Research memo

Center on Sanctions & Illicit Finance
FOUNDATION FOR DEFENSE OF DEMOCRACIES

Auditing Standards for Clients Doing Business with Iran

April 2017

Objective

This CSIF discussion memorandum provides an assessment of the responsibilities of an external auditing accounting firm whose clients are doing business with Iran. It covers auditing, disclosure, and reporting.

This assessment explains the nature of responsibilities for an external auditing firm and the responsibilities for strengthening the overall control environment in which trade with Iran is carried out.

This assessment is designed to create awareness of the nature of the auditor's professional duties with respect to Iranian business. CSIF's goal is to initiate public discussion, encourage regulatory support, and, most importantly, to encourage leading accounting firms to voluntarily adopt relevant audit practices.

Summary

Iran represents a heightened risk for companies considering doing business in this emerging market. Despite the lifting of nuclear-related sanctions under the Joint Comprehensive Plan of Action (JCPOA), the U.S. maintains a number of non-nuclear sanctions based on Iran's continued support for terrorism, ballistic missile development, human rights abuses, and de-stabilizing activities in the Middle East.

- Both the U.S. and European Union maintain sanctions against Iran's Islamic Revolutionary Guard Corps (IRGC), which is a dominant player in Iran's economy, particularly in strategic sectors of primary interest to international companies and investors.[1] Although the Treasury has only designated two dozen IRGC-linked companies, through open-source research, we have identified at least 667 companies with significant IRGC influence either through equity shares or positions on the board of directors.[2]

1. Emanuele Ottolenghi, Saeed Ghasseminejad, Annie Fixler, and Amir Toumaj, "How the Nuclear Deal Enriches Iran's Revolutionary Guard," *Foundation for Defense of Democracies, October 2016.* (http://www.defenddemocracy.org/content/uploads/documents/IRGC_Report.pdf)
2. In the report cited in footnote 1, we noted that our research revealed at least 229 companies. Since then, we have identified another 438 companies; Information on Treasury's designations is available via the "Sanctions List Search" database, at http://sdnsearch.ofac.treas.gov/.

The Foundation for Defense of Democracies' Center on Sanctions and Illicit Finance (CSIF) provides policy and subject matter expertise in areas of illicit finance, financial power, and economic pressure to the global policy community. CSIF seeks to illuminate the critical intersection between the full range of illicit finance and national security, including money laundering, terrorist financing, sanctions evasion, proliferation financing, cyber crime and economic espionage, and corruption and kleptocracy. For more information on CSIF's work, please visit www.defenddemocracy.org/csif.

- Iran remains designated as a jurisdiction of primary money laundering concern and subject to special measures under Section 311 of the USA PATRIOT Act.[3]

- Iran remains on the Financial Action Task Force's "blacklist" because of the illicit finance risks it poses to the integrity of the global financial system.[4] This international anti-money laundering standards body urges its members "to advise their financial institutions to apply enhanced due diligence to business relationships and transactions with natural and legal persons from Iran."

- First Deputy Managing Director at the IMF David Lipton warned that Iran's "banking system needs to be able to effectively channel credit to the private sector. This will require addressing the high levels of nonperforming loans, bolstering bank capital, restructuring weak institutions, dealing with unlicensed financial institutions, and strengthening risk management systems and bank supervision."[5]

- The International Monetary Fund further noted, "Iranian banks suffer from weak asset quality and thin capitalization, in part because of government-mandated credit policies and limited enforcement power of banking supervisors. State influence in Iran's banking system tends to weaken underwriting standards, which puts asset quality at risk."[6]

- Companies doing business in Iran have been subject to fines under the U.S. Foreign Corrupt Practices Act, the UK Bribery Act, and other anti-bribery laws for participating in corrupt practices as part of business activities in Iran. For example, French oil company Total S.A. paid $398 million in fines to U.S. authorities for paying for access to Iran's oil fields; a Norwegian firm paid a $3.5 million fine to authorities for violating anti-bribery laws; and also been shown to have bribed Iranian officials for drilling rights.[7]

- London-based hedge fund Sturgeon Capital estimates that only 10 percent of companies on the Tehran Stock Exchange are "sanctions-compliant," not exposed to entities that were or continued to be sanctioned.[8] Additionally, there are allegations of widespread insider trading.[9]

- International risk, transparency, and competitiveness rankings:

    - Iran ranks 150th out of 189 countries on the World Bank's 2016 "Ease of Doing Business" Index on "protecting minority investors," and 140th in "resolving insolvency."[10]

3. Federal Register / Vol. 76, No. 228 / Monday, November 28, 2011, page 72878. (https://www.gpo.gov/fdsys/pkg/FR-2011-11-28/pdf/2011-30331.pdf); U.S. Department of the Treasury, "Fact Sheet: New Sanctions on Iran," November 21, 2011. (https://www.treasury.gov/press-center/press-releases/Pages/tg1367.aspx)
4. Financial Action Task Force, "Public Statement - 21 October 2016," October 21, 2016. (http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/public-statement-october-2016.html)
5. David Lipton, "Iran — Achieving its Potential in the Global Economy," *Central Bank of Iran, May 17, 2016.* (https://www.imf.org/external/np/speeches/2016/051716.htm)
6. International Monetary Fund, "Regional Economic Outlook: Middle East and Central Asia," October 2015. (http://www.imf.org/external/pubs/ft/reo/2015/mcd/eng/pdf/mreo1015.pdf)
7. Jonathan Schanzer and Amir Toumaj, "Opinion: Why Boeing shouldn't do business with Iran," *Market Watch, July 12, 2016.* (http://www.defenddemocracy.org/media-hit/schanzer-jonathan-opinion-why-boeing-shouldnt-do-business-with-iran/)
8. Ladane Nasseri, Samuel Potter, and Golnar Motevalli, "What Investors Need to Know About Entering Iran's Stock Market," *Bloomberg, January 17, 2016.*(http://www.bloomberg.com/news/articles/2016-01-17/what-investors-need-to-know-about-entering-iran-s-stock-market)
9. Behrouz Mina, "Traders Stung as Tehran Stock Exchange Slumps," *Iran Wire, January 28, 2015.* (https://iranwire.com/en/features/853)
10. "Doing Business 2016: Ease of Doing Business in Iran, Islamic Republic," *World Bank Group, accessed July 8, 2016.* (http://www.doingbusiness.org/data/exploreeconomies/iran/)

