

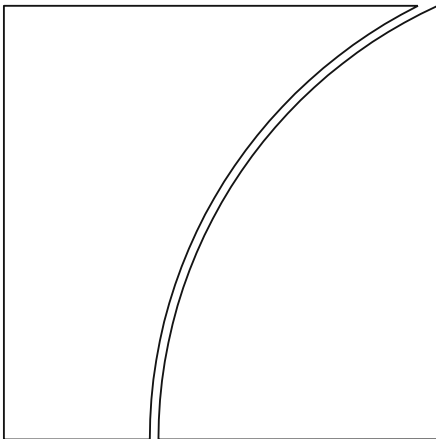
# Basel Committee on Banking Supervision

## Consultative Document

### **External audits of banks**

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## Acronyms

BCBS/the Committee	Basel Committee on Banking Supervision
Core Principles	Core Principles for Effective Banking Supervision, September 2012
EQCR	engagement quality control review
FSB	Financial Stability Board
GPPC	Global Public Policy Committee
IAASB	International Auditing and Assurance Standards Board
IAPN	International Auditing Practice Note
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
IRB	internal ratings-based (approach)
ISA	International Standard on Auditing
ISQC	International Standard on Quality Control
IT	information technology
PIOB	Public Interest Oversight Board
SIB	systemically important bank
SPE	special purpose entity

# External audits of banks

## 1. Executive summary

1. The recent financial crisis not only revealed weaknesses in risk management, control and governance processes at banks, but also highlighted the need to improve the quality of external audits of banks. Given the central role banks play in contributing to financial stability, and therefore the need for market confidence in the quality of external audits of banks' financial statements, the Basel Committee on Banking Supervision (the Committee) is issuing this document on external audits of banks. It forms part of the Committee's commitment to help improve audit quality at banks. This document enhances and replaces *The relationship between banking supervisors and banks' external auditors* (January 2002)<sup>1</sup> and *External audit quality and banking supervision* (December 2008).<sup>2</sup>

2. Implementation of the 16 principles and observation of the explanatory guidance in this document are expected to improve the quality of bank audits and enhance the effectiveness of prudential supervision, which will then contribute to financial stability. Through these principles and explanatory guidance, the document describes supervisory expectations regarding audit quality and how that relates to the external auditor's work in a bank. This document specifically sets out supervisory expectations of how:

- (a) external auditors can discharge their responsibilities more effectively;
- (b) audit committees can contribute to audit quality in their oversight of the external audit;
- (c) an effective relationship between the external auditor and the supervisor, which allows greater mutual understanding about the respective roles and responsibilities of supervisors and external auditors, can lead to regular communication of mutually useful information; and
- (d) regular and effective dialogue between the banking supervisory authorities and the relevant audit oversight bodies can enhance the quality of bank audits.

3. The document also notes the Committee's continued commitment to work through international bodies to enhance audit quality.

## 2. Introduction, application, structure and the Committee's international engagement

### Introduction

4. The banking sector is unique among sectors of the economy because it plays a central role in contributing to the financial stability of and the provision of financial resources to the economy. This sector includes major global banks that are systemically important banks (SIBs), the failure of one or more of which could trigger a global financial crisis. In addition, banks have a unique operating model.

5. Supervisors are primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks in order to maintain market confidence and

<sup>1</sup> [www.bis.org/publ/bcbs87.pdf](http://www.bis.org/publ/bcbs87.pdf).

<sup>2</sup> [www.bis.org/publ/bcbs146.pdf](http://www.bis.org/publ/bcbs146.pdf).

protect the interests of depositors. Consequently, 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.

6. An external auditor plans and performs the audit of a bank's financial statements to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, and are prepared, in all material respects, in accordance with an applicable financial reporting framework.<sup>3</sup> In many ways, the supervisor and the external auditor have complementary concerns regarding the same matters. For example, the audit of financial statements may help identify weaknesses in internal controls relating to financial reporting at a bank which may, therefore, inform supervisory efforts in this area and contribute to a safe and sound banking system.

7. Although the focus of this document is on the quality of the audit performed by the external auditor, an audit in accordance with internationally accepted auditing standards is conducted on the premise that the management<sup>4</sup> and, where appropriate, those charged with governance<sup>5</sup> have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.<sup>6</sup>

8. The Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision (September 2012, Core Principles) provide a framework of minimum standards for sound supervisory practices and are considered universally applicable.<sup>7</sup> Core Principle 27 focuses on prudential regulations and requirements for banks in relation to financial reporting and external audits.<sup>8</sup> This guidance set out in this document is consistent with Core Principle 27.

9. The application and the structure of each section in this document are described below, followed by an outline of the key international relationships between the Committee and other groups relevant to external auditing.

## Application

10. This document applies to the following entities subject to a statutory audit:

- all banks, including those within a banking group;
- holding companies whose subsidiaries are predominantly banks; and
- holding companies subject to prudential supervision whose subsidiaries are predominantly banks.

All of these structures are referred to as banks or banking organisations in this document.

<sup>3</sup> International Standard on Auditing (ISA) 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing*, paragraph 11.

<sup>4</sup> See paragraph 14.

<sup>5</sup> See paragraph 14.

<sup>6</sup> ISA 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing*, paragraphs 4 and A2-A11.

<sup>7</sup> BCBS Core Principles, paragraph 39.

<sup>8</sup> The Principle states that the supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.



11. 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. The Committee recognises that some countries have found it appropriate to adopt legal frameworks and standards (eg for listed firms), as well as accounting and auditing standards, which may be more extensive and prescriptive than the principles and explanatory guidance set forth herein. Such frameworks and standards tend to be particularly relevant for larger or publicly traded banks or financial institutions.

12. This document has been prepared with the full awareness that significant differences exist in national institutional, legislative and regulatory frameworks amongst jurisdictions,<sup>9</sup> including accounting and auditing standards, supervisory techniques and institutional corporate governance structures. 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.

13. The principles set out in this document should be applied in accordance with the national legislation and corporate governance structures applicable in each country.

14. The following terms are used in this document, with the meanings specified:

- Financial statement audit – An audit of a bank’s financial statements by an external auditor in accordance with internationally accepted auditing standards.<sup>10</sup>
- Statutory audit – An audit carried out to comply with the requirements of particular legislation or regulations. In some jurisdictions, this may include only the financial statement audit. In other jurisdictions, this may also include extended reporting by external auditors on matters such as internal controls and regulatory returns.<sup>11</sup>
- External auditor – The audit firm and the individual audit engagement team members. Where relevant, specific references are made to the audit firm or the individual audit engagement team members in certain paragraphs.
- Banking supervisory authority – 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.
- Supervisor<sup>12</sup> – The group of supervisory personnel at a banking supervisory authority who are directly involved with the supervision/examination of a specific institution.

<sup>9</sup> Some of these differences are outside the scope of banking supervision. Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to implementing the best practices contained in this guidance, and to take steps to foster effective processes where it is within their legal authority to do so. Where it is not, supervisors may wish to consider supporting legislative or other reforms that would allow them to have a more direct role in this regard.

<sup>10</sup> BCBS Core Principle 27, essential criterion 2, states that the supervisor holds the bank’s board and management responsible for ensuring that the financial statements issued annually to the public bear an independent external auditor’s opinion as a result of an audit conducted in accordance with internationally accepted auditing practices and standards.

International Standards on Auditing (ISAs) are an example of those internationally accepted auditing standards. In this guidance, all references to internationally accepted auditing standards will be to ISAs, although the references would apply equally to other equivalent internationally accepted auditing standards.

<sup>11</sup> See Annex 1 for more examples of contents of extended reporting which forms part of the statutory audit in certain jurisdictions.

<sup>12</sup> See also BCBS Core Principle 27, footnote 83, for the meaning of “supervisor”, which is broader than the meaning specified in paragraph 14 and is relevant for Principle 12.

- Board and senior management<sup>13</sup> – The governance structure at a bank composed of a board and senior management. The Committee recognises that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions. Some countries use a two-tier structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries, by contrast, use a one-tier structure in which the board has a broader role. Still other countries have moved or are moving to an approach that discourages or prohibits executives from serving on the board or limits their number and/or requires the board and board committees to be chaired only by non-executive board members. Given these differences, this document does not advocate a specific board structure. The terms “board” and “senior management” are only used as a way to refer to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction.
- Audit committee – A specialised committee established by the board, the mandate, scope and working procedures for which are set out in a charter or other instrument. As stated in the BCBS paper on *Principles for enhancing corporate governance* (October 2010), to increase efficiency and allow deeper focus in specific areas, boards in many jurisdictions establish certain specialised board committees – the audit committee being one of them. The paper further recommends that, for large and internationally active banks, an audit committee or equivalent should be required. It also outlines the overall responsibilities of the audit committee.<sup>14</sup>
- Those charged with governance – The person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity<sup>15</sup> as defined by internationally accepted auditing standards. Such person(s) or organisation(s) is (are) typically the board of directors.<sup>16</sup> Where the board of directors establishes an audit committee in a bank to assist it in meeting its responsibilities by charging the audit committee with specific tasks and responsibilities, in such circumstances the audit committee can be viewed as taking on the role of those charged with governance in relation to those specific tasks and responsibilities.<sup>17</sup>

## Structure

### The external auditor and audit quality

15. Audit quality includes delivering an appropriate, independent professional opinion on the financial statements, in compliance with internationally accepted auditing standards.<sup>18</sup> Internationally

<sup>13</sup> See BCBS (October 2010), *Principles for enhancing corporate governance*, paragraph 12.

<sup>14</sup> See BCBS (October 2010), *Principles for enhancing corporate governance*, paragraphs 50–51.

<sup>15</sup> ISA 260, *Communication with those charged with governance*, paragraph 10(a).

<sup>16</sup> See the meaning of “board” within this paragraph.

<sup>17</sup> ISA 260, *Communication with those charged with governance*, paragraph 12, states – “If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body” (ref: A5–A7).

The existence of both the board of directors and the audit committee does not impede the external auditor from reporting at two levels, both to the board of directors and to the audit committee, should the external auditor determine that it is necessary to do so for the purposes of complying with the requirements of internationally accepted auditing standards in relation to the specific tasks and responsibilities charged to the audit committee by the board of directors.

<sup>18</sup> See footnote 10.

accepted auditing standards require the external auditor to possess and demonstrate certain attributes while applying a rigorous audit process.

16. Given that internationally accepted auditing standards are applicable to all entities, Section 4 of this document builds upon these standards and lays out the supervisory expectations of the external auditor regarding the audit of a bank. Moreover, Section 4 highlights the key areas where significant risks of material misstatement in banks' financial statements often arise, which therefore require the auditor's particular attention for a quality audit.

#### Engagement between the external auditor and the audit committee

17. Regular and effective engagement and communication between the external auditor and the audit committee contribute to audit quality.

18. Amongst its other responsibilities, the audit committee<sup>19</sup> is responsible for overseeing the bank's external auditor. A soundly constituted audit committee can play a key role in contributing to audit quality. Section 5 discusses the audit committee's responsibilities in relation to the oversight of, and its relationship with, the external auditor.

