



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

**Chairman**

**Via email**

Mr Arnold Schilder  
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Dear Arnold

As you are aware, the Committee is finalising the revisions to its guidance on external audits of banks, which has been issued today for consultation. We are grateful that your organisation was willing to have a member of its board serve as an observer at meetings of our working group that developed the revised external audit document. This collaboration has been beneficial and is greatly appreciated. This letter aims to acknowledge our common interest in recognising the importance of banks' external audits to financial stability and to share our views on how to enhance the quality of external audits.

The Committee is very supportive of the IAASB's current strategy and work programme which sets as its first priority "*supporting global financial stability*". This programme draws lessons from the financial crisis and aims at enhancing the role of auditors through the revision of existing International Standards on Auditing (ISAs) and the development of new auditing standards. At the same time, the Financial Stability Board has recommended improving the relationship between auditors and supervisors and the intensity and effectiveness of regulation of external audits.<sup>1</sup>

As part of its ongoing efforts to help improve the quality of bank audits, including promoting better governance processes through an enhanced role for audit committees, the Committee has developed its revised guidance – "*External audits of banks*" – which integrates key elements of the Committee's 2008 document "*External audit quality and banking supervision*" and the 2002 guidance "*The relationship between banking supervisors and banks' external auditors*,"<sup>2</sup> jointly developed with the IAASB.

The Committee's new guidance addresses audit quality by establishing enhanced supervisory expectations of auditors and audit committees, and encourages

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<sup>1</sup> [www.financialstabilityboard.org/publications/r\\_111104ee.pdf](http://www.financialstabilityboard.org/publications/r_111104ee.pdf).

<sup>2</sup> The 2002 document was issued by the Committee as guidance and by the IAASB as International Auditing Practice Statement (IAPS) 1004.

greater communication with prudential regulators. The document emphasises the specific areas of the external audit of a bank which we regard as particularly important for audit quality. However, it does not set out specific requirements for auditors, which is outside the Committee's authority.

While highly supportive of the ISAs, the Committee believes that the existing standards do not sufficiently address several significant issues faced by bank auditors. In our view, this is the case if a given ISA is not absolutely clear, lacks sufficient application guidance, or has gaps in the requirements. In the attached annex, we describe our suggestions for areas where the ISAs can be enhanced. Furthermore, the decision taken by your organisation in 2011 to withdraw International Auditing Practice Statements, such as IAPS 1006, *Audits of the Financial Statements of Banks*, from the IAASB's authoritative material has created a void in both (i) international auditing literature with regard to the unique risks present in the external audits of banks, and (ii) guidance regarding the expected responses to those risks by external auditors of banks.

To address these deficiencies, the Committee has evaluated various approaches from enhancing authoritative materials to the provision of non-authoritative materials such as an International Auditing Practice Note (IAPN) that could be considered in conjunction with the Committee's revised external audit guidance. However, our preference is for the IAASB to enhance its authoritative materials for the following reasons:

- Despite having received unqualified audit reports shortly before their failure or near failure, several banks experienced serious difficulties during the recent financial crisis that raised legitimate questions relating to audit expectations and audit quality, making clear the need to improve both;
- The complexity in the application of current and expected new accounting standards – especially with regard to financial instruments and other issues specific to banks – indicates that there is a need to develop new auditing standards or robust guidance for the audit of banks specific to the application of these accounting standards;
- The complexity of banks' activities, and growth in associated disclosures, creates an evolving and ever more challenging audit environment, thereby triggering the need for additional audit guidance; and
- While the Committee's external audit guidance has authority amongst banking regulators, audit oversight bodies are not compelled to look to the guidance when assessing external audits of banks.

For these reasons, the Committee believes that the IAASB should seek ways to enhance its authoritative framework. This would be a significant step toward making audits of bank financial statements more robust.

This objective could be met by identifying the existing ISAs that are the most relevant to banks and enhancing them. The Committee's revised guidance on external audits not only refers to existing internationally accepted auditing standards (such as ISAs) to draw readers' attention to specific requirements on certain topics, but it also addresses issues that build on these standards, especially those dealing with auditor scepticism, fair value accounting estimates, loan loss provisioning, disclosures and the going concern assessment. We believe

enhancing the ISAs in these areas is essential to the improvement of the quality of audits of banks.

Enhancing the ISAs, however, may not capture all the relationships between the standards that arise when auditing a bank. Therefore, we also suggest that the IAASB develop a dedicated practice note for audits of banks to be used in conjunction with the Committee's guidance on external audits.