- It ranks 130th out of 168 countries on Transparency International's Corruption Perceptions Index, and 101st out of 128 on the International Property Rights Index.11
- The Basel Institute on Governance ranked Iran as the worst country in the world with regard to risks from money laundering and terrorism financing in its annual Anti-Money Laundering Index report.[12]
- The World Economic Forum's Global Competitiveness Index ranked Iran very low - 134/144 - for Financial Market Development on the World Economic Forum's Global Competitiveness Index for 2015-2016, with a specific rank of 121 for soundness of banks, 122 for regulation of securities exchanges, 138 for ease of access to loans, and 125 for venture capital availability.[13]
- Rated 6/7 on the 2016 OECD country risk, composed of transfer and convertibility risk (i.e. the risk a government imposes capital or exchange controls that prevent an entity from converting local currency into foreign currency and/or transferring funds to creditors located outside the country) and cases of force majeure (e.g. war, expropriation, revolution, civil disturbance, floods, earthquakes).[14]

Mandatory professional guidelines define the duties and responsibilities of the external auditor in circumstances in which the audit client is engaged in activities where there is higher than normal risk, there is no legal certainty, or there may be activities linked to possible violations of laws either directly or indirectly by the client. The norms governing the professional duties of auditing accountants are based on the following sources, which are included as attached appendices:

- Audit standards of the Public Company Accounting Oversight Board (PCAOB), the professional supervisory body established in the United States to professionally oversee audit work as carried out by accounting firms. The PCAOB publishes standards governing audits and inspects the audits carried out by accounting firms.

11. Corruption by Country/Territory: Iran," *Transparency International, accessed February 12, 2016.* (https://www.transparency.org/country/#IRN); "Iran," *The International Property Rights Index 2016, accessed October 24, 2016.* (http://internationalpropertyrightsindex.org/country?c=IRAN)

12. "Basel AML Index 2016 Report," *Basel Institute on Governance*, July 27, 2016. (https://index.baselgovernance.org/sites/index/documents/Basel_AML_Index_Report_2016.pdf)

13. World Economic Forum, "Iran, Islamic Rep.," *The Global Competitiveness Report 2015-2016, accessed October 27, 2016.* (http://www3.weforum.org/docs/gcr/2015-2016/IRN.pdf)

14. "Country Risk Classifications of the Participants to the Arrangement on Officially Supported Export Credits ," *Organisation for Economic Co-operation and Development, June 24, 2016.* (http://www.oecd.org/tad/xcred/cre-crc-current-english.pdf); "The country risk classifications are meant to reflect country risk. Under the Participants' system, country risk is composed of transfer and convertibility risk (i.e. the risk a government imposes capital or exchange controls that prevent an entity from converting local currency into foreign currency and/or transferring funds to creditors located outside the country) and cases of force majeure (e.g. war, expropriation, revolution, civil disturbance, floods, earthquakes). The country risk classifications are not sovereign risk classifications and should not, therefore, be compared with the sovereign risk classifications of private credit rating agencies (CRAs). Conceptually, they are more similar to the "country ceilings" that are produced by some of the major CRAs. … The final country risk classifications are achieved through a thorough discussion amongst experts and a consensus-building process. The group of country risk experts meet several times a year. These meetings are organised so as to guarantee that every country is reviewed whenever a fundamental change is observed and at least once a year. Although the meetings and details of the CRAM are confidential and no official reports of the deliberations are made publicly available, the list of country risk classifications is published after each meeting." "Country Risk Classification," *Organisation for Economic Co-operation and Development, accessed October 27, 2016.* (http://www.oecd.org/tad/xcred/crc.htm)

- International audit standards of the International Auditing and Assurance Standards Board (IAASB).
- Directives of the Basel Committee on Banking Supervision, which operates in Switzerland under the Bank for International Settlements.

Given the special circumstances involved in business activities with Iran, including a higher than normal risk environment, an accountant's professional duty includes, but is not limited to the following:

- A decision whether or not to accept or continue a client relationship taking into consideration the client's integrity and reliability and the specific and general risks involved in providing services to the client.
- Adjustments to the audit procedures to identify and manage reporting risks including the nature and extent of the company's internal controls with respect to financial reporting. These include:
    - A thorough examination of the company and its business environment, including the regulatory and legal environment, business risks, and the company's main activities and its ties with key customers, suppliers, distributors, and other business entities.
    - Planning and implementation of the auditing of the internal controls involved in the company's financial reporting.
    - Thorough assessment of the effectiveness of internal controls that minimize the risks of error. These include: (a) company-level controls and risk assessment procedures; (b) activity and line of business controls; and, (c) special auditing procedures for emerging market activities anchored in Auditing Standard No. 8 of the PCAOB.
- Special auditing procedures for emerging market activities must:
    - Correspond to the auditing account's assessment regarding fraud and deception risks.
    - Adjust the auditing procedures to the special risks associated with the possible concealment of related parties.
    - Adjust the auditing procedures to the risks associated with illegal activities in which the audited client may be involved.
- Auditing standard AS2405 lists the duties of the auditor in an auditing process where there is a possibility that the client has carried out illegal activity.
- Auditing standard AS2505 lists the rules governing ties with the auditing client's lawyers in the assessment of contingent liabilities. The developing industry of opinions supporting foreign companies undertaking business in Iran requires the accountant to be particularly careful of an overreliance on these opinions.
- The lack of transparency regarding ownership and control ties in Iran's economy, including by still designated entities such as Iran's Islamic Revolutionary Guard Corps, underscores the accountant's duties in the auditing process linked to business with related parties. This is anchored in auditing standard AS2410.

- An accountant engaged in auditing clients involved in business with Iran may have to rely on the assessments and opinions of other accountants. The auditing rules governing this reliance are anchored in auditing standard AS1205.

The principles of the international audit standards of the International Auditing and Assurance Standards Board (IAASB) and the Basel Committee on Banking Supervision that govern the external audits of banks are based on the U.S. professional approach and follow a similar approach to the key issues discussed above.

A. QC Section 20, paragraphs 14 and 15[1]

Acceptance and Continuance of Clients and Engagements

.14 Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. **Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized.** Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide.

