



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: edcomments@ifac.org

Mr James Gunn
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International Auditing and Assurance
Standards Board (IAASB)
International Federation of Accountants
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15 November 2010

Exposure Drafts ISA 315 (Revised) and ISA 610 (Revised)

Dear Mr Gunn

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the IAASB's 15 July 2010 Exposure Draft ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, and ISA 610 (Revised), *Using the Work of Internal Auditors*.

The Committee's has long promoted strong corporate governance practices in banking organisations.¹ The financial crisis that began mid-2007 has reaffirmed that strong internal controls, including an internal audit function and an independent external audit, are crucial building blocks for sound corporate governance. The Committee recognises that the board and senior management should make effective use of the work conducted by a firm's external auditors as well as its internal audit and internal control functions. The Committee also encourages consultation among supervisors, internal auditors and external auditors in order to make their cooperation as efficient and effective as possible.

The Committee therefore supports the overall objective of revising ISA 315 and ISA 610 to build a stronger framework for evaluating and using the work of a bank's internal auditors with external audits. We encourage IAASB to be more direct in describing the circumstances under which it is appropriate for external auditors to use the work of internal auditors. In this regard, IAASB should consider including specific criteria, such as those that are set out in the Committee's August 2001 document *Internal audit in banks and the supervisor's relationship with auditors*. These criteria are similar to the criteria promoted by professional associations such as The Institute of Internal Auditors.

¹ In October 2010, the Committee published *Principles for enhancing corporate governance*. This guidance, which reflects lessons learned from the financial crisis, revised earlier guidance issued by the Committee in 2006. In addition, in August 2001 the Committee published *Internal audit in banks and the supervisor's relationship with auditors*. These documents can be accessed by visiting www.bis.org.

The Committee also has some specific comments. These are set out below.

Specific Comments

Nature and role of the internal audit function

The Committee supports the approach taken in paragraph 23 of ED ISA 315 requiring that the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, how it fits in the entity's organisational structure, and the activities performed or to be performed. However, the related application and other explanatory material (paragraphs A101-103b) should include criteria relating to the standing of the internal audit function within the entity.

The internal audit function plays a vital role in an entity's corporate governance. Therefore, the Committee recommends that the external auditor should assess the permanency of the internal audit function within the entity and whether the entity can rely on an adequate internal audit function that is appropriate to its size and the nature of its operations (including whether the internal audit function has appropriate resources and qualified staff available).

The external auditor should also assess the existence and content of any internal audit charter (or terms of reference) that specifies the standing and authority of the internal audit function within the entity. Such a charter should establish at a minimum:

- the objectives and scope of the internal audit function,
- its position within the organisation,
- its powers,
- its responsibilities and relationship with other control functions and
- the accountability of the head of the internal audit department.

In addition, the external auditor should consider how any charter is applied in practice. For most banks, charters would be approved by the board of directors (or equivalent level). For those banks where charters are not available, the rights of the internal audit department are generally assured by equivalent supervisory regulation.

Placing reliance on internal audit - the relationship between objectivity and competence

The Committee believes that the drafting of paragraph 14 and related application and other explanatory material should be more positive and straightforward. As currently drafted, this paragraph essentially states in the negative form, *that the external auditor shall not use an internal audit function when there is either a low degree of "objectivity", "competence" or both.* We believe that it would be clearer to express the requirement as "The external auditor shall only use the internal auditor's work if there is both a high degree of objectivity and a high level of competence."

Furthermore, the application material does not expand on the principle in paragraph 14. We believe that the IAASB needs to consider whether there should be minimum conditions when applying the concepts of objectivity and competence

in practice. In effect, paragraph A7 shows the inherent weakness of the proposed approach as it offers little or no guidance to the external auditor when applying the requirement of paragraph 14. Such conditions would constitute a threshold above which reliance on an internal audit function can be placed. Therefore, we recommend modifying paragraph 14 as noted above as well as the related application material to actively require the external auditor to consider using the work of the internal auditors only when the threshold is achieved. The threshold should be judged by the external auditor based on the refinements proposed to the criteria in ED ISA 315 above, and in ED ISA 610, paragraph A6. Paragraph A6 of ED ISA 610 should be amended to recognise that the independent internal audit function should be separated from the activities being audited and the day-to-day internal control process in order to maintain its objectivity. Each auditor forming part of that function should also be competent.

Specifically:

- Under the subtitle "objectivity," attention needs to be drawn to the concept of the internal audit function being independent of the activities audited and from the day-to-day internal control process. That is, the internal audit function needs to be independent of the management of the entity's day-to-day activities. Attention also needs to be drawn to the concept of impartiality, ie meaning that the internal audit function should be in a position to perform its assignments free from "bias" and "interference" (the first notion "bias" is mentioned in the ED), and
- Under the subtitle "competence", attention needs to be drawn to the competence (ie skills, qualifications and experience) of every internal auditor forming part of the internal audit function. This is essential for the proper functioning of the bank's internal audit function.

Direct assistance engagements

The Committee agrees with the IAASB that direct assistance is not possible when the internal audit lacks objectivity and competence (paragraph 21 of ED ISA 610). However, we believe that it would be clearer to express the requirement in the positive form, so that it reads "The external auditor shall only obtain the direct assistance of an internal auditor if the internal auditor has both a high degree of objectivity and a high degree of competence."

We believe that paragraph 23 and related application material in paragraphs A22-A28 of the ED ISA 610 need to be made more precise in order to be helpful to the external auditor. The current wording would allow an internal auditor to perform a wide range of activities for the external auditor. This is a fundamental concern that would undermine the perceived independence of the external auditor. We strongly encourage the Board to address this issue within ED ISA 610.

We are aware that the Ethics Board of the International Federation of Accountants has considered the relationship between direct assistance and the independence of the external auditor. However, this issue needs to be more clearly explained. Specifically, ED ISA 610 needs to draw a distinction between those circumstances when an external auditor simply places reliance on the work done by an internal auditor and those circumstances when an external auditor actively supervises an internal auditor. In the latter case, we believe that the internal auditor could be perceived to be part of the engagement team of the external auditor and that this may be perceived as compromising the external auditor's independence. We also

believe that paragraph 23 of ED ISA 610 that address the circumstances when direct assistance is not allowed should be drafted in a more direct manner, specifically restricting direct assistance to those areas deemed to be of low inherent risk and requiring no or very little judgment, rather than the current approach that prohibits direct assistance when the internal auditor would make significant judgments.

The matter of direct assistance is also linked to comments that the Committee has previously made on the July 2009 Revised Code of Ethics to the Ethics Board. Our comments related to auditors providing internal audit services to public interest entities. We continue to encourage both Boards to make clear distinctions between the external auditor relying on work done by the internal auditor in the course of the external audit engagement, and the external auditor being actively and directly assisted by the internal auditor during the course of the external audit engagement.² We believe that the former arrangement can support effective external audit in certain circumstances, but that much greater caution should be exercised regarding the latter arrangement.

With this in mind, we believe that there would be value in adding more specific examples of audit procedures that it would be acceptable for the internal auditor to perform to the application material in paragraphs A22-A28 of ED ISA 610. We also question the inclusion of the word “ordinarily” in paragraph A27; we would assume that the direction, supervision and review of audit procedures performed by the internal auditor should be more extensive than if members of the engagement team performed the work.

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This letter has been prepared by the Committee’s Accounting Task Force, chaired by Ms Sylvie Mathérat, Director of the Banque de France, and has been approved by the Committee.

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Yours sincerely



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² In some instances, the internal audit function is outsourced to the external auditor’s firm. In such instances there is a clear self review threat.