#### Engagement between the supervisor and the external auditor

19. Effective communication between the supervisor and the external auditor enhances the effectiveness of supervision of the banking sector. This relationship will then also contribute to audit quality.

20. The supervisor and the external auditor have a mutual interest in building and maintaining an effective relationship, which fosters regular communication of useful information. Section 6 provides principles and explanatory guidance for facilitating an effective relationship between the supervisor and the external auditor at the levels of the supervised bank, the audit firm and the accounting profession as a whole.

#### Engagement between the banking supervisory authority and the audit oversight body

21. The banking supervisory authority and the relevant audit oversight body share a strong mutual interest in ensuring quality independent audits. Regular and effective dialogue between the banking supervisory authority and the audit oversight body at a national level can assist in identifying and dealing with key issues in relation to the conduct of bank audits. Section 7 sets out the principles for facilitating effective communication between these bodies.

22. Supervisors are in a unique position to identify audit quality issues at both the industry and individual audit level. Regular and effective engagement between the supervisor and the relevant audit oversight body may enable the supervisor to provide timely feedback on such issues. Additionally, the supervisor may, if necessary, take action to address issues raised by the audit oversight body.

### The Committee's international engagement on external auditing

23. Approaches for dealing with supervisory concerns about the quality of the audit of an individual bank may differ across jurisdictions, but all approaches should be designed to contribute to enhancing audit quality. In its effort to promote audit quality, the Committee engages in regular dialogue and discussion with the relevant international stakeholders on external audit matters. These stakeholders include, but are not limited to, the following:

<sup>19</sup> See paragraph 14.

- the Financial Stability Board (FSB), whose objectives include the enhancement of the effectiveness of banking supervision;
- the Monitoring Group, which is responsible for advancing the public interest in areas related to international audit quality;
- the Public Interest Oversight Board (PIOB), which is responsible for improving the quality and public interest focus of the international standards formulated by standard-setting boards operating under the auspices of the International Federation of Accountants (IFAC) in the areas of audit and assurance, education and ethics, including oversight of the public interest activities of three of the IFAC's independent standard-setting boards and their respective consultative advisory groups;
- the consultative advisory groups of the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA), which are responsible for developing international auditing and ethics standards respectively;
- the International Forum of Independent Audit Regulators (IFIAR), which is responsible for improving audit quality globally, including through independent inspections of auditors and/or audit firms; and
- the Global Public Policy Committee (GPPC), which is comprised of representatives from the six largest international accounting networks and focuses on public policy issues for the accounting profession.

24. The objective of this dialogue is to enable the Committee and the relevant international stakeholders<sup>20</sup> to identify and discuss relevant issues and topics on a timely basis so that supervisors, external auditors and audit oversight bodies can take appropriate action. As such, these discussions should address not only current issues and topics, but also emerging areas and trends that raise concern.

### 3. Overview of the principles

- **Principle 1:** The external auditor of a bank should have banking industry knowledge and competence sufficient to respond appropriately to the risks of material misstatement in the bank's financial statements and to properly meet any additional regulatory requirements that may be part of the statutory audit.
- **Principle 2:** The external auditor of a bank should be objective and independent in fact and appearance with respect to the bank, consistent with the more stringent requirements applicable to public interest entities in internationally accepted ethical standards.
- **Principle 3:** The external auditor should exercise professional scepticism when planning and performing the audit of a bank, having due regard to the specific challenges in auditing a bank.
- **Principle 4:** Audit firms undertaking bank audits should comply with the more stringent requirements on quality control applicable to listed entities in internationally accepted quality control standards, having due regard to the complexity of a bank audit.
- **Principle 5:** The external auditor of a bank should identify and assess the risks of material misstatement in the bank's financial statements, taking into consideration the complexities of banking activities and the need for banks to have a strong control environment.

<sup>20</sup> The Committee is a member of the FSB, the Monitoring Group, the PIOB and the consultative advisory groups of the IAASB and the IESBA, and is an observer at the IFIAR.

- **Principle 6:** The external auditor of a bank should respond appropriately to the significant risks of material misstatement in the bank's financial statements.
- **Principle 7:** The audit committee should have a robust process for approving, or recommending for approval, the appointment, reappointment, removal and remuneration of the external auditor.
- **Principle 8:** The audit committee should monitor and assess the independence of the external auditor.
- **Principle 9:** The audit committee should monitor and assess the effectiveness of the external audit.
- **Principle 10:** The audit committee should have effective communication with the external auditor to enable the audit committee to carry out its oversight responsibilities and to enhance the quality of the audit.
- **Principle 11:** The audit committee should require the external auditor to report to it on all relevant matters to enable the audit committee to carry out its oversight responsibilities.
- **Principle 12:** The supervisor<sup>21</sup> and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.
- **Principle 13:** The external auditor should report to the supervisor matters that are likely to be of material significance to the functions of the supervisor.
- **Principle 14:** There should be open, timely and regular communication between the banking supervisory authority, the audit firm and the accounting profession as a whole on key risks and systemic issues as well as a continuous exchange of views on appropriate accounting techniques and auditing issues.
- **Principle 15:** There should be regular and effective dialogue between the banking supervisory authority and the relevant audit oversight body.
- **Principle 16:** The banking supervisory authority and the audit oversight body should observe appropriate confidentiality requirements when sharing information.

#### 4. Supervisory expectations relevant to the external auditor and the external audit of financial statements

25. External audits of financial statements performed in accordance with internationally accepted auditing standards enhance the confidence of all users, including supervisors, in the reliability of the audited financial statements and the quality of the information provided.

26. Audits of banks should be performed in accordance with internationally accepted auditing standards. As these standards are not industry-specific, for a quality audit supervisors expect external auditors not only to comply with internationally accepted auditing standards but also to tailor their audit work in response to the significant risks and issues applicable to banks.

27. External auditors are required to comply with applicable jurisdictional and, where relevant, internationally accepted ethical standards. However, given the complexity and systemic risks associated with banks, the external auditor of a bank should follow the most stringent rules for independence under

<sup>21</sup> See footnote 12.

these standards. Similarly, the external auditor of a bank should also follow the most stringent standards on quality control at the engagement level.<sup>22</sup>

28. Part A of this section describes the supervisor's expectations as a user of the bank's financial statements, specifically with respect to the external auditor's knowledge, competence, objectivity, independence, professional scepticism and quality control over the bank's audit. Part B identifies areas where supervisors believe there is often a significant risk of material misstatement in a bank's financial statements and factors to which the supervisor expects the external auditor to pay attention when auditing those areas.

29. While the primary focus in this section is on the financial statement audit, particularly in Principles 5 and 6, the external auditor may identify matters<sup>23</sup> in the course of the audit that are of interest to the supervisor and therefore should be considered for communication to the supervisor. Examples of such matters have been included in Section 6.

30. In some jurisdictions, as part of the statutory audit, the external auditor may also undertake additional work to provide assurance on internal controls or other aspects of a bank's operations. The principles set out in this section provide a relevant reference for the performance of such additional work.

31. The principles and explanatory guidance set out in this section provide a framework for the supervisor's interactions with the external auditor, the audit committee and the relevant audit oversight body. The outcome of these interactions will inform the supervisor's views as to the quality of the external audit and contribute to the supervisory process. These principles and explanatory guidance also provide a framework to assist the audit committee in selecting the external auditor and in assessing the external auditor's knowledge, competence, objectivity and independence as well as the effectiveness of the audit process.

## A. The supervisor's expectations of the external auditor of a bank

### Knowledge and competence

***Principle 1: The external auditor of a bank should have banking industry knowledge and competence sufficient to respond appropriately to the risks of material misstatement in the bank's financial statements and to properly meet any additional regulatory requirements that may be part of the statutory audit.***

32. Given the complexity and diversity of banking activities, and the legal and regulatory framework in which banks operate, the external auditor of a bank should have specialised knowledge and competence in auditing banks and should use experts as appropriate.

### Knowledge

33. The resources required to perform the audit should be such that the audit engagement team, as a whole, has:

- proficient knowledge and understanding of, and practical experience with, the banking sector, associated banking industry and bank-specific risks, and the operations and activities of banks and bank audits. The audit engagement team may acquire this proficiency through specific training, participation in bank audits or work in the banking sector;

<sup>22</sup> Principle 2, paragraph 42, principle 4 and paragraph 53.

<sup>23</sup> See paragraphs 47, 51, 69, 72, 85, 90 and 96.

- proficient knowledge of applicable accounting, assurance and ethical standards, industry practice and relevant guidance such as International Auditing Practice Note (IAPN) 1000;<sup>24</sup>
- proficient knowledge of relevant regulatory requirements in the areas of capital and liquidity, and a general understanding<sup>25</sup> of the legal and regulatory framework applicable to banks; and
- proficient knowledge and understanding of IT relevant to bank audits.

34. In addition, the external auditor should consider whether the audit engagement team should include specialists with a high degree of technical accounting knowledge relevant to banking, particularly given the complexity of the requirements of the applicable financial reporting framework pertaining to accounting estimates, including loan loss provisions, fair value measurements, and any areas known to be subject to differing interpretation or inconsistent or developing practices.

### *Competence*

35. Audit firms should have documented policies and procedures that set minimum competency criteria for members of a bank's audit engagement team.

36. Supervisors may have the ability to influence the competency requirements for external auditors. Where regulations and standards in particular jurisdictions do not include specific competency requirements for banks' external auditors, the supervisor may encourage professional and regulatory bodies to introduce requirements regarding training in, and experience with, bank auditing and accounting so that the audit engagement teams for bank audits are comprised of sufficiently competent staff.

37. Competence is particularly important in underpinning an external auditor's ability to exercise professional judgment and carry out key aspects of the audit, such as identifying and assessing the risks of material misstatement and designing and implementing appropriate responses to those risks.

### *Use of experts*

38. In some instances, such as the auditing of certain complex accounting estimates,<sup>26</sup> more specialised knowledge may be required to support the audit engagement team, eg additional expertise beyond that possessed by the audit engagement team's members in a field other than accounting or auditing. Examples of such areas are valuation of complex financial instruments, commercial property valuations and evaluation of highly complex IT environments, particularly in areas subject to significant risks of material misstatement.

39. Internationally accepted auditing standards<sup>27</sup> set out requirements for the nature, timing and extent of audit procedures which the external auditor should perform to assess the competence, capabilities and objectivity of the experts the external auditor may use. These are important factors in considering the reliability of the information or results produced by the expert.

<sup>24</sup> IAPN 1000, *Special considerations in auditing financial instruments*.

<sup>25</sup> ISA 250, *Considerations of laws and regulations in the audit of financial statements*, paragraph 12.

<sup>26</sup> IAPN 1000, paragraphs 78–80.

<sup>27</sup> As in ISA 620, *Using the work of an auditor's expert*, and ISA 500, *Audit evidence*, paragraph 8.

## Objectivity and independence

**Principle 2: The external auditor of a bank should be objective and independent in fact and appearance with respect to the bank, consistent with the more stringent requirements applicable to public interest entities<sup>28</sup> in internationally accepted ethical standards**

### Objectivity

40. Objectivity is a fundamental ethical principle and a key element of audit quality. It requires that the external auditor's judgment is not affected by conflicts of interest. As objectivity is a state of mind that in most cases cannot be directly observed by users of financial statements, it is important for the external auditor to be independent in both fact and appearance.