.15 Such policies and procedures should also provide reasonable assurance that the firm—

- **Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.**
- **Appropriately considers the risks associated with providing professional services in the particular circumstances.**

B. AS1205: Part of the Audit Performed by Other Independent Auditors[2]

Procedures Applicable to Both Methods of Reporting

.10 **Whether or not the principal auditor decides to make reference to the audit of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:**

[1] Public Company Accounting Oversight Board, "QC Section 20: Systems of Quality Control for a CPA Firm's Accounting and Auditing Practice," accessed October 25, 2016. (https://pcaobus.org/Standards/QC/Pages/QC20.aspx)

[2] Public Company Accounting Oversight Board, "AS 1205: Part of the Audit Performed by Other Independent Auditors," accessed October 25, 2016. (https://pcaobus.org/Standards/Auditing/Pages/AS1205.aspx)

- **Make inquiries as to the professional reputation and standing of the other auditor to one or more of the following:**
    - **The American Institute of Certified Public Accountants,[4] the applicable state society of certified public accountants and/or the local chapter, or in the case of a foreign auditor, his corresponding professional organization.**
    - Other practitioners.
    - Bankers and other credit grantors.
    - Other appropriate sources.
- **Obtain a representation from the other auditor that he is independent under the requirements of the PCAOB and the requirements of the Securities and Exchange Commission (SEC).**
- **Ascertain through communication with the other auditor**:
    - That he is aware that the financial statements of the component which he is to audit are to be included in the financial statements on which the principal auditor will report and that the other auditor's report thereon will be relied upon (and, where applicable, referred to) by the principal auditor.
    - **That he or she is familiar with accounting principles generally accepted in the United States of America and with the standards of the PCAOB and will conduct his or her audit and will report in accordance therewith.**
    - **That he has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the Securities and Exchange Commission, if appropriate.**
    - That a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

(Inquiries as to matters under *a*, and *c* (ii) and (iii) ordinarily would be unnecessary if the principal auditor already knows the professional reputation and standing of the other auditor and if the other auditor's primary place of practice is in the United States.)

.11 If the results of inquiries and procedures by the principal auditor with respect to matters described in paragraph .10 lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph .09, he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial statements to which his qualification extends should be disclosed.

C. AS2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements[3]

Planning the Audit

.09 **The auditor should properly plan the audit of internal control over financial reporting and properly supervise the engagement team members. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures -**

- **Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;**
- **Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;**
- **Matters relating to the company's business, including its organization, operating characteristics, and capital structure;**
- **The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;**
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee8 or management;
- **Legal or regulatory matters of which the company is aware;**

[3] Public Company Accounting Oversight Board, "AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements," accessed October 25, 2016. (https://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx)

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

- Preliminary judgments about the effectiveness of internal control over financial reporting;

- **Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;**

- **Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and**

- **The relative complexity of the company's operations.**

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

.10 Risk assessment underlies the entire audit process described by this standard, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.

.11 **A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk.** On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

.12 The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Identifying Entity-Level Controls

.22 **The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting.** The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

.23 Entity-level controls vary in nature and precision -

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

.24 **Entity-level controls include -**

- **Controls related to the control environment;**

- Controls over management override;

Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- **The company's risk assessment process;**
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

.25 **Control Environment. Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess -**

- **Whether management's philosophy and operating style promote effective internal control over financial reporting;**
- **Whether sound integrity and ethical values, particularly of top management, are developed and understood; and**
- **Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.**

D. AS2110: Identifying and Assessing Risks of Material Misstatement[4]

Performing Risk Assessment Procedures

.04 **The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures.**

.05 **Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets.** Also, risks of material misstatement may relate to, *e.g.*, personnel who lack the necessary financial reporting competencies, information systems that fail to accurately

[4] Public Company Accounting Oversight Board, "AS 2110: Identifying and Assessing Risks of Material Misstatement," accessed October 25, 2016. (https://pcaobus.org/Standards/Auditing/Pages/AS2110.aspx)

capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework**. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors.** This standard discusses the following risk assessment procedures:

- **Obtaining an understanding of the company and its environment (paragraphs .07-.17);**
- **Obtaining an understanding of internal control over financial reporting (paragraphs .18-.40);**
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs .41-.45);
- Performing analytical procedures (paragraphs .46-.48);
- Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs .49-.53); and
- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs .54-.58).

Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.

.06 In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of financial statements.

Obtaining an Understanding of the Company and Its Environment

.07 The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

- **Relevant industry, regulatory, and other external factors;**
- **The nature of the company;**

- The company's selection and application of accounting principles, including related disclosures;

- **The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and**

- The company's measurement and analysis of its financial performance.

.08 In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

.09 **Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework and the legal and political environment; and external factors, including general economic conditions.**

Nature of the Company

.10 **Obtaining an understanding of the nature of the company includes understanding:**

- The company's organizational structure and management personnel;

- The sources of funding of the company's operations and investment activities, including the company's capital structure, noncapital funding (*e.g.*, subordinated debt or dependencies on supplier financing), and other debt instruments;

- **The company's significant investments, including equity method investments, joint ventures, and variable interest entities;**

- **The company's operating characteristics, including its size and complexity;**

Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.

- The sources of the company's earnings, including the relative profitability of key products and services; and

- **Key supplier and customer relationships.**

E. AS2405: Illegal Acts by Clients[5]

Definition of Illegal Acts

.02 **The term illegal acts, for purposes of this section, refers to violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.**

Dependence on Legal Judgment

.03 Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Relation to Financial Statements

.04 **Illegal acts vary considerably in their relation to the financial statements. Generally, the further removed an illegal act is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of the act or to recognize its possible illegality.**

.05 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statements assertions rather than from the perspective of legality per se. The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in AS 1001,Responsibilities and Functions of the Independent Auditor.

.06 **Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an**

[5] Public Company Accounting Oversight Board, "AS 2405: Illegal Acts by Clients," accessed October 25, 2016. (https://pcaobus.org/Standards/Auditing/Pages/AS2405.aspx)

entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. For example, securities may be purchased or sold based on inside information. While the direct effects of the purchase or sale may be recorded appropriately, their indirect effect, the possible contingent liability for violating securities laws, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

The Auditor's Consideration of the Possibility of Illegal Acts

.07 As explained in paragraph .05, certain illegal acts have a direct and material effect on the determination of financial statement amounts**. Other illegal acts, such as those described in paragraph .06, may, in particular circumstances, be regarded as having material but indirect effects on financial statements. The auditor's responsibility with respect to detecting, considering the financial statement effects of, and reporting these other illegal acts is described in this section. These other illegal acts are hereinafter referred to simply as illegal acts**. The auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit made in accordance with PCAOB auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Audit Procedures in the Absence of Evidence Concerning Possible Illegal Acts

.08 Normally, an audit in accordance with PCAOB auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. **The auditor should make inquiries of management and the audit committee concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations. Where applicable, the auditor should also inquire of management concerning—**

- **The client's policies relative to the prevention of illegal acts.**

- **The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.**

The auditor also obtains written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See AS 2805, Management Representations.) The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts.

Specific Information Concerning Possible Illegal Acts

.09 **In applying audit procedures and evaluating the results of those procedures, the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as the following:**

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets

- Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties

- Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor

- Large payments for unspecified services to consultants, affiliates, or employees

- Sales commissions or agents' fees that appear excessive in relation to those normally paid by the client or to the services actually received

- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions

- Unexplained payments made to government officials or employees

- Failure to file tax returns or pay government duties or similar fees that are common to the entity's industry or the nature of its business

Audit Procedures in Response to Possible Illegal Acts

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should—

- Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client.

- Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.

