



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via e-mail: jamesgunn@ifac.org

Mr James Gunn
Technical Director
International Auditing and Assurance
Standards Board
529 Fifth Avenue, 6th Floor
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Invitation to Comment: *Improving the Auditor's Report*

Dear Mr Gunn

The Basel Committee on Banking Supervision (the Committee) is pleased to respond to the IAASB's Invitation to Comment: *Improving the Auditor's Report* (ITC). External audits of banking organisations are an important element of the bank supervisory process¹ and the Committee believes that high-quality audits of banks, coupled with the communication of useful information by auditors to users of the audited financial statements, enhance market confidence.

The Committee supports changes to the auditor's report that would bridge the information and expectations gaps of investors and other users of audited financial statements. These changes, however, should not alter the auditor's fundamental role of opining on the financial statements or impair the auditor's independence. Communicating additional information in the auditor's report on financial statements as a result of audit procedures performed can enhance understanding of the statements by banking supervisors, investors and other users. This could increase the transparency of the audit process, including its outcomes and limitations, and provide users with a better understanding of the responsibilities of auditors and a bank's management. Furthermore, improvements to the auditor's report may enhance a bank's safety and soundness through better market discipline. Additionally, since banks are also end users of audited financial statements, eg in the credit decision process, improvements to the auditor's report may help banks improve their overall credit risk management.

The Committee offers the following comments and suggestions for your consideration as you evaluate possible changes to the auditor's report.

¹ The importance of external audits in the supervisory process is embodied in the Basel Committee's "Core Principles for Effective Banking Supervision" (September 2012), the global standard for the sound prudential regulation and supervision of banks and banking systems. Principle 27 specifically covers financial reporting and external audit. The document is available at www.bis.org/publ/bcbs230.pdf.

Pass/Fail model

The fundamental role of the auditor is to opine on the truth and fairness of the information presented in the financial statements prepared by the management in accordance with the applicable financial reporting framework. As such, the Committee supports retaining a pass/fail model for the auditor's report that reflects a clear and unambiguous opinion on the audited financial statements.

We also agree with the IAASB's view regarding the prominent placement of the auditor's opinion in the auditor's report. Additional disclosures should be based on the results of the audit procedures performed by the auditor in accordance with International Standards on Auditing (ISAs) and should not result in the auditor assuming or performing management functions or responsibilities.

Auditor commentary and Emphasis of Matter paragraphs

The ITC discusses the benefits and use of an auditor commentary that leverages off existing Emphasis of Matter paragraphs. This includes required paragraphs for certain important matters, as well as the addition of clarifying language to better explain both the auditor's and management's responsibilities with respect to the audited financial statements.

An auditor commentary in the standard auditor's report may reduce the information and expectations gaps and could also increase the readability of the auditor's report. For example, an auditor commentary could address critical management representations relied upon in arriving at the audit opinion and how conclusions were reached regarding certain significant matters which require judgement, such as loan loss provisions.

To avoid overreliance on an auditor commentary and Emphasis of Matter paragraphs by financial statement users, care should be taken within the body of the auditor's report to refer the reader to important information contained in the body of the financial statements and in the notes thereto. At the same time, the auditor's report should not be used solely as a roadmap to help the user navigate through the financial statements with no other incremental value being provided. We recommend that any proposed auditor commentary focus on providing decision-useful and entity-specific information on matters such as significant judgements made and significant risks assessed by the auditor. The auditor's report should not become too lengthy and obscure its primary purpose, which is to disclose the auditor's opinion on the audited financial statements as a whole.

The aim of improving clarity will require that there are no discrepancies between the final opinion on the financial statements and the inferences drawn from the additional information provided by the auditors. Any such additional information should support and be consistent with the opinion expressed. We therefore believe that the IAASB should consider developing principles that will help auditors in exercising their judgment in determining the information and the level of detail, that should be included in their report. In particular, we believe that the principles should highlight auditors' need to be careful to ensure any additional information about the context and the conduct of the audit or matters particularly important to users' understanding of the financial statements cannot be seen by the users as a way of expressing an implicit qualified opinion.

The ITC indicates that an auditor commentary would be required for public interest entities (PIEs) and could be provided at the discretion of the auditor for other entities. The ITC indicates that, at a minimum, PIEs would include listed entities. Given the importance of banking organisations in maintaining financial stability and the nature of their business (eg where they may hold assets in a fiduciary capacity for a large number of stakeholders), we recommend that the IAASB should include banking organisations in the definition of PIEs.

Requirements that will directly impact the IAASB's proposals on auditor comment are also being developed by the US Public Company Accounting Oversight Board² (PCAOB) and the European Commission³ (EC). We therefore recommend that the IAASB collaborate with these organisations given the potentially high relevance of their respective initiatives.