### Independence

41. Independence<sup>29</sup> is freedom from situations and relationships in which a reasonably informed third party would conclude that an external auditor's objectivity is impaired. Jurisdictional and internationally accepted auditing standards<sup>30</sup> and internationally accepted ethical standards<sup>31</sup> lay out frameworks for external auditors to identify and respond to threats to independence.

42. The external auditor of a bank must comply with the applicable jurisdictional and internationally accepted ethical standards. Furthermore, the Committee believes that the external auditor of a bank should comply with the more stringent independence standards for public interest entities.<sup>32</sup> To the extent that any of the rules within any one of these standards on ethics is more restrictive than the corresponding rule in the other standards on ethics, the external auditor must comply with the more restrictive rule.

43. Independence should be observed not only in the context of the bank that is being audited but also with respect to the bank's related entities.<sup>33</sup>

<sup>28</sup> Public interest entities are defined under the IESBA Code of Ethics for Professional Accountants, paragraph 290.25, as – "(a) all listed entities; and (b) any entity: (i) defined by regulation or legislation as a public interest entity; or (ii) for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator."

<sup>29</sup> IESBA Code of Ethics for Professional Accountants, paragraph 290.6, states – *Independence comprises:*

*(a) Independence of Mind*

*The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.*

*(b) Independence in Appearance*

*The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised.*

<sup>30</sup> ISA 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with ISAs*; ISA 220, *Quality control for an audit of financial statements*, paragraph 11; and ISA 260, *Communication with those charged with governance*, paragraphs 17 and A21–23.

<sup>31</sup> IESBA Code of Ethics for Professional Accountants.

<sup>32</sup> See footnote 28.

<sup>33</sup> IESBA Code of Ethics for Professional Accountants, paragraph 290.27, states – "In the case of an audit client that is a listed entity, references to an audit client [...] include related entities of the client (unless otherwise stated). When the audit team knows or has reason to believe that a relationship or circumstance involving another related entity of the client is relevant to the evaluation of the firm's independence from the client, the audit team shall include that related entity when identifying and evaluating threats to independence and applying appropriate safeguards."



44. External auditors of a bank should comply with applicable jurisdictional requirements on the rotation of members of the audit engagement team.

45. The audit engagement team members, the audit firm and, when applicable, network audit firms<sup>34</sup> should comply with the independence requirements of both the home jurisdiction and the overseas regulatory authority (in the case where the bank is ultimately regulated by an overseas authority).

46. When assessing whether any relationship or circumstance poses a threat to an external auditor's independence,<sup>35</sup> the external auditor should evaluate not just the specific rules on independence, but also the substance of the threat to independence, and how a reasonably informed third party would perceive the threat and its effect on the external auditor's objectivity. The provision of significant non-audit services by the audit firm and, when applicable, network audit firms to the bank being audited may particularly affect a third party's perception of the external auditor's independence. Such situations should be carefully evaluated for threats to the external auditor's objectivity and perceived independence.

47. The supervisor expects the external auditor to consider actively potential threats to the auditor's independence, specifically the threat of self-review, when discussing accounting matters with the management. For example, complex transactions may be structured to achieve a particular accounting treatment and/or regulatory outcome. When an external auditor discusses with or provides advice to management on such matters, the external auditor must exercise care so as not to take on a management role or responsibility.

#### Professional scepticism

***Principle 3: The external auditor should exercise professional scepticism when planning and performing the audit of a bank, having due regard to the specific challenges in auditing a bank.***

48. Professional scepticism is defined as "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence".<sup>36</sup> Professional scepticism should manifest itself not only through the auditor obtaining corroborating evidence for management's assertions, but also challenging management's assertions, actively considering whether there are alternative accounting treatments that are preferable to those selected by management, and documenting the approach, the evidence obtained, the rationale applied and the conclusions reached. Throughout the audit, the auditor should "adopt a questioning approach when considering information and forming conclusions".<sup>37</sup>

49. Exercising appropriate professional scepticism is critically important in audits of banks because of the number and significance of accounting estimates and the potential for limited objective evidence supporting those estimates. Professional scepticism is particularly important when auditing areas that:

- (a) involve significant management estimates and judgments because these are more prone to management bias;
- (b) involve significant non-recurring or unusual transactions; or
- (c) are more susceptible to fraud and errors being perpetuated due to weak internal controls.

<sup>34</sup> IESBA Code of Ethics for Professional Accountants, paragraphs 290.13–24.

<sup>35</sup> IESBA Code of Ethics for Professional Accountants, paragraph 100.12, identifies categories of threats to an auditor's independence.

<sup>36</sup> IAASB (July 2012), *Handbook of international quality control, auditing, review, other assurance, and related services pronouncements – glossary of terms*.

<sup>37</sup> IAASB (February 2012), *Staff questions & answers – professional scepticism in an audit of financial statements*.

50. Specific areas where professional scepticism should be exercised by the external auditor of a bank include impairment calculations, fair value measurements and going concern assessments, including assessments of solvency and liquidity. Other examples may include complex transactions structured to achieve a particular accounting treatment and/or regulatory outcome by the management where the audit engagement partner has or ought to have reasonable doubt that the proposed accounting treatment and/or regulatory outcome is consistent with the relevant financial reporting framework or regulatory requirements. In this context, the external auditor should actively challenge management's assumptions and judgments and form independent views. This includes challenging evidence obtained from management that corroborates management's view.

51. Where a bank consistently utilises valuations that are at the high or low end of a range of acceptable valuations or when there are other indications of possible management bias, the external auditor should consider this in the overall risk assessment of the bank and should inform those charged with governance, where appropriate.

52. The evidence of the extent of professional scepticism exercised should be demonstrable and understandable through audit documentation that describes how, why and what conclusions were reached by the external auditor. In this regard, internationally accepted auditing standards establish minimum requirements for audit documentation.<sup>38</sup>

## Quality control

***Principle 4: Audit firms undertaking bank audits should comply with the more stringent requirements on quality control applicable to listed entities<sup>39</sup> in internationally accepted quality control standards, having due regard to the complexity of a bank audit.***

53. Audit firms must comply with the applicable jurisdictional and internationally accepted standards on quality control. Furthermore, the Committee believes that the external auditor of a bank should comply with the more stringent requirements on quality control applicable to listed entities in internationally accepted quality control standards. To the extent that any of the rules within any one of these quality control standards is more restrictive than a corresponding rule in the other quality control standards, the external auditor must comply with the more restrictive rule.

54. The audit of a bank should be subject to an engagement quality control review (EQCR)<sup>40</sup> performed internally by the audit firm prior to the issuance of the audit opinion. The engagement quality control reviewer should have the appropriate knowledge and competence to review bank audits.<sup>41</sup> The reviewer should exercise professional scepticism in assessing the quality of audit evidence and whether the auditor's judgments are appropriate.

55. EQCR should be part of a broader firm-level internal system of quality control that emphasises quality and consultation and creates a culture of compliance with auditing and ethical standards.

56. Where a network of audit firms is involved in the audit of a bank, the individual audit firms within the network should apply quality control processes that comply with this document. In such cases, the lead audit engagement partner should be responsible for the performance of a quality audit by all

<sup>38</sup> ISA 230, *Audit documentation*.

<sup>39</sup> A listed entity is defined under International Standard on Quality Control (ISQC) 1, *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*, Paragraph 12(i) as "an entity whose shares, stock or debt are quoted or listed on a recognised stock exchange, or are marketed under the regulations of a recognised stock exchange or other equivalent body".

<sup>40</sup> ISQC 1, *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*, paragraph 35.

<sup>41</sup> The knowledge and competence of the engagement quality control reviewer should be consistent with supervisory expectations of the audit team as a whole as described in Principle 1 and related explanatory guidance.

the teams reporting to it. In doing so, the lead partner may place reliance on the processes by which quality control is exercised within the network firms that report to it. For example, the lead audit engagement partner of a group audit may rely on the firm's processes for (a) ensuring that each audit engagement team member (i) acquires the appropriate skills, knowledge and experience to perform bank audits and (ii) complies with independence rules, and (b) monitoring adherence to the audit firm's policies and procedures on quality control.

57. The involvement of the engagement quality control reviewer throughout the audit, and the outcome of the quality control review, should be evident in the audit working papers. Any significant discussions between the engagement quality control reviewer and the audit engagement team, particularly in areas where views may have differed<sup>42</sup> and as to how conclusions were reached, should be fully documented in the audit working papers. Thus in jurisdictions where the supervisor has access to the external auditor's working papers, the quality control review would also be at the supervisor's disposal.

## B. Supervisory expectations of the audit of a bank's financial statements

Identifying and assessing significant risks of material misstatement specific to a bank's financial statements

***Principle 5: The external auditor of a bank should identify and assess the risks of material misstatement in the bank's financial statements, taking into consideration the complexities of banking activities and the need for banks to have a strong control environment.***

### *Identifying potential risks*

58. Banks are exposed to a variety of risks that can potentially affect the results of their operations or financial condition. These include, but are not limited to, credit risk, market risk, liquidity risk, operational risk and regulatory risk. New risks may emerge or the significance of each risk may change over time as a result of various factors that may be driven by changed circumstances or developments both internal and external to the bank.

59. In designing and performing the audit of a bank, the external auditor should assess the inherent and control risk to determine the risk of material misstatements at the financial statement and assertion levels. By doing so, the external auditor gains an understanding of internal controls that are relevant to the audit, and particularly of the control environment designed by the bank.

60. To respond to the assessed risk of material misstatement, an external auditor follows an audit strategy that includes both substantive procedures and control testing. Given the nature of bank activities, including those involving a high volume of transactions, banks implement controls designed to address risks posed to the organisation. As a result, the external auditor of a bank should perform extensive tests of controls over financial reporting to assess whether, and to what extent, the auditor can rely on them.

### *Materiality*

61. An understanding of the concept of materiality and determination of materiality thresholds is needed in order to establish the audit strategy, and identify and assess whether a risk of material misstatement exists in the financial statements.

<sup>42</sup> The external auditor should also discuss these matters with the bank's audit committee (see paragraph 123).

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.

63. The external auditor should exercise caution when evaluating identified misstatements. These misstatements could be an indicator of wider issues within the bank which could potentially lead to material misstatements in the financial statements as a whole. Therefore, individual misstatements should not be dismissed solely because they are below the level of materiality set for planning purposes.

64. For individual account balances, specific classes of transactions or disclosures,<sup>43</sup> internationally accepted auditing standards require the external auditor to determine a lower level of materiality for those particular account balances, classes of transactions or disclosures, if the external auditor believes that "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". This is particularly relevant for audits of banks because certain financial statement items are used in the calculation of key metrics used by a wide range of users of the financial statements. For example, regulatory ratios such as the leverage ratio, liquidity ratio and capital adequacy ratio are calculated based on account balances in the financial statements or are derived from the financial statements.

