The Japanese Institute of
Certified Public Accountants
4-4-1, Kudan-Minami, Chiyoda-ku, Tokyo 102-8264, Japan
Phone: 81-3-3515-1130 Fax: 81-3-5226-3356
E-mail: kigyokaikei@jicpa.or.jp
http://www.jicpa.or.jp/english/

June 21, 2013

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Comments on the Basel Committee's Consultative Document "External audits of banks"

The Japanese Institute of Certified Public Accountants ("we", "our", and "JICPA") is grateful for the opportunity to comment on the Consultative Document "External audits of banks" ("the document").

The document states that it "forms part of the Committee's commitment to help improve audit quality at banks" (paragraph 1) and is expected to "enhance the effectiveness of prudential supervision, which will then contribute to financial stability" (paragraph 2). It also states that "to enhance the effectiveness of supervision, supervisors have a keen interest in the quality with which external auditors perform bank audits. Building effective relationships with external auditors can also enhance banking supervision" (paragraph 5).
Considering the role of the external auditors and the relevant parties around them, we would like to point out the following.

- The supervisor and external auditor sometimes have complementary concerns regarding the same matter, such as a bank's internal control or risk management system. Yet the objectives of bank supervision and the external audit are not necessarily consistent. An audit process which provides assurance over the reliability of the financial statements prepared by a bank is not necessarily a process that contributes to the overall objective of supervision.
- The management of a bank is responsible for operating the bank and an external auditor is as an independent third party. When an external auditor conducts an audit of financial statement, it does not necessarily do so expressly to ensure the prudence of the bank.
- We understand that the principle of the document is to enhance the effectiveness of the external audit. If, however, the banking supervisory authority expects the external auditor of a bank to follow requirements beyond those envisaged in the generally accepted auditing standards, discrepancies in the responsibilities recognised by the external auditors may arise.

In consideration of the above, JICPA has prepared the comment letter on the document

considering the following perspectives.

- Given the differences in the objectives of banking supervision and the financial statement audit, auditors should not be burdened with undue responsibility for the sake of achieving the objective of banking supervision. Placing undue responsibility on external auditors may make it difficult to concentrate audit resources, which in turn may prevent the real objective of a financial statement audit from being achieved. (Comment No. 2, 3, 5, 8(2), 9(2), 10, 11)
- If the external auditor communicates directly with the banking supervisory authority before considering the decisions of the management or discussing the matters with the management, it may interfere with the division of responsibility between the management and auditor and prevent the management from discharging its full responsibility. (Comment No. 6(1), 6(2)). Our comments on the document follow below.

1. Application

Paragraph 10 of the document states that the document applies to "all banks" subject to statutory audits. We think the scope should be narrower. Instead of "all banks," we propose that the scope be narrowed to SIBs only or to banks other than unlisted banks or small deposit-taking financial institutions.

(Reason)

Paragraph 11 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." Yet in reviewing the document, we find no recognizable indication that implementation according to criteria such as the significance or risk profile of the bank, is allowed.

Japan has a number of small deposit-taking financial institutions (such as cooperative regional financial institutions) that cannot be readily considered as systemically important financial institutions. It thus seems inappropriate to require the application of requirements such as those in paragraphs 27, 42, and 53 to all financial institutions without exception.

2. Importance

In relation to the requirements in the internationally accepted auditing standards (hereinafter referred to as the "ISA") (paragraph 10 of ISA 320), paragraph 64 describes the use of a lower level of materiality for regulatory ratios such as the leverage ratio, liquidity ratio, and capital adequacy ratio. While the financial statement figures used to calculate these metrics are subject to financial statement audits, figures other than those in the financial statements are also used in the calculation. In addition, the metrics themselves are not subject to audits. We thus think it would be inappropriate to show them as examples.

(Reason)

Paragraph 10 of ISA 320 requires the auditor to determine a lower level of materiality to be applied to particular classes of transactions, account balances or disclosures. Yet

the document assumes that these classes of transactions, account balances or disclosures are subject to audit. In addition, the auditor is only required to determine the materiality level or levels to be applied in circumstances where there is one or more particular class of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole "could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements". Therefore, the auditor is not required to use the lower level of materiality in all circumstances.