Going concern

The Committee also supports the concept of an auditor concluding on the appropriateness of management's use of the going concern assumption in preparing financial statements. We also support an auditor making an explicit statement as to whether it has identified material uncertainties about the ability of the audited entity to continue as a going concern. However, we also believe that international convergence is important in this area. We therefore recommend that the IAASB collaborate with the PCAOB and the EC, as these organisations are also developing requirements regarding management's use of the going concern assumption.

The Committee recognises the financial stability implications that may arise from uncertainties related to the going concern assumption if such uncertainties were noted in the financial statements of banking organisations. We therefore recommend that the IAASB consider developing requirements specific to banks regarding the assessment of management's use of the going concern assumption, and the auditor's related disclosures and commentary. For banking organisations, disclosures regarding liquidity concerns may have significant implications. A lack of comparability in auditor reporting regarding going concern uncertainties may result in the communication of misleading information to users of audited financial statements, and could produce other adverse unintended consequences. The Committee is willing to support the IAASB in the development of such requirements specific to banking organisations.

Disclosure of material weaknesses in internal control over financial reporting

The auditor is currently required to communicate to those charged with governance material weaknesses in internal control over financial reporting identified by the auditor during a financial statement audit. However, any such material weaknesses are not currently required to be disclosed in the annual

² PCAOB's work in this area is focused on Emphasis of Matter paragraphs.

³ Article 22 of the EC's draft regulation sets out specific requirements related to the statutory audit of public-interest entities.

report. We believe that disclosure of any material weaknesses noted during a financial statement audit would provide meaningful information to users of audited financial statements. The Committee therefore encourages the IAASB to consider requiring disclosure of material weaknesses in internal control over financial reporting identified by the auditor during the course of a financial statement audit. This additional information could potentially be disseminated through the audit committee's report or through the board's report. Further, as stated in the sections above, it should be clear to the user that disclosure of this additional information only relates to internal control over financial reporting and should not undermine the auditor's overall opinion on the financial statements.

Disclosure of the name of the engagement partner

The Committee agrees with the IAASB's belief set forth in paragraph 72 of the ITC that disclosure of the engagement partner's name in the auditor's report should be required for all entities. We also believe that this requirement would provide the engagement partner with a greater sense of personal accountability for the conduct and quality of the audit.

Auditor's independence and division of responsibilities

A key aspect of the value of an auditor's report is the auditor's independence in both fact and appearance. The auditor's independence should not be impaired in the pursuit of enhanced information such that the user perceives the auditor performing the responsibilities of the audited entity's management. Also, while conducting an audit, an atmosphere of candid and open communication must exist between the auditor, management and the audit committee to enable a high quality audit. The IAASB should consider the impact any changes to the auditor's report may have on the auditor's independence as well as how it may impact the communication flow between the auditor, management and the audit committee.

Additionally, the Committee agrees with the principle set forth in paragraph 9 of the ITC, which addresses the need to preserve the separate and distinct responsibilities of management, those charged with governance, and the auditor. However, in some instances, it appears that the responsibilities of those charged with governance have been grouped with those of management. For example, the Illustrative Auditor's Report in the ITC groups the description of the responsibilities of management and those charged with governance in the same paragraph. To highlight the distinct responsibilities of those charged with governance and management and avoid confusion regarding these responsibilities, the Committee recommends that any description of their respective responsibilities be provided in separate paragraphs in the auditor's report.

Outreach efforts

The Committee encourages the IAASB to continue its outreach efforts with other policy makers and standard setters such as the EC, the PCAOB and national auditing standard setters. This will help promote international consistency in the auditor's reporting model.

Audit quality

Finally, although the ITC discusses possible ways to improve auditor reporting, it does not directly address the quality of the audit work performed that forms the basis for the information provided in the auditor's report. Changes to auditor reporting per se will not ensure that audits are conducted in accordance with applicable auditing standards and are of high quality. Thus, while we are supportive of and commend the IAASB's efforts to enhance the value of auditor reporting, we also encourage the IAASB to continue its work to explore the topic of audit quality, and the role of auditing and assurance standards in promoting it.

We look forward to reviewing and providing comments on any proposed new ISAs and amendments to existing ISAs that follow from this ITC.

These comments have been prepared by the Committee's Accounting Task Force, chaired by Sylvie Mathérat, Deputy Director General at the Bank of France. If you have any questions regarding our comments, please feel free to contact Ms Mathérat (+33 1 4292 2602), Patricia Sucher, who chairs the Audit Subgroup of the Accounting Task Force, at the United Kingdom Financial Services Authority (+44 207 066 6544), or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely



Stefan Ingves