.11 The additional audit procedures considered necessary, if any, might include procedures such as the following:

- Examine supporting documents, such as invoices, canceled checks, and agreements and compare with accounting records.

- Confirm significant information concerning the matter with the other party to the transaction or with intermediaries, such as banks or lawyers.

- Determine whether the transaction has been properly authorized.

- Consider whether other similar transactions or events may have occurred, and apply procedures to identify them.

The Auditor's Response to Detected Illegal Acts

.12 **When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.**

The Auditor's Consideration of Financial Statement Effect

.13 **In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.**

.14 **The auditor should consider the effect of an illegal act on the amounts presented in financial statements including contingent monetary effects, such as fines, penalties and damages. Loss contingencies resulting from illegal acts that may be required to be disclosed should be evaluated in the same manner as other loss contingencies. Examples of loss contingencies that may arise from an illegal act are: threat of expropriation of assets, enforced discontinuance of operations in another country, and litigation.**

.15 **The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, such as loss of a significant business relationship, that information should be considered for disclosure.**

Implications for Audit

.16 The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.

Communication With the Audit Committee

.17 **The auditor should assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor's report with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and the effect on the financial statements. Senior management may wish to have its remedial actions communicated to the audit committee simultaneously. Possible remedial actions include disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control activities. If senior management is involved in an illegal act, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it.**

Effect on the Auditor's Report

.18 **If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements**

taken as a whole, depending on the materiality of the effect on the financial statements.

.19 **If the auditor is precluded by the client from obtaining sufficient appropriate evidential matter to evaluate whether an illegal act that could be material to the financial statements has, or is likely to have, occurred, the auditor generally should disclaim an opinion on the financial statements.**

.20 **If the client refuses to accept the auditor's report as modified for the circumstances described in paragraphs .18 and .19, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to the audit committee or board of directors.**

.21 **The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.**[2]

Other Considerations in an Audit

.22 In addition to the need to withdraw from the engagement, as described in paragraph .20, the auditor may conclude that withdrawal is necessary when the client does not take the remedial action that the auditor considers necessary in the circumstances even when the illegal act is not material to the financial statements. Factors that should affect the auditor's conclusion include the implications of the failure to take remedial action, which may affect the auditor's ability to rely on management representations, and the effects of continuing association with the client. In reaching a conclusion on such matters, the auditor may wish to consult with his own legal counsel.

.23 **Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects his opinion on the financial statements. The auditor should recognize, however, that in the following circumstances a duty to notify parties outside the client may exist:**[3]

- **When the entity reports an auditor change under the appropriate securities law on Form 8-K**
- **To a successor auditor when the successor makes inquiries in accordance with AS 2610, Initial Audits—Communications Between Predecessor and Successor Auditors**
- **In response to a subpoena**

- **To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency**

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing illegal acts with parties outside the client.

Responsibilities in Other Circumstances

.24 An auditor may accept an engagement that entails a greater responsibility for detecting illegal acts than that specified in this section. For example, a governmental unit may engage an independent auditor to perform an audit in accordance with the Single Audit Act of 1984. In such an engagement, the independent auditor is responsible for testing and reporting on the governmental unit's compliance with certain laws and regulations applicable to Federal financial assistance programs. Also, an independent auditor may undertake a variety of other special engagements. For example, a corporation's board of directors or its audit committee may engage an auditor to apply agreed-upon procedures and report on compliance with the corporation's code of conduct under the attestation standards.

F. AS 2410: Related Parties[6]

Introduction

.01 This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.[1]

Objective

.02 The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.[2]
Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

.03 **The auditor should perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110,Identifying and Assessing Risks of Material Misstatement.**

[6] Public Company Accounting Oversight Board, "AS 2410: Related Parties," accessed October 25, 2016. (https://pcaobus.org/Standards/Auditing/Pages/AS2410.aspx)

The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- **Obtaining an understanding of the company's process (paragraph .04);**
- Performing inquiries (paragraphs .05-.07); and
- Communicating with the audit engagement team and other auditors (paragraphs .08-.09).

Note: Obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

Note: Performing the risk assessment procedures described in paragraphs .04-.09 of this standard in conjunction with the risk assessment procedures required by AS 2110 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

.04 In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:

- **Identifying related parties and relationships and transactions with related parties;**
- **Authorizing and approving transactions with related parties; and**
- Accounting for and disclosing relationships and transactions with related parties in the financial statements.

Performing Inquiries

.05 The auditor should inquire of management regarding:

- **The names of the company's related parties during the period under audit, including changes from the prior period;**
- **Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);**

- **The nature of any relationships, including ownership structure, between the company and its related parties;**

- **The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;**

- **The business purpose for entering into a transaction with a related party versus an unrelated party;**

- Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and

- Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

.06 The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph .05 of this standard. The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquires, by considering whether such individuals are likely to have knowledge regarding:

- The company's related parties or relationships or transactions with related parties;
- The company's controls over relationships or transactions with related parties; and
- The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

.07 The auditor should inquire of the audit committee, or its chair, regarding:

- The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and

- Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Identifying and Assessing Risks of Material Misstatement

.10 **The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.**

Note: In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should

take into account the information obtained from performing the procedures in paragraphs .04-.09 of this standard and from performing the risk assessment procedures required by AS 2110.

Responding to the Risks of Material Misstatement

.11 The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement. This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Note: The auditor also should look to the requirements in paragraphs .66-.67A of AS 2401, Consideration of Fraud in a Financial Statement Audit, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AS 2401.67 requires that the auditor evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk

.12 **For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:**

- Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

- **Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties;**

- **Determine whether any exceptions to the company's established policies or procedures were granted;**

- Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

- **Perform other procedures as necessary to address the identified and assessed risks of material misstatement.**

Note: The applicable financial reporting framework may allow the aggregation of similar related party transactions for disclosure purposes. If the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph .12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

G. AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments[7]

.05 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- **Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.**

- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].

- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.

- **Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59]. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.**

.06 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor

[7] Public Company Accounting Oversight Board, "AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," accessed October 25, 2016. (https://pcaobus.org/Standards/Auditing/Pages/AS2505.aspx)

should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.07 The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Examples of such procedures are as follows:

- Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.
- Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.
- Obtaining information concerning guarantees from bank confirmation forms.
- Inspecting other documents for possible guarantees by the client.

Inquiry of a Client's Lawyer

.08 A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments. Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration. However, evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.

.09 The matters that should be covered in a letter of audit inquiry include, but are not limited to, the following:

- Identification of the company, including subsidiaries, and the date of the audit.
- A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.
- **A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.**

- As to each matter listed in item b, a request that the lawyer either furnish the following information or comment on those matters as to which his views may differ from those stated by management, as appropriate:

    - A description of the nature of the matter, the progress of the case to date, and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).