### *Assessing the risks of material misstatement*

#### Internal control and its components

65. According to internationally accepted auditing standards, internal control components are the control environment, risk assessment process, information and communication systems and processes, control activities and monitoring of controls.<sup>44</sup>

66. As stated in the BCBS *Principles for enhancing corporate governance*, a robust internal control environment is critical to the strength of a bank's governance system and its ability to manage risk.<sup>45</sup> Consequently, when obtaining an understanding of the bank's internal control environment, the external auditor should, amongst other considerations:

- assess the "tone at the top", ie whether management, with the involvement of those charged with governance, is promoting a robust control environment;
- determine whether the control environment extends to all types of operations and service offerings and encompasses all subsidiaries and branches of the banking group;
- understand the bank's approach to outsourcing/offshoring of business activities and functions and assess how internal control over these activities is maintained; and
- obtain an adequate understanding of the organisation of key control functions within the bank and its subsidiaries. At a minimum, key control functions include the internal audit, risk management, compliance and other monitoring functions.

67. Compensation arrangements at a bank may be a good indicator of the culture within the organisation because they can influence the behaviour of the bank's personnel and the quality of corporate governance. The external auditor should pay particular attention to the risks of material misstatement in the financial statements due to fraud, particularly where banks employ compensation

<sup>43</sup> ISA 320, *Materiality in planning and performing an audit*, paragraphs 10 and A10.

<sup>44</sup> ISA 315, *Identifying and assessing the risks of material misstatement through understanding the entity and its environment*, Appendix 1.

<sup>45</sup> BCBS (October 2010), *Principles for enhancing corporate governance*, paragraph 70.

arrangements that may encourage excessive risk-taking or other inappropriate behaviour amongst their personnel.

### Control activities

68. Internationally accepted auditing standards require the external auditor to obtain an understanding of control activities relevant to the audit which, in the auditor's judgment, are necessary to assess the risks of material misstatement and to establish the audit strategy. The assessment of the control activities over financial reporting is critical for the design of further audit procedures responsive to assessed risks. When identifying and assessing risks of material misstatement and assessing controls, the external auditor should take account of the following factors:

- the knowledge and competence of those in charge of financial reporting and of other control functions having an impact on financial reporting;
- the nature of hedging strategies employed by the bank which, if complex, improperly structured or inadequately monitored, can have accounting and solvency implications;
- the use of complex financial instruments involving significant estimates of fair value;
- the provision of custodial services to retail and/or institutional clients and the procedures in place to avoid co-mingling of client and proprietary assets;
- the volume of transactions by type of activity and/or presence of significant non-routine transactions;
- the use and monitoring of internal accounts;
- the structure and complexity of IT systems for conducting business and for facilitating efficient business and financial reporting, as they may lead to increased risk of fraud or error, particularly where there is potential for individual override of the control system or the potential for fraudulent transactions to go undetected due to the sophistication and complexity of the IT systems;
- the number, scope and geographical dispersion of subsidiaries and the necessity for complex consolidation procedures;
- the existence of significant transactions with related parties; and
- the use of off-balance sheet financing arrangements, such as special purpose entities (SPEs) and other complex structures.

69. Banking supervisors and those charged with governance, such as the audit committee, need to be satisfied that the internal control is commensurate with the nature, volume and complexity of the bank's activities and is organised in accordance with regulatory and legal requirements. The internal control of a bank must be robust and reliable in order to cope with stressed environments. Significant deficiencies in internal control which have been identified by the external auditor should be communicated in writing to those charged with governance and senior management, and other deficiencies in internal control should be communicated to the senior management at an appropriate level of responsibility on a timely basis.<sup>46</sup> In addition, the Committee believes that the external auditor should 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

<sup>46</sup> ISA 265, *Communicating deficiencies in internal control to those charged with governance and management*, paragraphs 9 and 10.

related to accountability. Such matters may include significant decisions or actions by management that lack appropriate authorisation.<sup>47</sup>

### *Internal audit*

70. The internal audit function is an important element of the overall internal control environment.<sup>48</sup> It provides assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes.<sup>49</sup> The work of internal auditors can help external auditors assess the quality of the internal control processes and identify risks.

71. Whether or not the external auditor expects to use the work of a bank's internal auditors, provided there is no reason to doubt their knowledge, competence and objectivity, the external auditor should engage with, and seek information on key internal audit findings from, the internal auditors. This may provide valuable input into the external auditor's understanding of the entity and its environment and aid in identifying and assessing risks of material misstatement. The external auditor should consider reading relevant internal audit reports if the information obtained from engaging with the internal auditors indicates issues that may have an impact on the financial statement audit.

72. The external auditor's observations on and, where relevant, evaluation<sup>50</sup> of a bank's internal audit function are of particular interest to the audit committee and the bank's supervisor given the role an effective internal audit function plays in maintaining a robust control environment in a bank.

Responding to significant risks of material misstatement specific to a bank's financial statements

***Principle 6: The external auditor of a bank should respond appropriately to the significant risks of material misstatement in the bank's financial statements.***

73. Having identified and assessed the risks of material misstatement, internationally accepted auditing standards require the auditor to identify any areas where there is a significant risk of material misstatement. Paragraphs 78-98 below set out key audit areas of a bank's financial statements, where there is often a significant risk of material misstatement.

74. In addition to the areas set out in paragraphs 78-98, there are other items in a bank's financial statements whose regulatory treatment could give rise to incentives for management bias in the recognition or measurement of such items. As a consequence, there is a greater risk of material misstatement of these items in the financial statements. This may lead to inappropriate application of regulatory rules to these items and a material misstatement of the bank's capital position. Examples of such items are deferred tax assets, investments in unconsolidated entities, pension fund assets, and the classification of financial instruments. External auditors should therefore be alert to any likelihood that the treatment of such items in the financial statements is influenced by management bias towards a desired regulatory outcome and consider this in their risk assessment of the bank. External auditors should also be aware that management bias may change over time depending on, for example, the extent to which the bank is able to meet its regulatory requirements. External auditors should evaluate estimates which may be subject to this bias, and any potential audit differences otherwise identified, in the context of the impact on regulatory capital or regulatory capital ratios, consistent with paragraph 64.

<sup>47</sup> ISA 260, *Communication with those charged with governance*, paragraph A25.

<sup>48</sup> BCBS (June 2012), *The internal audit function in banks*.

<sup>49</sup> BCBS, *ibid*, Principle 1.

<sup>50</sup> ISA 610 (revised), *Using the work of internal auditors*, paragraph 13.

75. Areas of significant risk of material misstatement particularly require an external auditor to apply professional judgment and experience. Internationally accepted auditing standards require that the external auditor obtain sufficient appropriate audit evidence<sup>51</sup> regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.<sup>52</sup>

76. Internationally accepted auditing standards require special audit consideration for areas where significant risks of material misstatement are identified.<sup>53</sup> Given that these areas are associated with issues that the external auditor identifies as highly important for the bank, these areas are worthy of discussion with those charged with governance.

77. As the categories of what may be a significant risk for a bank may change over time, the list of audit areas provided in paragraphs 78-98 of this document as areas where there is often a significant risk of material misstatement is not intended to be comprehensive.

### *Loan loss provisioning*

78. Loan loss provisioning is generally material for a bank's financial statements and the calculation of capital and key performance metrics. The measurement of loan loss provisions in accordance with internationally accepted accounting principles involves complex judgments about credit risk which may be subjective in nature.

79. The factors that the external auditor needs to consider in identifying and assessing the significant risks of material misstatement in relation to loan loss provisioning and the related allowance for loan losses include:

- (a) The estimation techniques used to compute provisions and how the techniques vary among and within banks.
- (b) How management has assessed the effect of estimation uncertainty on the level of provisioning, and the effect such uncertainty may have on the appropriateness of the recognised provision and the sufficiency of the related allowance for loan losses in the financial statements.
- (c) All known and relevant impairment indicators for loan exposures which include previously unexpected adverse developments in the market or economic environment, adverse movement in interest rates, restructuring, inadequate underwriting policies adopted by the bank, overdue payments, failure of the borrower to meet budgeted revenues or net income, covenant breaches and forbearance.
- (d) Whether the bank has sought perspectives and data from different functions within the bank, including risk management, credit and internal audit, as well as reliable sources external to the bank, including peer data and regulator perspectives so as to consider all relevant and available information in assessing impairment.
- (e) Accounting rules for provisioning may differ from the provisioning rules that apply for regulatory reporting or capital purposes. It may therefore be customary for banks to have different processes and systems to generate loan loss provisions for accounting purposes and for regulatory purposes. Further, there can be material differences in the application of the same set of accounting and/or regulatory rules by individual banks. Large differences between provisions for accounting purposes and for regulatory purposes may indicate a risk of material misstatement of the accounting provision. In addition, whilst for regulatory capital purposes

<sup>51</sup> ISA 500, *Audit evidence*, paragraph 6.

<sup>52</sup> ISA 330, *The auditor's responses to assessed risks*, paragraph 6.

<sup>53</sup> For example, as in ISA 315, *Identifying and assessing the risks of material misstatement through understanding the entity and its environment*, paragraphs 27-29.

under the Basel framework the accounting loan loss provision for internal ratings-based approach (IRB) portfolios is replaced by the regulatory expected loss provision, the level of the accounting provision may nevertheless have an impact on the level or the composition of regulatory capital, due to the treatment of the tax effect of provisions and the allocation of any excess provision to capital tiers. External auditors should be alert to any management bias in this area.

- (f) Disclosures should enable users to assess the loan loss provisioning methodology applied by the bank, regarding how it relates to credit risk for that bank, and how it compares with methodologies applied across the banking sector.

### *Financial instruments measured at fair value*

80. A bank's portfolio of financial instruments measured at fair value can range from "plain vanilla" financial instruments which are frequently traded in liquid markets with observable market prices, and involve less measurement uncertainty, to those which are customised, complex, and where the valuation is based on significant unobservable inputs with a substantial amount of management judgment. Financial instruments measured at fair value also include financial instruments that are subject to an impairment assessment which is a key area of judgment.

81. Where there are changes in the composition of a bank's portfolio of financial instruments – whether due to changes in customer demand, the bank's approach to managing risk and liquidity, or changes in prudential regulation – the bank will need to evaluate any accounting implications of the changes.

82. Accounting standards contain requirements on recognition; initial and subsequent measurement (including impairment); reclassification from fair value to amortised cost; presentation; and disclosures.<sup>54</sup> Because these requirements are complex, they may be difficult to interpret and apply, and therefore the external auditor often needs to utilise more complex and wider-ranging audit procedures to obtain sufficient appropriate audit evidence to satisfy him/herself that the financial statements are not materially misstated. The classification of an individual financial instrument may be particularly important for achieving a favourable regulatory outcome.

83. In adopting a sceptical approach to management's assumptions regarding the valuation of financial instruments for which there are significant unobservable inputs, IAPN 1000, Special considerations in auditing financial instruments, sets out specific audit procedures that may be followed in auditing financial instruments measured at fair value.

### *Liabilities including contingent liabilities arising from non-compliance with laws and regulations, and contractual breaches*

84. Non-compliance with, or material breaches of, the prudential framework, conduct requirements, legal requirements or contractual agreements could lead to legal or supervisory actions against a bank, thereby exposing the bank to potential litigation and/or the imposition of substantial penalties. Such events may require recognition of provisions, contingent liabilities and/or qualitative disclosures in the bank's financial statements. Further, any adverse impact on the bank's reputation resulting from this non-compliance could have consequences for the bank's going concern assessment.