ISA 720 requires an auditor to read information other than that being audited. However, reading other information is to identify material inconsistencies with the audited financial statements, and the term "material" in this standard does not clearly relate to "materiality" used in the context of a financial statement audit.

3. Assessing the risks of material misstatements (control activities)

Paragraph 69 requires an external auditor to communicate in writing "all matters that are likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability." We think such communication should only be recommended, rather than required, when the external auditor becomes aware of such facts. We also believe that it should be acceptable for the external auditor to convey this communication verbally, as well as in writing. We also propose that the paragraph should clearly describe these matters as "matters identified during financial statement audits," in order to clarify the scope of responsibilities of the external auditor.

(Reason)

Paragraphs 3 and A25 in ISA 260 treat these matters as supplementary. When the auditor becomes aware of such matters, the auditor may choose to, but is not required to, communicate such matters to those charged with governance. In addition, these are not matters an auditor is expected to find during the course of an audit.

Further, paragraph 19 of ISA 260 (the paragraph prescribing the matters to be communicated in writing) states that "written communications need not to include all matters that arose during the course of the audit". Written communications are only required for matters such as independence or significant findings from the audit.

4. Loan loss provisioning

The estimation techniques used to compute provisions and how the techniques vary among and within banks (paragraph 79 (a)) are included among the factors the external auditor needs to consider. Yet confidentiality requirements under the current system make it difficult to collect and compare information on banks not directly audited by the auditor. It may be necessary to limit this information to published information. If the purport of paragraph 79 (a) is to require comparison of the accounting policies or estimation methods themselves rather than details such as individual judgments, the paragraph should clearly state so. Meanwhile, as supervisors have access to more information than external auditors, they can support the external auditors based on

information they themselves have compared and analyzed.
(Reason)
Access to information on banks that are not being audited is subject to firewall and restricted even within an audit firm. Certain limitations are thus imposed on collecting, comparing, and considering such information. Even if it were possible to compare and consider this information, confidentiality requirements would make it difficult to specifically communicate the issues identified during the process to financial institutions. We recommend that a sentence be added to limit this information to published information.

5. Liabilities including contingent liabilities arising from non-compliance with laws and regulations, and contractual breaches
Paragraph 85 requires the external auditor to notify the supervisor immediately when the external auditor identifies material breaches of prudential regulations. We believe this requirement to notify the supervisor immediately goes beyond the role of the external auditor and should be removed. If the paragraph is to be included, it should be stated that the external auditor is expected to exercise judgment in accordance with the applicable laws and regulations of the relevant jurisdiction.
(Reason)
Information subject to prudential regulations is usually not subject to financial statement audits. Rather, it is regularly calculated and reported to the supervisor by the bank. An external auditor who conducts a financial statement audit does not always monitor the bank's financial condition. It seems unlikely that an external auditor will identify a material breach of prudential regulations in the course of a financial statement audit in advance of the bank or supervisor.
There is no framework in Japan requiring an external auditor to notify the supervisor when the auditor identifies material breaches of prudential regulations. Paragraph 27 of JICPA's Auditing Standards Committee Statement 250 "Consideration of Laws and Regulations in an Audit of Financial Statements" only states that if the auditor has identified or suspects noncompliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to the regulatory authority (paragraph 27 of JICPA's Auditing Standards Committee Statement 250 "Consideration of Laws and Regulations in an Audit of Financial Statements" is equivalent to paragraph 28 of ISA 250).
Moreover, an external auditor should initially follow the process required by laws and regulations which allows the disclosure of confidential information (i.e., where reports on facts concerning illegal acts or other violations are required based on laws and regulations) under the provisions of Article 6(8) of JICPA's code of ethics (Article 6 (8) of JICPA's code of ethics is equivalent to paragraph 5 of Section 100, and Section 140 of Handbook of the Code of Ethics for Professional Accountants).
Therefore the requirement to "immediately" notify the supervisor when the external auditor identifies breaches of prudential regulations of material significance is not consistent with the legal framework and auditing practice in Japan.