    - An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

    - With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

- As to each matter listed in item c, a request that the lawyer comment on those matters as to which his views concerning the description or evaluation of the matter may differ from those stated by management.

- **A statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [AC section C59].**

- A request that the lawyer confirm whether the understanding described in item f is correct.

- A request that the lawyer specifically identify the nature of and reasons for any limitation on his response.

Inquiry need not be made concerning matters that are not considered material, provided the client and the auditor have reached an understanding on the limits of materiality for this purpose.

.10 In special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or

other complex judgments. The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure of litigation, claims, and assessments.

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STAFF AUDIT PRACTICE ALERT NO. 8

AUDIT RISKS IN CERTAIN EMERGING MARKETS

October 3, 2011

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Executive Summary

Emerging markets play an increasingly important role in the global economy given their high economic growth outlook and significant market size.[1/] Recent disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the Board's oversight activities highlight the need for heightened awareness of risks when performing audits of companies with operations in emerging markets.

This practice alert focuses on risks of misstatement due to fraud ("fraud risks") that auditors might encounter in audits of companies with operations in emerging markets, auditors' responsibilities for addressing those risks, and certain other auditor responsibilities under PCAOB auditing standards. Local business practices and cultural norms in emerging markets may differ from those in more developed markets, and auditors should be alert to the effect of these differences on the risks of material misstatement. Auditors should focus on the audit procedures required to respond to those risks.

[1/] According to information in the Statistical Appendix of International Monetary Fund *World Economic Outlook: Slowing Growth Rising Risks* (September 2011), emerging market countries accounted for over 40 percent of global gross domestic product in 2010.

Fraud risks may be encountered in audits of companies in any region, whether the region is an emerging or developed market. Auditors have a responsibility to assess fraud risks in the financial statements that they audit and to perform audit procedures that respond to those risks, regardless of the regulatory environment.[2/] The specific nature and characteristics of fraud risks, however, can vary depending upon, among other things, the environment in which the company operates, including the maturity and the robustness of the regulatory environments in the countries in which the company conducts its business activities.

Authorities in many emerging market countries are taking steps to improve investor protection. The PCAOB, however, has observed from its oversight activities some conditions in audits of certain companies in emerging markets that indicate heightened fraud risk. Other situations have come to light in recent corporate filings with the Securities and Exchange Commission ("SEC") and in SEC orders suspending trading in securities of certain companies in emerging markets. In just two months in 2011, more than 24 companies with their principal place of business in the People's Republic of China ("PRC") filed Forms 8-K with the SEC reporting auditor resignations, accounting irregularities, or both.[3/] In some instances, the auditor's letter of resignation stated that the auditor resigned because of circumstances that could constitute illegal acts for purposes of Section 10A of the Securities Exchange Act of 1934 ("Exchange Act").[4/] Since then the SEC's actions have expanded, including instituting stop order proceedings against two PRC-based companies.[5/] Further, additional auditor resignations have occurred.[6/]

[2/] See paragraph 4 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* and paragraphs 3-4 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[3/] See letter from SEC Chairman Mary Schapiro, dated April 27, 2011, to the Chairman of the House Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, Congressman Patrick McHenry, at http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf.

[4/] See the discussion in the section on illegal acts below.

[5/] See SEC Press Release, Stop Order Proceedings Instituted Against China Intelligent Lightning and Electronics, Inc., and China Century Dragon Media, Inc. (June 13, 2011) at: http://www.sec.gov/news/press/2011/2011-127.htm.

[6/] See, e.g., Longtop Financial Technologies Limited, Form 6-K (May 23, 2011), Exhibit 2 at:

Examples of conditions and situations indicating heightened fraud risk in certain companies in emerging markets that have been observed by PCAOB staff or reported in an SEC filing include:

- Existence of two separate and different sets of financial books and records;
- Discrepancies between the company's financial books and records and audit evidence obtained with respect to the existence and accuracy of cash balances, accounts receivable, and revenues;
- Auditor difficulties in confirming cash balances, including when requesting to visit the offices of the company's bank, or questions about the authenticity of bank statements provided to the auditor;
- Auditors' follow-up visits to bank offices indicating serious discrepancies between bank confirmations provided to the auditor and the bank's actual records, such as previously undisclosed material borrowings and no record of or significant differences regarding certain transactions;
- Attempts by management to intercept or alter confirmation requests or responses;
- Irregularities in sales contracts, such as a company-specific seal affixed on the sales contract that does not belong to the purported customer named in the contract;
- Recognizing revenue from contracts or customers whose existence could not be corroborated;
- Recording sales of products shipped to warehouses or freight forwarders where no customer is identified;
- Undisclosed material facts surrounding acquisition transactions, sales transactions, and off-balance-sheet transactions with related parties;
- Recording of assets for which evidence of control, ownership, or title is either unclear or difficult to corroborate;
- Potential double counting of fixed assets;

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http://www.sec.gov/Archives/edgar/data/1412494/000095012311052882/d82501exv99w2.htm.

- Recording of uncorroborated operating expenses for which the business purpose is unclear;
- Manipulation of the accounting records to mischaracterize or conceal payment of bribes or other improper payments;
- Significant unexplained discrepancies between amounts included in the financial statements in SEC filings and amounts included in financial reports to other regulators, such as local authorities;
- Use of personal-type bank accounts held in the name of corporate officers or employees instead of corporate-type bank accounts for company business; and
- Unusual delays by management in the production of routine documents requested by the auditor.[7/]

PCAOB standards require auditors to perform their audits to respond to fraud risks and other risks of material misstatement, and to obtain relevant and reliable evidence that is sufficient to support the auditor's opinion.[8/] This practice alert discusses certain considerations that may be relevant when performing audits in emerging markets.

Although the conditions, situations, and fraud risks described in this alert have been observed in audits of companies in certain emerging markets, they might also be present at companies in other markets. The matters discussed in this alert are relevant whenever such conditions, situations, or fraud risks are present in audits of companies located in emerging or developed markets.

Consideration of Fraud is an Integral Part of the Audit

The consideration of fraud is an integral part of the audit under PCAOB standards. PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free

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[7/] In addition to indicating a heightened fraud risk, in some circumstances, the conditions and situations in this list also may be indications of illegal acts which are discussed in the section on illegal acts below.

[8/] See, generally, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* Auditing Standard No. 13 and Auditing Standard No. 15, *Audit Evidence.*

of material misstatement due to error or fraud.[9/] The auditor should exercise professional skepticism, and "conduct the audit engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present."[10/] PCAOB auditing standards related to the auditor's assessment of and response to risk[11/] and AU sec. 316, collectively, describe the auditor's responsibilities for identification, assessment, and response to fraud risks.