85. In the course of the audit, the external auditor should remain alert to actual or suspected breaches of prudential regulations, particularly those that are likely to be of material significance to the

<sup>54</sup> Also see BCBS (April 2009), *Supervisory guidance for assessing banks' financial instrument fair value practices*, available at [www.bis.org/publ/bcbs153.pdf](http://www.bis.org/publ/bcbs153.pdf).



functions of the supervisor. As noted in Section 6 below,<sup>55</sup> if the external auditor identifies any such breaches of material significance, the auditor should notify the supervisor immediately.

### *Disclosures*

86. A number of factors have contributed to an increased demand from users for more relevant and extensive qualitative and quantitative disclosures. These include the increased complexity of business transactions, including off-balance sheet transactions and non-recognition of assets and liabilities, and increased use of fair value and other accounting estimates, with significant uncertainties and changes in measurement attributes.

87. While accounting standards specify disclosure objectives, the standards may not always prescribe in all circumstances specific disclosures to meet those objectives. Therefore, there may be a substantial amount of judgment in assessing whether disclosures are presented fairly in accordance with the disclosure objectives in the relevant accounting framework.

88. Increased transparency through fairly presented public disclosures enhances market confidence. It is therefore important that the bank provide disclosures which present the bank's financial condition, the risks to which it is exposed and how they are managed, and are meaningful and responsive to changes in market conditions and perceived risks.

89. In responding to the significant risks in this area of audit, the external auditor has an important role to play in encouraging consistent and meaningful disclosures which present the bank's financial condition in a way that is informative and understandable to users of financial statements.

90. In the course of its audit work, the external auditor should be alert to any indications that disclosures in financial statements are not consistent with the bank's prudential information such as capital adequacy and liquidity position disclosures within the financial statements.

### *Going concern assessment*

91. A going concern gives rise to two separate issues:

- (a) whether the going concern basis of preparation of financial statements is appropriate; and
- (b) the external auditor's evaluation of the bank's assessment of its ability to continue to meet its obligations for the foreseeable future (for at least 12 months after the date of the financial statements)<sup>56</sup> and whether there are material uncertainties in this regard that should be disclosed in the applicable accounting framework.

92. The work the external auditor performs to assess the going concern status of a bank is different from that likely to be performed for a non-bank entity because of the contractual terms of bank assets and liabilities (maturity mismatch), the potential for regulatory intervention, and the impact that the signalling of any uncertainty over the bank's ability to continue as a going concern could have on the short-term viability of the bank.

93. Examples of reasons that make the going concern assessment of a bank unique are as follows:

- (a) Current emerging risks and concerns specific to the bank or the banking industry as a whole may have an impact on the historical trends for the specific bank in such a manner that the historical trends may not reflect the likely trend over the next year. For example, during periods of market turmoil, normal sources of funding may no longer be available, as deposits payable on demand may run off more quickly than historical experience would contemplate and such deposits may be difficult to replace.

<sup>55</sup> See paragraphs 156 and 166.

<sup>56</sup> ISA 570, *Going concern*, paragraph 13.

(b) As banks are highly leveraged, a small change in asset valuation may have a substantial impact on the adequacy of a bank's regulatory capital. Market risks may be such that financial instruments held at fair value may be subject to substantial changes in value in the short term and significant volatility over the longer term. A decrease in regulatory capital may result in a downgrade by rating agencies making funding more expensive and possibly harder to obtain.

94. Given these and other risks, banks are required to meet liquidity requirements and capital ratios set by the bank supervisory authority. There should be equal emphasis on the evaluation of liquidity and solvency of the bank for the period over which the going concern assumption has been assessed:

(a) Liquidity:<sup>57</sup> Factors to assess include the reasonableness and reliability of the cash forecast for at least 12 months after the date of the financial statements, liquidity risk disclosures, regulatory or contractual restrictions on cash, loan covenants, and pension funding.

(b) Solvency:<sup>58</sup> Given the potential adverse impact of capital adequacy concerns on the confidence in a bank and, as a consequence, on the bank operating as a going concern,<sup>59</sup> the external auditor will need to consider the robustness of the bank's system for managing capital.<sup>60</sup> In addition, the external auditor will need to consider the capital position in relation to the current and any known future capital requirements, definitions of capital resources, and challenges of raising capital. This is particularly critical where capital levels are strained, access to capital resources is restricted or where, for example, the bank's annual report or internal capital projections include ambitious projections of improvements in capital levels.

95. In responding to the significant risks in this area of audit, and assessing management's assertion that a bank is a going concern, factors which are necessary to consider are:

(a) the robustness of the bank's own systems and controls for managing liquidity, capital and market risk;

(b) the prudential information that is reported to supervisors covering the bank's solvency and capital;

(c) any external indicators that reveal liquidity or funding concerns; and

(d) the availability of short-term liquidity support.

96. Given the above risks and the possible systemic implications, 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.<sup>61</sup>

### *Securitisations – SPEs*

97. The banking sector is involved in activities such as sponsoring (or originating) structured products/transactions that support maturity, credit and liquidity transformation risks more often than other industry sectors. The sponsoring bank does not ordinarily fund such activities. The funding is

<sup>57</sup> See *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011); and *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010.

<sup>58</sup> See footnote 57.

<sup>59</sup> Non-compliance with capital requirements is one of the examples noted in ISA 570, *Going concern*, paragraph A2, under other events or conditions that may cast significant doubt about the going concern assumption.

<sup>60</sup> The bank's system for identifying and measuring its regulatory capital and assessing the adequacy of its capital resources in relation to the bank's risk exposures and established minimum ratios, including management's process for stress testing.

<sup>61</sup> See paragraph 166.

generally provided by other parties. However, the sponsoring bank may be exposed to risks such as reputational risk in the event of the sponsored entity encountering financial or operational difficulties.

98. Such activities require special consideration by the external auditor and are of interest to the supervisor for the following reasons:

- (a) Accounting concern – Accounting frameworks are often principles-based, which may result in different treatments of each of these complex transactions. In addition, because these are highly structured products, their accounting treatment may vary based on the facts and circumstances of each transaction, eg where SPEs are tailored to remain off the bank’s balance sheet. In these instances, it is necessary for the auditor to evaluate the judgments made by the management and consider whether the accounting treatment is appropriate and the disclosures are sufficient.
- (b) Regulatory concern – Because of the complexity of the securitisation and the chain of financial intermediation, the sponsoring bank in an “originate to distribute” model may underestimate the real risk transferred or the risk retained on its balance sheet (including reputation risk and conflicts of interest in case of defaults on the securitised assets). Even so, the originator may be able to benefit from an off-balance sheet treatment for the assets underlying these transactions and hence may not be required to hold additional regulatory capital unless specifically required by the supervisor. The external auditor should be alert to when the supervisor requires additional capital even though the off-balance sheet accounting treatment applied by the bank is appropriate.<sup>62</sup>
- (c) Interconnectivity – Increases the correlation between banks and other non-banking sectors, which can add to the global systemic risk.

## 5. Supervisory expectations with regard to a bank’s audit committee and its relationship with the external auditor

99. The BCBS’s paper on the *Internal audit function in banks* (June 2012)<sup>63</sup> and its paper on *Principles for enhancing corporate governance* (October 2010)<sup>64</sup> describe the main responsibilities of a bank’s audit committee. The audit committee has, amongst others, a number of responsibilities with respect to the external auditor and the statutory audit. The audit committee approves, or recommends to the board of directors for approval, the appointment, reappointment, dismissal and compensation of the external auditor. The audit committee also monitors and assesses the independence of the external auditor.

100. The audit committee oversees the bank’s statutory audit process. Key aspects of the audit committee’s work encompass the assessment of the effectiveness of the external audit process. The audit committee should require that senior management take the necessary corrective actions to address the findings and recommendations of the external auditor in a timely manner.

101. The discussion below focuses on the audit committee’s responsibilities in relation to the oversight of, and its relationship with, the external auditor to promote and support the integrity, objectivity and independence of the auditor, the quality of the external audit and the competencies that

<sup>62</sup> Supervisory actions such as requiring firms to hold additional capital may also have an impact on the going concern assessment of the firm.

<sup>63</sup> [www.bis.org/publ/bcbs223.pdf](http://www.bis.org/publ/bcbs223.pdf).

<sup>64</sup> [www.bis.org/publ/bcbs230.htm](http://www.bis.org/publ/bcbs230.htm).

underpin that quality. To enable the audit committee to carry out its oversight responsibilities, which also contribute to the effectiveness of the audit process, the principles in this section promote effective two-way communication between the audit committee and the external auditor. It is important to note that all the discussions below stem from an important overarching principle: namely, that there should be a frank, open working relationship and a high level of mutual respect amongst all parties involved.

102. The principles and explanatory guidance in this section form the basis for the supervisor's monitoring of the effectiveness of the audit committee in its oversight of the external auditor.

#### Appointment of the external auditor

***Principle 7: The audit committee should have a robust process for approving, or recommending for approval, the appointment, reappointment, removal and remuneration of the external auditor.***

103. The audit committee has the primary responsibility for approving, or recommending to the board of directors for approval, the appointment, reappointment, removal and remuneration of the external auditor. In doing so, the audit committee should determine appropriate criteria for selecting the external auditor and regularly assess the knowledge, competence, independence (see Principle 8 below) of the external auditor and effectiveness (see Principle 9 below) of the external audit, having due regard to the guidance in Section 4.

104. The audit committee's procedures for approving or recommending the approval of the external auditor should also include a risk assessment of the likelihood of the withdrawal of the external auditor from the audit, and how the bank would respond to that risk.

105. The 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.

106. If the board of directors has approval responsibilities with respect to the external auditor, but does not accept the audit committee's recommendation, it should include in the annual report, and in any papers relating to the appointment/reappointment/dismissal of the external auditor, a statement explaining the audit committee's recommendation and the reasons why the board of directors has taken a different position.

107. The audit committee should assess the overall quality of the external auditor, prior to its first appointment and at least annually thereafter. To that end, the audit committee should request that the external auditor report on the external auditor's own internal quality control procedures, including the audit firm's EQCR process, and any significant matters of concerns arising from these procedures. The audit committee should also consider, where available, the external audit firm's annual transparency report and any inspection reports on the audit firm issued by the relevant oversight body.

108. The audit committee should maintain an understanding and knowledge of:

- the structure and governance of the audit firm;
- the current nature of the audit environment, including any overseas jurisdictions where the bank operates;
- significant issues and concerns raised by the relevant audit oversight body regarding the audit firm, and the auditor's action in addressing these concerns, to understand how these shortcomings may affect the quality of the audit of the bank;
- the nature of banking regulatory actions and conditions that could have an impact on the external auditor's work on the bank, including any regulatory actions and conditions specific to the bank being audited, or to actions and conditions that the supervisor is imposing on all banks (for example, through newly implemented regulations and policies); and

- public lessons learned from any recent external audit failures associated with the bank's audit firm and how the firm has dealt with them so that similar deficiencies do not occur.