Note, also, that this paragraph is supposed to explain how the external auditor deals with audit risks. It seems inconsistent for a paragraph with this purpose to refer to the external auditor's duty to report to the supervisor (the same applies to paragraph 96).

6. Going concern assessment

(1) In relation to paragraphs 91 to 96, we believe that the management should be required to conduct that assessment first. To this end, generally accepted accounting principles (GAAP) should be established to require bank management to make industry-specific considerations in relation to the going concern assessment.

(Reason)

If the external auditor is required to make a going concern assessment unique to the banking industry, the management should also be required to make the same assessment under the same framework as the external auditor.

(2) Paragraph 96 states that "if there are any significant doubts which may cause material uncertainty over the bank's ability to continue as a going concern, and 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 do not believe this should be a requirement.

(Reason)

Material uncertainty over a bank's ability to continue as a going concern is something the bank should assess first. The external auditor determines if the responses or disclosures by the bank are appropriate in relation to the period-end financial statements. We therefore think it would be inappropriate for the external auditor to make that assessment and notify the supervisors before the bank makes the assessment. In addition, an external auditor conducting a financial statement audit will not always monitor events that affect the going concern status of a bank.

When a material uncertainty over a company's ability to continue as a going concern arises, the auditing practice of Japan requires the external auditor to express an unqualified opinion, a qualified opinion, or an adverse opinion, with emphasis-of-matter paragraphs in the auditor's report according to the appropriateness of disclosure in the financial statements. In this circumstance, the auditor is not expected to report the material uncertainty to the supervisory authority before an audit opinion is expressed. In addition, a material uncertainty over a company's ability to continue as a going concern is not considered a circumstance where the auditor is allowed to disclose confidential information under the provisions of Article 6 (8) of JICPA's code of ethics (Article 6 (8) of JICPA's code of ethics is equivalent to paragraph 5 of Section 100, and Section 140 of Code of Ethics for Professional Accountants). Therefore, it is not consistent with the practice in Japan.

7. Independence of the external auditors

Paragraph 114 states that "audit committees should have a policy in place that stipulates the frequency with which there should be a tender for the external audit contract." This can be construed to mean that such tenders are required. We believe,

instead, that an audit committee should be required to deliberate only the need for a tender for the external audit contract by closely considering the safeguards in place to mitigate self-review or familiarity threats (such as the external auditor's quality control systems or the rotation of members of the audit engagement team), or any adverse effect that the rotation has on audit quality. We propose that paragraph 114 be revised accordingly.

(Reason)

There are no reasonable grounds to believe that there is a connection between the length of an audit firm's tenure and the external auditor's objectivity or independence. Even if the tenure has been long, there are ways to rationally maintain the independence of the external auditor by enhancing the system for the rotation of members and quality control systems within the audit firm. We believe that the current systems within audit firms are sufficient to ensure the independence of the external auditor. We fail to see how a long audit tenure would impair the external auditor's independence.

For the aforesaid reasons, we see no need for requiring a policy that stipulates the frequency of tenders.

8. Effectiveness of the external audit

(1) We believe that "the level of materiality" an audit committee should consider in paragraph 120 should be changed to "the concept of materiality."

(Reason)

Paragraph A13 of ISA 260 refers to "the concept of materiality" in relation to matters to be communicated by the auditor, but not to "the level of materiality." We also suspect that the effectiveness of the audit could be undermined when the level of materiality in the external audit is indicated (even when indicated by the audit committee).

(2) We recommend the deletion of two passages from paragraph123 (the paragraph stipulating the matters the audit committee should discuss with the external auditor): first, "a comparison of the bank's position with that of its peer group"; second, "particularly in those circumstances where the audit engagement partner's conclusions differed from those of the engagement quality control reviewer."

(Reason)

If the external auditor was required to provide information or opinions with regard to a comparison of a bank's position relative to its peers, it would only be at liberty to provide information that has already been published. We doubt, therefore, that such a requirement would facilitate effective communication.