Identifying and Assessing Fraud Risk Factors[12/]

Fraud risks may arise from a variety of sources, including external factors and internal factors. The auditor should perform risk assessment procedures[13/] and evaluate whether the information gathered from those procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.[14/]

As part of risk assessment procedures, the auditor "should obtain an understanding of the company and its environment"[15/] in order to "understand the events, conditions, and company activities that might reasonably be expected to

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[9/] See paragraph 3 of Auditing Standard No. 8, *Audit Risk*.

[10/] AU sec. 316.13.

[11/] Auditing Standard No. 8, Auditing Standard No. 9, *Audit Planning*, Auditing Standard No. 10, *Supervision of the Audit Engagement*, Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, Auditing Standard No. 12, Auditing Standard No. 13, Auditing Standard No. 14, *Evaluating Audit Results*, and Auditing Standard No. 15.

[12/] According to paragraph 65 of Auditing Standards 12, "[f]raud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists." See, generally, AU sec. 316.85.

[13/] See paragraphs 4-58 of Auditing Standard No. 12, which describe risk assessment procedures the auditor should perform.

[14/] See paragraphs 59-73 of Auditing Standard No. 12, which discuss identifying and assessing the risks of material misstatement, due to error or fraud, using information obtained from performing risk assessment procedures.

[15/] Paragraph 7 of Auditing Standard No. 12.

have a significant effect on the risks of material misstatement."[16/] This includes, for example, understanding:[17/]

- The relevant industry and regulatory factors, including the legal, and political environment, which may include matters such as:
  - The company's significance in the regional or local economy and its level of influence over its industry, and regional or local government, and
  - Cultural norms in the business and regulatory environments;
- The company's objectives, strategies, and related business risks; its organizational structure; and sources of funding of the company's operations;
- The company's significant investments, including equity method investments, joint ventures, and variable interest entities ("VIEs");[18/]
- The sources of the company's earnings, including the relative profitability of key products and services; and
- The company's key supplier and customer relationships.

Significant differences can exist between the business environments faced by companies with operations in emerging markets and those in developed markets, which may affect the risk of misstatement in the financial statements. For example, companies in emerging markets may be subject to rapidly changing or less consistent regulatory oversight and reporting requirements, whereas companies in developed markets may not.[19/] These and other aspects of the business environment in emerging markets can create incentives, pressures, and opportunities that may lead to a heightened risk of fraud.

16/ Ibid.

17/ See paragraphs 9-17 of Auditing Standard No. 12.

18/ See Subtopic 810-10 of the Financial Accounting Standards Board’s Accounting Standards Codification for a definition of a variable interest entity.

19/ See, generally, Silvia Iorgova and Li Lian Ong *The Capital Markets of Emerging Europe: Institutions, Instruments and Investors*, IMF Working Paper WP/08/103 (April 2008), at: www.imf.org/external/pubs/ft/wp/2008/wp08103.pdf.

Incentives and Pressures

As with public companies in developed countries, emerging market companies seeking to raise capital in international markets may wish to present a strong financial position and robust growth in revenue and earnings. In turn, this may create incentives or pressures to manipulate the financial statements rather than report poor results or bad news to the investing public. For example, if a company failed to consummate a previously announced acquisition, there is a risk that management might manipulate the financial statements to make them appear as though the acquisition has occurred. As another example, management at remotely located operating units of large multinational companies locations may feel pressure to report inflated results.

In addition to the incentives and pressures routinely considered in audits of public companies, auditors should consider any unique characteristics of the emerging market company or its environment that might result in specific fraud risks. For example, a company might engage in a significant business partnership with a state-owned entity or VIE. In that situation, the company might be motivated to consolidate the partnership or VIE to strengthen its reported financial position, even if significant legal restrictions prevent the company from obtaining a controlling interest in the partnership or assets. For instance, a company might enter into contractual arrangements with a VIE that are designed to enable the company to consolidate the VIE, even though there might be significant uncertainties regarding the economic substance of those arrangements.[20/] As another example, legal restrictions on the movement of company assets might lead companies to maintain substantial amounts of cash or other liquid assets in business units in certain jurisdictions, which can create incentives for misappropriation of assets.

Opportunities

Some fraud risks arise when internal or external conditions and weak internal controls provide opportunities for management or employees of the company to engage in fraudulent activities. Certain aspects of the business environment in emerging markets can create opportunities to perpetrate fraud, as discussed in the examples below.

For example, a company in an emerging market might have a dominant presence in the geographic region in which it is located because it is the single largest employer in the region, or it may exercise control over raw materials on

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[20/] Additionally, such VIE structures can result in increased risks related to omitted, incomplete, or inaccurate disclosures. See paragraphs 12-13 of Auditing Standard No. 12.

which other companies in the region depend. The company's management might have strong ties with the local or state government. In such circumstances:

- Management might be able to dictate terms or conditions to local suppliers or customers, which might result in non-arm's length transactions.

- Management might be able to pressure personnel of a local bank or other third parties to provide fraudulent information to the auditor.

- Company employees might not be willing to report instances of fraud for cultural reasons or fear of retribution from management. While whistleblower protections have been introduced in many emerging market countries, observers have said that there is still a need to improve the effectiveness of the whistleblower programs.[21/]

Additionally, weak internal controls and lack of robust governance mechanisms have been observed in companies in certain emerging market countries. This may stem from a lack of familiarity in local cultures with certain governance concepts, such as prohibition of self-dealing, even where similar legal concepts exist.[22/] For example, such a culture might provide opportunities for management to influence other senior company officials or various third parties to provide false or misleading information to the company's auditors.

If criticizing or questioning a figure of authority is contrary to the local culture, the company's employees may be hesitant to express any concerns about management's actions to an auditor. Such an environment can provide additional opportunities for management to override controls or intentionally misstate the financial statements.[23/]

As another example, a company in an emerging market might be created as a spin-off from a larger private or state-owned entity. The operating components of the larger entity may be among the company's largest suppliers or customers. In certain instances, the same individual or group that controls the

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[21/] See Organization for Economic Co-operation and Development (OECD) *Corporate Governance in Asia 2011: Progress and Challenges*, Corporate Governance, OECD Publishing (2011), pg 36, at: http://dx.doi.org/10.1787/9789264096790-en.

[22/] Ibid, pg 25.

[23/] See AU sec. 316.08.

company might also control the company's suppliers and customers.[24/] Such situations might provide opportunities for management to:

- Enter into undisclosed side agreements with the related parties, or
- Collude with the related parties to create false documentation to support fictitious transactions.

Some emerging market companies employ as their chief financial officer ("CFO") an individual based in, or from, another region or country. Such a CFO might lack knowledge of the local language and the company's business practices and, therefore, might not be able to effectively perform certain important entity-level controls, thereby creating opportunities for company personnel to commit or conceal fraudulent misstatement of the financial statements. Similar conditions and risks may be present at significant subsidiaries of multi-national companies in emerging markets.