109. The audit committee should also satisfy itself that the level of the audit fees is commensurate with the scope of work undertaken. Where fee reductions are offered and accepted, the audit committee should seek assurance that these reductions do not imply an inappropriate increase in the materiality level to be applied by the external auditor, or a narrowing of the external auditor's proposed scope of the audit, or a reduction in the attention which will be given to each business component and the significant audit risks identified.

110. The audit committee should discuss and agree to the terms of the engagement letter issued by the external auditor prior to the approval of the engagement. Where relevant, the audit committee should agree to an engagement letter that has been updated to reflect changes in circumstances, such as those arising from changes in legal requirements and changes in the scope of the external auditor's work as a result of revisions to internationally accepted auditing standards which have arisen since the previous year.

111. If the external auditor resigns or communicates an intention to resign, the audit committee should follow up on the reasons/explanations giving rise to such resignation and consider whether the audit committee needs to take any action in response to those reasons.

#### Independence of the external auditors

***Principle 8: The audit committee should monitor and assess the independence of the external auditor.***

112. The independence of the external auditor is one of the main prerequisites for an adequate level of audit quality. As such, the audit committee should understand the applicable independence requirements. The audit committee should have procedures to monitor and assess the independence of the external auditor at least annually, taking into consideration relevant national laws, regulations and professional requirements. The assessment should also involve a consideration of all relationships between the bank and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor.

113. Where the audit firm has been the external auditor of the bank for many years, there may be a perception that there is a familiarity or self-interest threat to the external auditor's objectivity and independence in its audit of the bank. However, when the bank changes its external auditor, there is a risk that the depth of understanding of the bank and its activities and systems will be lost. This may affect the new external auditor's ability to identify risks of material financial statement misstatements and respond to them appropriately, and hence may detract from the quality of the audit.

114. Audit committees should have a policy in place that stipulates the frequency with which there should be a tender for the external audit contract. The policy should also call for the audit committee to consider periodically whether there should be a limit to the length of an external auditor's tenure as the bank's external auditor given the potential impact of audit firm rotation on independence and audit quality.

115. Audit committees should understand the audit firm's policy on rotation of members of the audit engagement team and the audit firm's compliance with any jurisdictional or other local regulatory requirements in this regard.

116. As described in Principle 2, the audit committee should seek assurance that the audit engagement team members and their firm and, when applicable, the network external auditors have no financial, personal, business or other relationships with the bank which could adversely affect the auditor's actual or perceived independence and objectivity. The audit committee should seek from the external auditor, at least on an annual basis, information about the audit firm's policies and processes for maintaining independence and monitoring compliance with the relevant independence requirements.

117. Audit committees of banks should develop a formal policy which governs the acceptance of non-audit services provided by the auditor.<sup>65</sup> Amongst other provisions, the policy should include criteria for the types of non-audit services that the external auditor may provide or is prohibited from providing, and rules stipulating when advance approval by the audit committee is required for the auditor's performance of non-audit services. The policy should be reviewed periodically and compliance should be monitored, taking into account the contents of Section 4 of this document.

118. Where non-audit services are provided by the external auditor, the audit committee should monitor and establish that the provision of such services does not impair the external auditor's objectivity and independence, taking into consideration various factors including the skills and experience of the external auditor, safeguards in place to mitigate any threat to objectivity and independence, and the nature of and arrangements for non-audit fees.<sup>66</sup>

119. Where the external auditor provides non-audit services to the bank, the bank's annual report should explain to shareholders the nature of and the fee arrangements for the non-audit services received, and how auditor independence is safeguarded.

#### Effectiveness of the external audit

#### ***Principle 9: The audit committee should monitor and assess the effectiveness of the external audit.***

120. 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, in particular those areas described in Section 4 of this document.

121. The audit committee should consider whether the proposed resources to execute the audit plan are reasonable given the scope of the audit engagement, the nature and complexity of the bank's operations, and its structure and activities. The audit committee should understand the nature and extent of audit work that the external auditor intends to rely upon where the audit work is performed by network firm personnel or other audit firms.

122. The audit committee should obtain confirmation from the external auditor that there is adequate knowledge, competence and expertise within the audit engagement team and that the audit will be conducted in compliance with internationally accepted auditing standards, as well as any applicable laws and regulations.

123. The audit committee should discuss with the external auditor the findings of the latter's work. In the course of its monitoring, the audit committee should:

- obtain an understanding of the external auditor's view on any major issues that arose during the audit (including those issues that were subsequently resolved as well as those that have been left unresolved), in particular the external auditor's explanation of the significant judgments the audit engagement team made and the conclusions it reached. This should include the discussions with management and the judgments involved, the range of possible outcomes and, where available, a comparison of the bank's position with that of its peer group (on an anonymous basis), including a comparison with previous periods on such major issues;
- 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

<sup>65</sup> Paragraph 67 of the BCBS paper on *The internal audit function in banks* (June 2012) states that, as a sound practice, banks should not outsource internal audit activities to their own external auditor. Any departure from this best practice should be limited to small banks and should remain within the bounds of the applicable ethical standards for the statutory or external auditor.

<sup>66</sup> As set out in Annex 2 to the BCBS paper on the *Internal audit function in banks* (June 2012).

- circumstances where the audit engagement partner's conclusions differed from those of the engagement quality control reviewer; and
- review the nature and levels of misstatements identified during the audit, obtaining explanations from management and, where necessary, the external auditor as to why certain errors might remain unadjusted.
124. The audit committee should also discuss with the external auditor the audit representation letters<sup>67</sup> before signature by the board of directors/senior management and give particular consideration to matters where specific representation has been requested. The audit committee should consider whether the information provided on each of the items in the representation letters is complete and appropriate based on its own knowledge.
125. As part of the ongoing monitoring process, the audit committee should discuss with the auditor the management letter<sup>68</sup> (or equivalent) and any other audit-related reports<sup>69</sup> provided to the bank. In particular, the audit committee should discuss with the external auditor any significant deficiencies identified in the bank's control environment and in its internal control over financial reporting.
126. At the end of the audit engagement period, the audit committee should:
- consider whether the audit firm has followed its audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditor to address those risks;
  - obtain feedback about the conduct of the audit from key bank personnel involved, eg the heads of finance and internal audit; and
  - report to the board of directors on the effectiveness of the external audit process.
127. The audit committee should seek to obtain information from the external auditor on the main findings of audit quality reviews of the bank's audit and the audit firm's quality control systems by audit oversight bodies.

#### Relationship between the audit committee and the external auditor

***Principle 10: The audit committee should have effective communication with the external auditor to enable the audit committee to carry out its oversight responsibilities and to enhance the quality of the audit.***

128. The foundation for an effective relationship is regular, timely, open and honest communication between the audit committee and the external auditor. Regular dialogue between the two parties should be held throughout the reporting cycle of the bank.
129. While both cooperation and challenges are needed between the external auditor and the audit committee for the external audit to be effective, the need for cooperation should never prevent robust challenges from being made when needed. Such challenges are a key responsibility of the audit committee and are part of the productive dialogue on key judgments that can result in stronger and deeper understanding of and views on the positions of all parties.

<sup>67</sup> ISA 580, *Written representations*, requires the auditor to request management (ie management and, where applicable, those charged with governance) to provide written representations that it has fulfilled certain of its responsibilities. It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other ISAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

<sup>68</sup> The management letter is a document issued by the bank's external auditor that communicates to the bank's management the internal control-related matters that have come to the auditor's attention during the statutory audit process.

<sup>69</sup> As mentioned in paragraph 151, this could include extended audit reports issued by the external auditor which in certain jurisdictions may be a part of the external auditor's statutory audit work.

130. In order to reinforce the audit committee's effectiveness and enhance the quality of the audit, the audit committee should consider inviting the external auditor to attend audit committee meetings (except when discussing matters in relation to the assessment of the external auditor), even if there are no items explicitly relevant to the external audit on the agenda. The external auditor's attendance should facilitate the exchange of views on business performance, risk and other topics. Further, to enhance audit quality, the audit committee should consider, if necessary, assisting the external auditor to gain access to any other committee meetings that the external auditor determines to be relevant for the auditor's work.

131. The audit committee should have the right and authority to meet regularly – in the absence of executive management – with the external auditor. This will enable the audit committee to understand and discuss all issues that may have arisen between the external auditor and bank management in the course of the external audit and how these issues have been resolved. In addition, these meetings should address any other matters that the external auditor believes the audit committee should be aware of in order to exercise its responsibilities.

132. The audit committee should discuss with the auditor any matters arising from the statutory audit that may have an impact on regulatory capital or disclosures. This may include discussion of the interaction between the accounting information and the regulatory information, eg accounting impairment charges versus regulatory expected losses, or the consistency of the bank's Pillar 3 reporting with its annual report.

133. The audit committee should discuss with the external auditor any significant issues identified in the course of the audit, in particular in areas which could be relevant to future financial statements, to promote early discussion and planning. This includes upcoming changes in accounting standards or regulations and the consequences of material transactions.

134. The audit committee should also communicate to the external auditor matters that are likely to be of significant influence on the conduct of the statutory audit. Such matters may encompass subjects that the audit committee believes warrant particular attention, significant communications with the supervisor, or other matters that the audit committee considers may influence the audit of the financial statements.

#### Reporting by the external auditor to the audit committee

***Principle 11: The audit committee should require the external auditor to report to it on all relevant matters to enable the audit committee to carry out its oversight responsibilities.***

135. In some jurisdictions, as part of the statutory audit, the auditors are also required by law or regulations to express an opinion on the control environment of the bank and provide additional reporting of matters identified accordingly. The explanatory guidance in the following paragraphs only covers reporting to the audit committee that may be required in the context of the financial statement audit.

136. The audit committee should expect the external auditor to communicate promptly to the audit committee any significant audit findings noted in the course of the audit and any significant problems encountered in carrying out the audit.

137. Upon completion of the audit work, the external auditor should report to the audit committee on the outcome of the audit in writing. The contents of these written reports should be aligned with the requirements set by internationally accepted auditing standards<sup>70</sup> for matters to be communicated to those charged with governance,<sup>71</sup> the recommendations made in this document, and any additional requirements under applicable laws and regulations.

<sup>70</sup> ISA 260, *Communication with those charged with governance*.

<sup>71</sup> See paragraph 14 and ISA 260, paragraphs 11 and 12.



138. In addition to the above, where not already covered by the recommendations in other parts of this document and the relevant auditing standards, the audit committee should request that the external auditor report to it in writing on other significant matters, including the following:

- Key areas of significant risk of material misstatement in the financial statements, in particular on critical accounting estimates or areas of measurement uncertainty (eg loan loss provisioning and valuation uncertainties), including potential valuation bias and consequential effects on earnings, compensation structures and regulatory ratios.
- Areas of significant management and auditor judgment, including judgments pertaining to the recognition, de-recognition, measurement or disclosure of relevant items within the financial statements and, where relevant, judgments about material uncertainties that may cast doubt on an entity's ability to continue as a going concern (including consideration of liquidity/funding issues of the entity).
- Outsourcing of key external audit work (eg with respect to audits of subsidiaries) to another audit firm or use of external experts to assist with the external audit.
- Significant internal control<sup>72</sup> deficiencies identified in the course of the statutory audit.
- 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.<sup>73</sup>
- Areas of financial statement disclosures, for the bank itself and relative to its peers, which the auditor believes could be improved, including the results of discussions with management.