The Committee welcomes further discussions with the IAASB and would be pleased to contribute to efforts to enhance existing auditing standards and develop new standards relevant to audits of banks. The attached Annex provides more details in areas of importance that the Committee identified during the development of its revised guidance.

These comments have been prepared by the Committee's Accounting Task Force, chaired by Mr René van Wyk, Registrar of Banks at the South African Reserve Bank. If you have any questions regarding our comments, please feel free to contact Mr van Wyk (+27 12 313 3601), Ms Patricia Sucher of the UK FSA (+44 203 461 8159), or Mr Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Stefan Ingves', is centered below the text 'Yours sincerely'.

Stefan Ingves

## Annex

### Recommended Enhancements to Selected IAASB Standards

In developing our revised external audit guidance, we identified several areas in the IAASB's existing standards that we believe could be enhanced to address particular risks in the audit of a bank. Many of these proposed enhancements are likely to apply to all audits and not only those of banks. They are as follows:<sup>3</sup>

**(i) International Standard on Quality Control 1 (ISQC 1), Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements, and ISA 220, Quality Control for an Audit of Financial Statements**

We believe several aspects of these standards could be improved.

- (a) The engagement quality control review (EQCR) can contribute to ensuring consistency in the quality of audits. Therefore, we believe that all banks should be subject to an EQCR, in line with the EQCR requirement for audits of financial statements of listed entities (ISQC 1, paragraph 35(a)).
- (b) One area of focus in ISQC 1 is the exercise of appropriate professional judgement, which we believe is critical to the performance of a quality audit. Whilst paragraph 37 of ISQC 1 is clear in this respect, we believe that paragraph 42 of ISQC 1 and paragraph 25 of ISA 220 on documentation of the EQCR place emphasis on process rather than on substance. Our work with banks suggests that those performing EQCRs pursuant to ISQC 1 and ISA 220 for bank audits may take a checklist approach. Such an approach provides little evidence of the outcome of discussions of significant matters with the engagement partner and of the review of selected engagement documentation and conclusions reached relating to significant judgements made by the engagement team (paragraphs 37(a) and (c) of ISQC 1 and paragraphs 20(a) and (c) of ISA 220). Paragraph 44(a) of ISQC 1 includes a clear documentation requirement which is applicable only in the case of differences of opinion between the engagement partner and the engagement quality control reviewer.

Paragraph 42 of ISQC 1 and paragraph 25 in ISA 220 could be enhanced by having a specific requirement for the EQCR documentation to include a summary of significant engagement documentation reviewed and of the discussions between the engagement quality control reviewer and the engagement partner on all matters of significant judgement.

We believe that the results of the EQCR should also be communicated to those charged with governance, and more specifically to the audit committee, as part of the communication between the external auditor and those charged with governance. Accordingly, we recommend that the IAASB amend ISA 260 in this regard.

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<sup>3</sup> The list is not exhaustive and refers only to those standards we considered in developing our revised guidance.

- (c) ISQC 1 makes no mention of professional scepticism. Given the importance of auditor scepticism to audit quality, we suggest that paragraph 37 be enhanced by requiring the audit firm to establish policies and procedures requiring the EQCR to include discussion of how the engagement team has demonstrated professional scepticism during the course of the audit. Similarly, this discussion also should be included in the required documentation referred to in paragraph 42.
- (d) Paragraphs 36, 42(b) and 44(b) of ISQC 1, and paragraphs 19(c) and 25(b) of ISA 220, require that the EQCR be completed before the audit report is dated, while paragraph A43 of ISQC 1 indicates that the EQCR should be conducted at appropriate stages during the engagement. Nevertheless, because the requirements of ISQC 1 focus mainly on the timing around the issuance of the audit report, we believe audit firms may tend to carry out the EQCR close to the end of the audit. This is likely to produce the negative consequence of any issues arising only being dealt with if they are so significant that the audit report could not otherwise be signed.

Whilst this may not have been the intention of ISQC 1, we believe the standard should be clarified to require the EQCR reviewer to be involved from the early stages of the audit, rather than only at the end; for example, to monitor whether there are sufficient and appropriate professional and technical resources, including specialised accounting knowledge, within the engagement team and to ensure that the engagement team has followed the audit firm's policies for identifying and responding to significant risks throughout the audit. For the EQCR of bank audits, we find it important for the EQCR to also address the degree to which the audit engagement team has considered accounting and regulatory information.