In some emerging market countries, controlling shareholders exercise strong oversight over executive management and foster a corporate culture focused on long-term value creation. In other jurisdictions, controlling shareholders have the opportunity to engage in abusive conduct, a problem that is magnified in jurisdictions where transparency is poor and where a weak rule of law fails to give minority investors proper judicial recourse.[25/]

The Auditor's Response to Fraud Risks

PCAOB standards require that the auditor design and implement audit responses that address the identified and assessed fraud risks.[26/] The auditor's responses should include responses that have an overall effect on how the audit is conducted (e.g., making appropriate engagement assignments) and responses

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[24/] See OECD *Guide on Fighting Abusive Related Party Transactions in Asia*, OECD Publishing (2009), pgs 9-12 and 14-16, at: www.oecd.org/dataoecd/39/57/43626507.pdf.

[25/] See Melsa Ararat and George Dallas (International Finance Corporation), *Corporate Governance in Emerging Markets: Why it Matters to Investors – and What They Can Do About It*, Global Corporate Governance Forum (2011), pg 11, at: http://www.ifc.org/ifcext/cgf.nsf/Content/PSO_22_Melsa.

[26/] See paragraph 3 of Auditing Standard No. 13.

involving the nature, timing, and extent of audit procedures (e.g., modifying the planned audit procedures).[27/]

Under PCAOB standards, "[t]he auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence."[28/] Ineffective responses to fraud risks may result in the auditor's failure to detect material misstatement of the financial statements or failure to obtain sufficient appropriate audit evidence to support the opinion in the auditor's report. Examples of the application of professional skepticism in response to the assessed fraud risks may include "modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and ... obtaining sufficient appropriate evidence to corroborate management's explanations or representations."[29/]

Performing Audit Procedures to Respond to Fraud Risks

The auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks, including certain procedures to address the risk of management override of controls.[30/]

Many of the conditions discussed above that indicate heightened fraud risk appear to involve possible attempts to overstate the amounts of assets or revenues in the companies' financial statements. When performing audit procedures to address certain fraud risks, especially those involving the existence of assets such as cash and accounts receivable, it is important to

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[27/] See Auditing Standard No. 13, which establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

[28/] Paragraph 7 of Auditing Standard No. 13.

[29/] Ibid.

[30/] See paragraphs 13 and 15 of Auditing Standard No. 13. Additionally, as part of the auditor's response to the assessed risks of material misstatement due to fraud, the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed. See paragraph 5c of Auditing Standard No. 13. Also, see paragraphs 14-15 of Auditing Standard No. 5.

obtain audit evidence through direct written communication with a knowledgeable third party who is objective and free from bias with respect to the audited entity.[31/]

If, through the performance of risk assessment procedures, other audit procedures, or by other means, the auditor becomes aware of conditions that call for a heightened degree of professional skepticism with respect to the authenticity of documents, the auditor should perform additional procedures to determine that the reliability of evidence obtained in the course of the audit has not been compromised.[32/] In such circumstances, it would be unlikely for auditors to rely solely on management-provided documentation without obtaining documentation directly from third parties to corroborate management's assertions.

Confirmations

To respond to fraud risks related to the company's accounts with a bank or amounts due from customers, it is important for the auditor to confirm amounts included in the company's financial statements directly with a knowledgeable individual from the bank or customer who is objective and free from bias with respect to the audited entity rather than rely solely on information provided by the company's management.[33/] Under PCAOB standards, "[e]vidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources."[34/]

Further, under PCAOB standards, the auditor "should maintain control over the confirmation requests and responses."[35/] If the auditor identifies a risk

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[31/] See paragraphs .26-.27 of AU sec. 330, *The Confirmation Process* and the section on confirmations below.

[32/] See paragraph 9 of Auditing Standard No. 15.

[33/] See AU sec. 330.34, which states that there is a presumption that the auditor will request the confirmation of accounts receivable during an audit except under certain conditions that are unlikely to be present when fraud risks are present. For example, one of those conditions, the auditor's combined assessed level of inherent and control risk is low, is unlikely to be the case when a fraud risk is present.

[34/] Paragraph 8 of Auditing Standard No. 15. Also, AU secs. 330.26-.27 describe the auditor's responsibilities regarding confirmation with knowledgeable third parties who are objective and free from bias with respect to the audited entity.

[35/] AU sec. 330.28.

that the company's management, or someone else at management's request, could attempt to intercept or alter the confirmation requests or responses, the auditor should maintain control over the confirmation process by taking actions aimed specifically at addressing that risk. For example, if the auditor uses a courier to expedite the delivery of confirmation requests, the courier should be reliable and independent from management to ensure that the confirmation requests are delivered directly to the intended recipient. If there is a heightened risk of management interference in the confirmation process, it might be necessary for the auditor to deliver the confirmation request personally and/or to observe the intended recipient of the confirmation request complete the response in order to communicate directly with an independent and knowledgeable source.

Also, the auditor should evaluate who the intended recipient of the confirmation request is and whether the company's management has any influence over this individual to provide false or misleading information to the auditor.[36/] For example, if the company is the only or a significant customer or supplier of the confirming entity, the staff of that entity may be more susceptible to pressure from the company's management to falsify documentation provided to the auditor. As another example, the auditor might determine that confirmation responses cannot be relied upon if it appears that management interfered with the process because responses to confirmation requests were received from a personal e-mail account rather than a company network domain, or multiple confirmations are returned with similar handwriting and the same date, or confirmations returned from companies with different physical addresses contain mail stamps indicating same time processing.

If there is a heightened risk that the intended recipient is susceptible to management influence, the auditor should consider whether the response will provide meaningful and appropriate evidence and determine whether other procedures are necessary to obtain sufficient appropriate audit evidence.[37/]

Revenue Recognition

Under PCAOB standards, "[t]he auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks."[38/] Management might use a variety of tools to attempt to overstate revenue or conceal improprieties in recording revenue, including entering into improper bill-

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36/ See AU sec. 330.26-.27.

37/ See paragraph 4 of Auditing Standard No. 15 and AU sec. 330.27.

38/ Paragraph 68 of Auditing Standard No. 12.

and-hold transactions, generating invoices and customer contracts for non-existent transactions, altering original documentation, and establishing fake customers and mailing addresses.