139. For the purposes of complying with the requirements of internationally accepted auditing standards,<sup>74</sup> where significant matters are communicated to the audit committee, the external auditor should also determine if these matters need to be communicated to the board of directors.

## 6. The relationship between the supervisor and the external auditor

140. This section sets out the principles that promote effective relationships that will enable regular communication of mutually useful information in the context of a statutory audit between:

- the supervisor and the external auditor at the supervised bank level, regardless of whether the communication is mandatory (Subsection A – Principles 12 and 13); and
- the banking supervisory authority and the audit firm, and the accounting profession as a whole that is not specific to an individual bank (Subsection B – Principle 14).

141. The key objective of having effective relationships between the parties referred to above is to enhance the effectiveness of the supervision of the banking sector. This relationship will then also contribute to the quality of external audits.

<sup>72</sup> Including the control environment, risk assessment process, information and communication systems and processes, control activities and monitoring of controls in the bank.

<sup>73</sup> See paragraph 69.

<sup>74</sup> ISA 260, *Communication with those charged with governance*, paragraph 12, states – “If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body” (ref: A5–A7).

142. An effective relationship should enable each party to carry out its respective statutory responsibilities while not implying that either party is responsible for or should or can perform the statutory responsibilities of the other party.

### A. Effective relationship at the supervised bank level

143. The external auditor can provide the supervisor with valuable insight into various aspects of a bank's operations and management's attitude to the application of key accounting policies, judgments and models adopted. Conversely, the external auditor may obtain helpful insights from information originating from the supervisor where the supervisor provides an independent assessment in areas significant to the external audit and may focus attention on specific areas of supervisory concerns. In certain jurisdictions, the supervisor may also request the external auditor to perform specific assignments that go beyond the statutory audit work of the auditor.

**Principle 12: The supervisor<sup>75</sup> and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.**

144. Supervisors and external auditors should have an open and constructive relationship, with confidence in each other that information exchanged will be treated appropriately and confidentially.<sup>76</sup>

145. For an effective relationship to exist, the engagement between the supervisor and the external auditor should involve individuals who are knowledgeable, informed and empowered by their respective organisations to exchange information.

146. The supervisor may benefit from the results of the external auditor's work because in many respects the two parties have complementary concerns regarding the same matters although the focus of their concerns is different. Similarly, the external auditor may benefit from insights that the supervisor can communicate. However, in order to discharge their respective statutory responsibilities, each party should not use the work of the other as a substitute for its own work and the supervised entity should remain the main source of information for their respective work.

147. The terms, nature and scope of this relationship can be determined in individual jurisdictions and should be clear to both the supervisor and the external auditor – for example, through guidance issued by the banking supervisory authority.

#### *Access to communication with the bank*

148. The external auditor's work gives rise to the auditor's report on the annual/consolidated financial statements which is often used for prudential supervisory purposes. When performing a financial statement audit in accordance with internationally accepted auditing standards, the external auditor communicates with management and/or those charged with governance about significant matters relating to financial reporting or supplementary matters, and these communications may be accessed by the supervisor.<sup>77</sup> In the same manner, in certain jurisdictions, the external auditor may also have access to the supervisor's communications to the bank.<sup>78</sup>

<sup>75</sup> In the context of Principle 12, see BCBS Core Principle 27, footnote 83, for the meaning of "supervisor", which is broader than the meaning specified in paragraph 14.

<sup>76</sup> See paragraphs 160-163.

<sup>77</sup> In certain jurisdictions, the supervisor may also have access to the external auditor's working papers.

<sup>78</sup> The external auditor should review the supervisor's communications to the bank to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements as required by ISA 250, *Considerations of laws and regulations in an audit of financial statements*, paragraph 14(b) – "The auditor shall perform the

149. Given the benefits that may ensue, when communicating with management and/or those charged with governance of the bank, both the supervisor and the external auditor should consider communicating matters that may also be of mutual interest to each other in writing so that they form part of the bank's records to which the other party should have access.

#### *Direct communication at the supervised bank level*

150. In addition, effective communication should be established through one or a combination of direct written and oral communication channels, as dictated by the circumstances.

151. Written communication channels may include extended audit reports on the audited financial statements, which are submitted to the supervisor and are not available to the public.<sup>79</sup> In certain jurisdictions, these reports may be part of the external auditor's statutory audit work and may also cover assignments related to prudential supervisory requirements.

152. Oral communication channels may include bilateral meetings between representatives of the supervisor and the external auditor, and may be formal or ad hoc. In addition to bilateral meetings, trilateral meetings involving representatives of the supervisor, the external auditor and those charged with governance at the supervised bank can also be held.

153. Whilst not excluding any other effective communication channels, bilateral and trilateral meetings are examples of sound practice communication channels, particularly for SIBs.

#### *Communication of matters outside the scope of the external auditor's duty to report/alert*

154. The communication channels described in paragraphs 150-153, can be a helpful source of information for the supervisor about matters that are outside the scope of the external auditor's duty to report/alert discussed in Principle 13 and on which the supervisors can reasonably expect the auditors to form a view in the course of their audit of the bank's financial statements.

155. The contents of the external auditor's communication could cover all issues that the supervisor might consider relevant in carrying out its functions. Such issues may include current, emerging and thematic issues, and entity-specific and sector-wide issues. The external auditor should remain alert to the fact that these issues may also fall within the scope of the external auditor's duty to report/alert.

156. In addition to discussing with the supervisor areas where there is often a significant risk of material misstatement in the financial statements, Section 4 includes examples of areas where matters of interest to the supervisor may be identified by the external auditor in the course of the financial statement audit and therefore are relevant for communication to the supervisor. Examples of these matters are:

- Where a bank undertakes transactions to achieve a particular accounting or regulatory outcome such that the accounting treatment is technically acceptable, but it obscures the substance of the transaction.
- Where a bank consistently utilises valuations which are at the extreme ends of a range of acceptable valuations or there are other indications of possible management bias.
- Significant deficiencies in internal control processes and their observations on matters that are 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. This may include,

following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements: [...] b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities."

<sup>79</sup> Ordinarily, such reports would be issued for the attention of the board of directors of the audited bank, but should be delivered to the supervisor as well (directly or through the bank).

where relevant, their observations on the effectiveness of the internal audit function, the risk management function and the compliance function (where not already required by statute).

- Actual or suspected breaches of prudential regulations noted in the course of the audit.<sup>80</sup>
- Indications that disclosures in financial statements are not consistent with published prudential information.

157. Annex 1 to this document provides examples of the potential content of the extended audit reports described in paragraph 151. Annex 2 to this document provides guidance on the timing and examples of the potential content of the meetings between the supervisor and the external auditor, as circumstances may dictate.

158. Where bilateral and trilateral meetings are held, particularly in the case of SIBs, the timing and content of these meetings could be aligned with the typical phasing of the bank's external audit and/or the supervisory assessment of the bank. Of particular importance are the planning and concluding phases of the external audit. The meetings should focus on the key issues and judgments within the scope of the external auditor's statutory audit work.

159. The form, frequency and content of the communication described in this document between the supervisor and the external auditor of the supervised entity will vary depending on the jurisdictional circumstances, the characteristics and circumstances of the bank, and the supervisory model adopted in the relevant jurisdiction.

#### *Safe harbour available to external auditors*

160. External auditors are required by internationally accepted ethical standards to treat much of the information received while carrying out their functions as confidential. The existence of a legal provision that protects external auditors from disciplinary proceedings, any prosecution and liabilities when making disclosure in good faith to the supervisor (safe harbour) permits auditors to share information with the supervisor without contravening their duty of confidentiality.

161. In communications on matters that fall outside the scope of the duty to report/alert discussed in Principle 13 and which may be of interest to the supervisor, where a safe harbour does not exist,<sup>81</sup> it is reasonable for the supervisor to expect the external auditor to communicate these matters through the bank or directly with the bank's consent.

#### *Gateways available to supervisors*

162. If appropriate confidentiality rules are in place, the supervisor may decide to communicate bank-specific information to the external auditor when the information-sharing will help in its supervisory work and in turn assist the external auditor in conducting a quality external audit.

163. Before disclosing any information to the external auditor, supervisors should carefully 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.

<sup>80</sup> The external auditor should apply professional judgment in determining whether the breach identified is likely to be of significance to the supervisor. Not all breaches should be reported to the supervisor. The external auditor should report significant breaches to the supervisor. However, if the breach is of material significance, it should be reported immediately as described in paragraph 166.

<sup>81</sup> In jurisdictions where safe harbours do not exist, supervisors should be encouraged to work towards achieving a safe harbour which would provide that no duty to which the auditor is subject shall be contravened by communicating in good faith to the supervisor any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the supervisor.

**Principle 13: The external auditor should report to the supervisor matters that are likely to be of material significance to the functions of the supervisor.**

*Communication of matters within the scope of the external auditor's duty to report/alert*

164. When required by the legal or regulatory framework or by a formal agreement or protocol, the external auditor should promptly communicate matters of material significance to the supervisor (referred to as "duty to report/alert" matters).

165. On many occasions, the external auditor will have already identified and discussed these matters with the bank's management and/or those charged with governance as appropriate. However, it is not sufficient for the external auditor to rely on the bank to notify the supervisor when there is a duty on the part of the external auditor to report to/alert the supervisor directly<sup>82</sup> on such matters.

166. Laws or regulations provide that external auditors who make any such disclosure in good faith to the supervisor cannot be held liable for breach of a duty of confidentiality. The following are examples of matters that most jurisdictions prescribe as within the scope of the external auditor's duty to report/alert:<sup>83</sup>

- information that indicates the bank's failure to fulfil one of the requirements for a banking licence;
- a serious conflict within the bank's decision-making bodies or the unexpected departure of a manager in a key function;
- information that may indicate a material breach of laws and regulations or the bank's articles of association, charter or by-laws;
- material adverse changes in the risks of the bank's business and possible risks going forward; and
- a refusal to certify the financial statements or the expression of reservations in the audit report (other than a clean opinion) by the external auditor.

167. It is also usual practice for the external auditor to notify the supervisor of the external auditor's intent to resign or the bank's removal of the external auditor from office.

**B. Effective relationship at the levels of the audit firm and the accounting profession as a whole**

168. To assist in effective supervision of banks, it is important to identify system-wide, macroprudential risks which may have an impact on banks. In the course of their work, the banking supervisory authority and external audit firms obtain information which, when reviewed in its entirety, can assist in identifying changing and emerging key trends and developments that may be indicative of emerging systemic risk.

169. Audit firms may also identify emerging issues over inconsistent or inappropriate application of accounting standards which, if identified early, permit external auditors and supervisors to take timely remedial action.

**Principle 14: There should be open, timely and regular communication between the banking supervisory authority, the audit firm and the accounting profession as a whole on key risks and**

<sup>82</sup> In certain jurisdictions, legal requirements may be that such reporting must be done through the bank's management.

<sup>83</sup> See paragraphs 85 and 96.