- (e) The banking sector includes major global banks that are organised as a group. Paragraph 54 of ISQC 1 requires communication of the results of monitoring of network-wide procedures for ensuring quality control. In the context of a group audit, with significant subsidiaries or components being audited in different jurisdictions or by different network firms, consistent approaches to ensuring the quality of a bank audit are essential. As the EQCR's involvement at the group audit level must not be restricted to the review of the audit of the parent or holding company, ISQC 1 should define more precisely the responsibilities of the engagement quality control reviewer with respect to quality control procedures performed at the component levels. ISQC 1 also could be enhanced to encompass engagement quality control review procedures specific to audits of group financial statements.
- (f) We note that some audit firms perform pre-issuance technical reviews of banks' financial statements. Given banks' central role in contributing to financial stability and providing financial resources to the economy, we believe that all bank audits should be subject to a pre-issuance technical review. Paragraph 34 of ISQC 1 could be enhanced by including an additional requirement in this respect.

**(ii) ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements***

In most jurisdictions, subject to local legislation, auditors have a duty to report/alert under which they must communicate certain matters to banking supervisors. However, in many jurisdictions around the world, auditor-prudential supervisor dialogue, outside the duty to report/alert, is already well established or is anticipated (eg within the European Union<sup>4</sup>).

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<sup>4</sup> Refer to the European Union's draft audit regulation, Article 25, paragraph 2.

Therefore, it would be appropriate to incorporate a reference to this practice within paragraph 28 of ISA 250, and to further note that even outside a duty to report, auditors in many jurisdictions have relationships with supervisors that encourage dialogue about such matters.

**(iii) ISA 260, *Communication with Those Charged with Governance***

Banking regulators often have access to communications between the auditor and the bank. However, ISA 260 currently does not mandate that the auditor should always communicate in writing with those charged with governance. Given the importance of the auditor reporting to those charged with governance in contributing to audit quality, and to the work of the banking regulator, we believe that, for all banks, including bank holding companies and significant subsidiaries, the auditor should always communicate in writing to those charged with governance on all significant audit findings. The auditor's written communications also should address significant aspects of the audit approach, eg the auditor's approach to internal control (ISA 260, paragraph A13), and in particular whether or how the auditor intends to use the work of internal audit. Requiring written communication of these matters should be emphasised by amending or adding to paragraphs 19, A37 and A38 of ISA 260.

The Committee has already expressed in its *Principles for enhancing corporate governance*<sup>5</sup> its commitment to improve the corporate governance of banks. Achieving this goal depends to a large extent on the efficiency of the audit committee itself, and the auditor can provide useful contributions in this area.

In particular, it could be helpful for those charged with governance to receive written feedback from the auditors about their relations with management, the internal audit function, and the risk management function, where relevant, in order to help those charged with governance to assess the effectiveness of the bank's functions with which the external auditor has interacted during its audit work. The IAASB could consider adding this to paragraph 16 of ISA 260.

**(iv) ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment***

- (a) Banks operate in an environment where there is extensive regulation of their activities. They may have a variety of business models. To exercise professional scepticism and review the risks to banks independently, rather than only through the eyes of management, it is important for the auditor to understand the banks' business models, the regulatory regime in which they operate, the risks to which they are exposed, and how they manage them. We believe that the application material should be expanded to address specific industry and regulatory factors relevant to financial institutions about which auditors of banks should have appropriate knowledge.
- (b) Given the nature of banks' activities, their fiduciary and custodial duties, and the high volume of monetary transactions carried out by many banks, some of which may be complex, they need robust systems of internal control. Otherwise, banks risk breaching regulatory requirements, being unable to conduct orderly and prudent operations, and being unable to prepare financial statements that comply with the relevant financial reporting framework. We therefore believe there is a need for more application material on the specific risks arising from inadequate internal control systems in banks, eg in relation to ISA 315, paragraphs 14-24.

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<sup>5</sup> [www.bis.org/publ/bcbs176.pdf](http://www.bis.org/publ/bcbs176.pdf).

**(v) ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures**

In audits of banks, many of the material classes of transactions, account balances and disclosures involve significant management estimates, which are inherently difficult to audit and where auditor scepticism is even more important. The most significant estimates in the audits of banks are typically loan loss provisions and the fair values of complex, customised and/or non-traded securities, for which valuation is challenging. The Committee has noted in its revised external audit guidance that these areas would nearly always be considered areas of significant risk.

For loan loss provisioning, developing robust audit guidance is particularly important given the related accounting standard is about to be modified. The issuance of a new provisioning standard presents an opportunity for the IAASB to develop audit guidance in this area, which would significantly increase the quality of bank audits and public confidence in banks' financial statements.