In relation to the differences in conclusions between the audit engagement partner and the engagement quality control reviewer, paragraph 44 of the International Standard on Quality Control 1 states that no report should be dated until such differences are resolved, and paragraph 22 of ISA 220 states that no auditor's report should be issued until such differences of opinion are resolved. Under this approach, there would be no communication with the audit committee with regard to differences of opinion in the

audit firm if the auditor's report were to be issued. Requiring communication of differences of opinion with regard to individual matters still under review could also influence the audit committee to intervene in the external auditor's judgment process.

9. Relationship between the audit committee and the external auditor

(1) Paragraph 130 states that the audit committee should consider inviting the external auditor to attend audit committee meetings. This could be construed to mean that an audit committee is required to invite an external auditor to audit committee meetings. This interpretation could be avoided by adding something to the following effect: "the external auditor can attend audit committee meetings, if necessary."

(Reason)

The paragraph offers no description of an external auditor's position in an audit committee meeting. In our view, an external auditor can effectively communicate with an audit committee without actually attending the audit committee meetings.

(2) Paragraph 132 sets forth the matters the audit committee should discuss with the external auditor. Some of the examples provided in the paragraph exceed the matters the external auditor is obliged to keep track of in his or her professional capacity. We therefore propose the deletion of the sentence following "This may include…"

(Reason)

For example, the extent of the external auditor's involvement in regulatory capital differs amongst jurisdictions. Under some circumstances and in some jurisdictions, the external auditor may not be involved at all.

If comprehensive inspections and inspection reports were required, we believe that matters outside the external auditor's area of responsibility would arise. It would also be difficult for the external auditor to communicate in a responsible manner.

10. Reporting by the external auditor to the audit committee

For paragraph 138, we do not believe that the external auditor should be required to report to the audit committee on matters not already covered by the relevant auditing standards. Further, we see no reason for requiring the external auditor to submit its reports to the audit committee in writing.

(Reason)

"Areas of significant management judgment" or "matters that are likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability" are not always identified in the course of a financial statement audit. They are also likely to include matters beyond the expertise of the external auditor. Such a reporting requirement would place an excessive burden and responsibility on the external auditor.

11. Communication of matters outside the scope of the external auditor's duty to report/alert

Paragraphs 154 to 161 describe matters "outside the scope of the external auditor's duty to report/alert," but at the same time suggest that the auditor is required to

communicate those matters. The extent of the authority's expectations of the external auditor is also unclear, and the communication of such matters is beyond the scope of responsibilities of the external auditor.
The special prudential supervisory requirements described in Annex 1 also include matters that are outside the scope of responsibilities of the external auditor.
The "Guidance on the timing and content of meetings between supervisors and external auditors" in Annex 2 also includes matters beyond the scope of responsibilities of the external auditor. Meetings during the pre-close stage indicated in Annex 2, for example, may affect the audit schedule.
(Reason)
The primary role of the external auditor is to provide reasonable assurance that the financial statements are free from material misstatement. Requiring external auditors to communicate matters beyond the scope of their responsibility would burden them with excessive work and responsibility.

12. Gateways available to supervisors

Paragraphs 162 and 163 state that the supervisor may decide to communicate bank-specific information to the external auditor, and that supervisors should consider how sensitive the information is and the extent to which disclosing the information to the external auditor would support the supervisor discharging its duties, before disclosing any information to the external auditor. In some cases, the non-disclosure of such information could cause an external auditor to express incorrect opinions. We believe that the paragraphs should also point out that risk.
We also believe that this risk should be considered when establishing an effective relationship between the supervisor and the external auditor, as described in paragraph 143.
(Reason)
In some cases, an external auditor may express an incorrect opinion because the supervisor does not disclose matters that have come to the supervisor's attention due to its position as a supervisor. Such matters could include, for example, matters that give rise to uncertainty over the bank's ability to continue as a going concern.
It also would be inappropriate, from the point of view of financial administration, to fail to address matters that lead to the expression of incorrect opinions. A proper method for handling such matters should be considered.

Yours sincerely,

Sayoko Izumoto
Executive Board Member—Industry Audit Practice
The Japanese Institute of Certified Public Accountants