***systemic issues as well as a continuous exchange of views on appropriate accounting techniques and auditing issues.***

170. The banking supervisory authority and external audit firms should have regular discussions on existing and emerging key risks and systemic issues at the national level, as the exchange of such information is mutually beneficial. The communication should be open and in an environment that allows a frank exchange of views and ideas. If circumstances dictate, ad hoc meetings should be held to discuss matters requiring urgent action to allow each party to take appropriate action in a timely manner.

171. There should be periodic meetings at the national level between the banking supervisory authority and audit firms and professional accountancy bodies to discuss existing and emerging key risks and systemic issues.<sup>84</sup>

172. Key risks may be identified from discussions on:

- the appropriateness of accounting techniques for newly developed financial instruments, other aspects of financial innovation and securitisation; and
- existing issues such as market opacity, and impairment evaluations for a particular asset class.

These discussions on key risks could be indicative of systemic issues. They could also assist in achieving banks' adoption of the most appropriate accounting policies and their consistent application.

173. It is advisable for banking industry associations to be involved in discussions on these topics.

## **7. The relationship between the banking supervisory authority and audit oversight body**

174. Supervisory authorities often use audited information, either directly or as a basis for regulatory information. In many jurisdictions, audit oversight bodies are responsible for independently monitoring the quality of statutory audits as well as audit firms' policies and procedures supporting audit quality. Therefore, banking supervisory authorities and audit oversight bodies have a strong mutual interest in ensuring quality audits by the firms.

175. To promote effective dialogue between the banking supervisory authority and the audit oversight body, their respective roles should be clearly understood. The banking supervisory authority's focus is on the safety and soundness of the institutions under its supervision and the stability of the financial system as a whole. The audit oversight body's main role is to monitor the quality of audits in order to protect the interests of investors or further the public interest.

176. To facilitate effective dialogue between the banking supervisory authority and the audit oversight body, it is also beneficial to have an appropriate framework (eg through a memorandum of understanding between the two parties) for cooperation and information-sharing between the two bodies, subject to the confidential obligations of both parties and the relevant laws of the jurisdiction in which they are located. This may include the form, frequency and content of the dialogue. The cooperation framework should enable the banking supervisory authority to take appropriate actions to address the identified issues or topics.

<sup>84</sup> These meetings with audit firms and professional accountancy bodies should also be held at an international level through groups such as the Basel Committee (through the relevant group), the European Banking Authority and the Association of Supervisors of Banks of the Americas, as described in Section 2.

**Principle 15: There should be regular and effective dialogue between the banking supervisory authority and the relevant audit oversight body.**

177. Where there is an audit oversight body, the banking supervisory authority should establish regular dialogue with the relevant audit oversight body to deal with relevant issues in relation to the conduct of audits of the banks under supervision.

178. Effective dialogue can be established through both formal (eg scheduled regular meetings) and informal channels (eg ad hoc discussions). There should be an open and constructive two-way dialogue between the two parties.

179. Meetings between the banking supervisory authority and the audit oversight body should take place as frequently as deemed necessary to enable them to inform each other of topics or issues of mutual concern or interest arising from the performance of their duties that could be of relevance to the other authority, subject to relevant legal constraints.

180. Information exchanges between the two parties could include the robustness of the audit of certain areas particularly relevant to the banking supervisory authority, such as loan loss provisioning, or the auditor's consideration of the internal controls or risk management procedures of banks. The discussions may also include any issues or topics identified by the audit oversight body in the course of its inspections relating to audits of financial institutions (including audit deficiencies), and the audit oversight body's response to such issues, including follow-up with external audit firms and any corrective actions or other steps taken by the audit oversight body or external auditors to further strengthen external audits of financial institutions.

181. The banking supervisory authority may also discuss with the audit oversight body areas where there can be a significant risk of material misstatement, their concerns about the quality of the audit of a particular financial institution or any significant matters of concern in relation to the bank's external auditor or audit firms in general which may be relevant to the work of the audit oversight body.

182. Although identifying audit deficiencies is not a primary focus of the banking supervisory authority's work, on becoming aware of matters that may require action by the audit oversight body, the banking supervisory authority should consider communicating such matters to the audit oversight body.

183. The discussions should not be restricted to current issues or topics but should also include any significant thematic or emerging topics.

184. Depending on the outcome of the dialogue between the banking supervisory authority and the audit oversight body, where permitted, actions taken by the banking supervisory authority could include:

- raising issues identified by the audit oversight body with individual banks or their external auditors and encouraging remediation of these issues where appropriate; and
- initiating a cross-sector thematic review to analyse the impact of issues or topics identified by the audit oversight body.

**Principle 16: The banking supervisory authority and the audit oversight body should observe appropriate confidentiality requirements when sharing information.**

185. Information shared between the banking supervisory authority and the audit oversight body is likely to be subject to legal confidentiality requirements.

186. Where information is subject to a confidentiality requirement, the authority/body receiving the information should handle it in accordance with those requirements, and should consider:

- consulting the authority/body providing the information before disclosing the information to any third party; and
- notifying the other party if it receives a request or demand to provide the information on any basis potentially enforceable in law.

## Annex 1

### Guidance on the content of extended reports provided by the external auditors to supervisors

In certain jurisdictions, it is a well-established practice that external auditors submit to the supervisor an extended report (the so-called long-form audit report) on the audited financial statements of banks. These reports form part of the statutory audit work. The following is a list of examples of the potential content of such reports, which is not meant to be exhaustive.

#### Contents relating to the audit of the financial statements:

- description of the annual audit mandate, the audit strategy and the audit procedures;
- description and assessment of the significant accounting and valuation methods, including structured and complex accounting activities (eg asset-backed securities transactions, sale and leaseback transactions, use of special purpose entities, and barter transactions);
- description of significant events that took place during the year under review;
- description of material changes to the legal, financial and organisational basis of the bank (eg changes to the legal form, the capital structure, the company structure, the organisational structure, the composition of the board, the structure of banking operations and financial services provided, the lines of business, and the relations with affiliated parties);
- description of the internal controls over significant procedures and internal control functions (eg risk management, compliance, internal audit, audit committee, and management information systems);
- assessment of business performance;
- assessment of the development of the net asset position, especially the nature and extent of off-balance sheet assets and liabilities;
- comments and explanation on individual balance sheet items and profit and loss accounts, taking the principle of materiality into consideration;
- comments on whether the balance sheet items have been properly valued, the valuation adjustments and provisions are appropriate and the reporting requirements have been fulfilled;
- description of material agreements and pending legal disputes where these may have adverse effects on the net asset position;
- description of the contents and assessment of the enforceability of letters of comfort issued;
- assessment of the earnings position, including a description of the most important sources of and factors for generating earnings;
- assessment of the risk situation, the procedures for determining risk provisioning and the adequacy of risk provisioning;
- description of major features and material risks of the lending business, including risk concentrations and the way they are dealt with within the bank;



- description of general credit lines and noteworthy loans (eg significant non-performing loans, loans for which sizeable loan loss provisions are necessary or were necessary in the concluded financial year, significant loans to board members, and loans for which an exceptional type of collateral has been provided);
- follow-up on serious irregularities and weaknesses observed during previous audits; and
- summary of the key findings and results of the audit.

### Contents relating to special prudential supervisory requirements:

- assessment of the adequacy of risk management, including the internal control system and the internal audit and compliance functions;
- analysis of the bank's exposure to credit risk/counterparty risk, market risk, interest rate risk, settlement risk, foreign exchange risk, liquidity risk, profitability risk and operational risk;
- analysis of the amount and composition of the bank's own funds that have to be reported to the supervisor;
- assessment of the appropriateness of procedures for the preparation of prudential returns;
- assessment of the appropriateness of measures taken by the bank to determine the level of own funds, its liquidity ratio and its solvency ratio;
- assessment of the liquidity position and the liquidity management system of the bank;
- description and assessment of the provisions for preventing money laundering and terrorist financing; and
- description and assessment of the provisions on conduct of business rules.

## Annex 2

### Guidance on the timing and content of meetings between supervisors and external auditors

This annex provides guidance on the timing and examples of the potential content of meetings between supervisors and external auditors, as circumstances may dictate. The examples include types of matters of supervisory interest on which external auditors can reasonably be expected to form views, but which fall outside the usual “duty to report/alert” obligations.

#### Planning stage

- Risk assessment and scope – assessments in light of the external environment and the firm’s performance, business model and risk appetite.
- Recent supervisory risk assessments and other supervisory reviews if appropriate confidentiality rules are in place.
- Audit strategy/approach and views on materiality.
- Observations on internal controls (eg governance effectiveness, control environment, application controls and monitoring controls).
- Fraud due to deficiencies in the control environment.
- Views and judgments on key risk areas based on audit/supervisory work performed to date (where confidentiality rules permit), including specific significant transactions, material valuations and impairment decisions, methodologies and assumptions.
- Assessment of risks relating to the going concern assumption.
- Accounting policy application and changes.
- Sources of potential management bias.
- Culture and tone set from the top.
- Issues from previous years and how the firm had addressed them.
- Extent of work on internal controls over regulatory reporting, including capital.

#### Pre-close

- Update on all areas covered in previous meetings.
- Adequacy and reliability of disclosures in light of statutory reporting requirements and risks, transactions, judgments, and assumptions discussed in this and previous meetings.
- Critical accounting estimates and indications of management bias.
- Analysis of management’s going concern assessment.

- Content of (anticipated) reporting to those charged with governance.
- Unadjusted differences and the auditor's evaluation in light of materiality.
- Material control weaknesses identified in the bank's financial and regulatory reporting processes.
- Views on the control environment around regulatory reporting and calculation of capital resources.
- Possible modifications to the audit report.
- Additional matters arising from the audit.

## Others

Additional meetings may be held as appropriate during the audit phase, and after the conclusion of the audit to debrief on matters considered during the annual audit cycle and to consider any assessment of risks and anticipated issues.

## Members of the Accounting Task Force's Audit Subgroup

Chair: Ms Patricia Sucher, Financial Services Authority, UK

Canada	Office of the Superintendent of Financial Institutions	Kenneth Leung
China	China Banking Regulatory Commission	Zhenqiang Si
France	Bank of France	Nathalie Boutin
France	French Prudential Supervisory Authority	Hadrien Maillard
Germany	Deutsche Bundesbank	Dragomira Berberova
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Stefanie Jessen
Italy	Bank of Italy	Lidja Schiavo
Japan	Bank of Japan	Hiroyuki Yoshida
Japan	Financial Services Agency	Hiroshi Ozawa
Luxembourg	Commission de Surveillance du Secteur Financier	Martine Wagner
Netherlands	Netherlands Bank	Paul Bakker
Russian Federation	Central Bank of the Russian Federation	Elena Hakimova
Saudi Arabia	Saudi Arabian Monetary Agency	Fahd Alkhamees
Spain	Bank of Spain	Bárbara Olivares
Switzerland	Eidgenössische Finanzmarktaufsicht FINMA	Heinz Meier
Turkey	Banking Regulation and Supervision Agency	Gürcan Avcı
United Kingdom	Financial Services Authority	Veenu Mittal
United States	Board of Governors of the Federal Reserve System	Terrill Garrison
United States	Office of the Comptroller of the Currency	Graham Dyer
United States	Federal Deposit Insurance Corporation	Harrison Greene
Basel Committee Secretariat		Xavier-Yves Zanota