Given the potential for management bias, it is also particularly important that auditors sufficiently challenge management's estimates in these difficult areas of financial reporting. There should be more emphasis on this in the standard. One example, in relation to fair values, would be to strengthen paragraph A82 so that instead of merely stating that "where fair value accounting estimates are based on unobservable inputs,...the auditor may consider...how management supports" specified aspects of its estimates, it could add that the auditor may consider challenging management's inputs and assumptions and consider other reasonably alternative inputs assumptions. There is also scope for more application material to assist auditors in consistently applying ISA 540. We note that the IAASB is committed to establishing a working group to further consider issues related to fair value accounting estimates.<sup>6</sup> This working group could address application issues in this area. We would urge the IAASB to establish the working group as soon as possible. We stand ready to contribute to it when it is established.

As some accounting estimates in the financial statements are used in the calculation of banks' regulatory capital measures (eg deferred taxes, investments in unconsolidated entities), their recognition, measurement and classification is particularly important given the greater potential for management bias with these estimates. As such, we believe these should be added as additional indicators of the potential for management bias in paragraphs A124-A125 of ISA 540.

**(vi) Audit of Disclosures**

We also believe that the audit of disclosures merits special consideration by the IAASB. The Committee therefore welcomes the IAASB's proposed work in this area and will contribute input to that project as it develops. However, we have some initial observations regarding the audit of disclosures.

The auditor has to assess what may be material to users of financial statements regarding disclosures in the financial statements. For banks, there are certain regulatory ratios that may be published as part of the financial statements that are material to a wide range of users in assessing the performance of banks, eg capital ratios. Some of this information may be drawn from sources outside the financial reporting system. We believe there is a need for authoritative material for auditors that clarifies the audit work they should undertake in these areas.

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<sup>6</sup> IAASB Strategy and Work Program 2012-2014, paragraphs 29-30.

In addition, there is a need as part of the disclosure project to consider whether further application material is needed on specific areas such as the audit of fair value disclosures where financial instruments are held at amortised cost. This could be included in ISA 540. We are concerned that these disclosures are not given the required level of focus, particularly given the attention these disclosures receive for banks.

There is also a need to consider whether there should be further requirements and application material to support the external auditor's responsibilities in respect of the financial statements overall. Here, the Committee expects that the external auditor should evaluate whether the disclosures included in the financial statements, both quantitative as well as qualitative, are sufficient, and are consistent with his/her understanding of the bank's risk profile and activities and strategy, in particular with regard to:

- (a) the bank's overall objectives and strategies;
- (b) the bank's control framework for managing its key business risks;
- (c) the risks and uncertainties associated with its key business risks; and
- (d) all other related information included in the financial statements.

Requirements for the auditor's evaluation of these disclosures could be added to ISA 700, *Forming an Opinion and Reporting on Financial Statements*.

#### **(vii) ISA 570, *Going Concern***

The audit of the going concern assessment for a bank is challenging given:

- The nature of most banks' business models;
- That a bank's solvency and liquidity positions can change rapidly;
- That banks operate within a detailed regulatory framework covering liquidity and capital;
- The auditor's duty to report/alert responsibilities in these areas; and
- That providing any indication of material uncertainties casting doubt on a bank's ability to continue as a going concern in an audit report can be a self-fulfilling prophecy with consequences for financial stability.

To support auditors' application of professional scepticism in reviewing management's going concern assertion, we note that there is also a substantial amount of regulatory information on capital and liquidity that an auditor can consider as part of gathering sufficient appropriate audit evidence.

We believe that, as part of ISA 570, there is merit in the IAASB developing specific authoritative guidance for audits of banks that would cover an auditor's consideration of a bank's particular risks, the audit evidence that could be obtained, including regulatory liquidity and capital information, and the overall regulatory and reporting environment.

#### **(viii) ISA 620, *Using the Work of an Auditor's Expert***

For some accounting estimates, banks may use complex models. When these models are used, there are particular areas of risk where we believe there needs to be more specific guidance on when the external auditor should use an auditor's expert. For example, additional considerations when deciding whether to use an auditor's expert may include:



- Whether the financial statement assertion represents a new product or structure for the individual bank or the industry in general; and
- Whether recent events either within the individual bank or in the industry in general have highlighted previously unidentified risks.

These considerations are not included in IAPN 1000, *Special Considerations in Auditing Financial Instruments*. They could be added to paragraph A8 of ISA 620.

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