, perceived risk or other factors identified subsequent to planning. We recommend that the Committee include a recommendation that the audit committee obtain and evaluate management's materiality threshold and that the Consultative Document include recognition that the auditor's planning and evaluation thresholds may appropriately be different than management's.

Other items

- Paragraph 7 indicates that "The audit of the financial statements does not relieve management or those charged with governance of their responsibilities." We believe that the document would be enhanced by articulating management's responsibilities related to the audited financial statements, internal controls, regulatory compliance and other matters that are the responsibility of management.
- We agree with the guidance in paragraph 11 that states that "The implementation of the principles set forth in this document should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs." We believe that this guidance should be considered in the recommendations included in each specific principle.
- Paragraph 60 indicates that "...the external auditor of a bank should perform <u>extensive tests of controls</u> over financial reporting to assess whether, and to what extent, the auditor can rely on them" (emphasis added). The phrase "extensive tests of controls" is ambiguous. For example, we are unclear whether the Committee is calling for internal control testing that may not be required under auditing standards. Alternatively, we recommend that the committee set forth and justify the cycles (e.g., loans and deposits) for which testing of internal control over financial reporting is a necessity. We also believe that the Committee should clarify what it means to "extensively" test the controls throughout the period under audit. Further, we note that extensive testing of internal control (or any testing) might not be needed in respect to some accounts and cycles. We also observe that before deciding which controls to test, an auditor first seeks to obtain an understanding of the design of the controls and whether such controls are implemented prior to deciding whether tests of controls are appropriate.
- Paragraph 105 indicates that "[T]he audit committee should contribute a section to the bank's annual report which explains the approach taken regarding the recommendation of the appointment or reappointment of the external auditor, and should include supporting information on the tenure of the incumbent auditor." We agree that the audit committee should disclose such matters on a timely basis, but there may be places other than the annual report where such disclosure should be included.
- Paragraph 123 indicates that 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." We do not agree with the requirement that the engagement partner should disclose situations in which his or her conclusions were different at some point during the audit from the quality control reviewer. The engagement quality control review is an important factor in audit quality and we note that audit firms have important processes and controls in place to resolve differences in views that ultimately result in a firm view.
- We recommend that Paragraph 171 should also reference relevant audit oversight bodies.

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If you have any questions about our response, or wish to further discuss our comments, please contact Jack Katz, Global Leader – Financial Services, 1-212-542-9660, and Jack.Katz@us.gt.com.

Sincerely,

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