To develop an effective response to such fraud risks, it is important for the auditor to obtain an understanding of the company and its environment, including the sources and composition of revenues; specific attributes of revenue transactions; the company's business and financial reporting processes regarding revenue and amounts due from customers; and unique industry considerations. Such an understanding is important in order for the auditor to consider the ways in which revenue could be fraudulently misstated in order to design appropriate audit procedures to detect those types of misstatements. Also, PCAOB standards require the auditor to gain an understanding of the business rationale for significant unusual transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.[39/]

Exercising professional skepticism requires the auditor to, among other things, perform procedures to obtain and critically evaluate evidence from all sources rather than rely solely on management representations about the company's performance.[40/] For example, if the auditor performs an analytical procedure regarding revenue and management represents that a significant unexpected increase in revenue from the prior year results from increased production, the auditor should obtain evidence to corroborate this representation and critically evaluate whether the representation is reasonable based on the evidence obtained, such as, whether the company is capable of producing the additional output.[41/]

While the auditor is not expected to be an expert in document authentication, the auditor should exercise professional skepticism in reviewing documentation obtained as audit evidence, especially documentation provided by the company. Under PCAOB standards, "if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to

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[39/] See AU sec. 316.66.

[40/] See paragraph 7 of Auditing Standard No. 13 and AU sec. 333.02-.04.

[41/] See paragraphs 5-9 of Auditing Standard No. 14. When the auditor is performing an analytical procedure as a substantive test, see the requirements of AU sec. 329, *Substantive Analytical Procedures*.

respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit."[42/] For example, if the auditor suspects that management has falsified sales documentation, the auditor should perform additional procedures, such as performing procedures to obtain documentation directly from the company's customers or suppliers to compare it to documents provided by management.

Transactions with Related Parties

It is not uncommon for companies in emerging markets to be owned or controlled by a small group of individuals or a family. These individuals often serve as the senior members of the company's management and also may control some of the entities that the company does business with, such as customers or suppliers. Accordingly, transactions with related parties may play a significant role in the company's operations. The auditor, therefore, should be aware of a risk of undisclosed related party transactions or side agreements.

To obtain sufficient appropriate audit evidence with respect to related party transactions, an auditor should design and perform procedures that take into account the specific environment in which a company operates.[43/] In addition, pursuant to section 10A(a)(2) of the Exchange Act, auditors are required to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."[44/]

Some companies in emerging markets might have significant transactions with related entities that are not audited or are audited by another firm. For example, a company might purchase substantially all of its raw materials and utility services from or extend significant loans to a related unaudited entity. Paragraph A.2 of AU sec. 316.85 states in the Opportunities subsection that "significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm" constitute an example of a fraud risk factor that provides opportunities to engage in fraudulent financial reporting. Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, issued on April 7, 2010, describes certain

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[42/] Paragraph 9 of Auditing Standard No. 15.

[43/] See AU sec. 334, *Related Parties*, which describes procedures for the auditor to perform "to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure."

[44/] See 15 U.S.C. §78j-1(a).

requirements in PCAOB auditing standards regarding significant unusual transactions.[45/]

Other Matters that Affect Fraud Risk

Under PCAOB standards, "the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks."[46/] Matters indicating a heightened risk of fraud may include, for example:[47/]

- *Inconsistent, vague, or implausible responses from management* – In situations in which management fraudulently recorded non-existent sales transactions, management's explanation of an unexpected increase in revenue may be vague or inconsistent with the auditor's understanding of the company's operations.

- *Conflicting or missing evidence* – Documents provided by management may appear to have been altered or have internal inconsistencies. The auditor should critically assess such inconsistencies and discrepancies to identify whether they are indicative of fraudulent activities by the company's management or employees. For example:

    - The name of a third party on the letterhead of a confirmation response may be different from the name on a seal used to authenticate a signed document.

    - Amounts confirmed by the local branch of a bank may be different from those confirmed by the bank headquarters.

    - There may be conflicting or missing documentary support for the company's rights to assets.

- *Problematic relationships between the auditor and management* – To conceal fraudulent financial reporting, management might attempt to control the audit process by limiting the auditor's access

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[45/] Staff Audit Practice Alert No. 5 is located on the Board's web site at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

[46/] Paragraph 28 of Auditing Standard No. 14.

[47/] See Appendix C of Auditing Standard No. 14.

to sources of audit evidence, such as the company's personnel or third parties. For example:

- Management could request that the auditor send confirmation requests and receive replies through personnel of the company.
- Management could instruct the bank not to respond to the auditor's request to confirm the company's cash, deposit, or loan payable balances with the bank.
- Management engaged in fraudulent financial reporting might be unwilling to add or revise disclosures in the financial statements to make them more transparent.
- Management engaged in fraudulent financial reporting might be unwilling to appropriately address significant deficiencies in internal control on a timely basis, e.g., before the end of a financial reporting period.

Under PCAOB standards, restrictions on the scope of the audit imposed by the company's management or by circumstances, such as – among other things – the inability to obtain sufficient appropriate evidence or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion on the company's financial statements.[48/]

Other Considerations

Client Acceptance and Continuance

Under PCAOB standards, client acceptance and continuance is a required element of quality control for an auditor.[49/] This includes establishing policies and procedures to provide reasonable assurance that the auditor:

- "Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.

[48/] See paragraph .22 of AU sec. 508, *Reports on Audited Financial Statements*. Also, Auditing Standard No. 5 provides direction regarding modifications to the auditor's report due to restrictions on the scope of the audit of internal control over financial reporting.

[49/] See paragraph .07 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

- Appropriately considers the risks associated with providing professional services in the particular circumstances."[50/]

Conditions and situations previously described in this alert that indicate heightened fraud risk in companies with operations in emerging markets may also place additional demands on the auditor’s professional competence. In performing acceptance and continuance assessments for clients with operations in emerging markets, the auditor should consider his or her own ability to perform audits in emerging markets and, if using the work of accountants outside the auditor’s own firm, the auditor’s ability to supervise or assume responsibility for that work in accordance with PCAOB standards.

The PCAOB previously directed auditors' attention to the standards that apply to using the work of other auditors and engaging assistants from outside the firm – including auditors and assistants based outside the U.S. – in Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* ("Practice Alert No. 6"), issued on July 12, 2010.[51/] Practice Alert No. 6 noted, among other things, that the following factors may affect how an auditor plans and performs an audit of the financial statements of an issuer with substantially all of its operations outside of the U.S., including emerging market countries:

- Use of local audit firms or assistants from an outside firm to complete a portion of the audit work;
- The need to understand the local language;
- Additional travel time and expense necessary to complete an audit; and
- The need to understand the local business environment in which the client operates.

Making Engagement Assignments and Coordinating the Auditor's Response with Another Accounting Firm

PCAOB standards require that the knowledge, skill, and ability of engagement team members with significant engagement responsibilities, and the extent of supervision of engagement team members, be commensurate with the

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[50/] QC sec. 20.15.

[51/] Practice Alert No. 6 is located on the Board's web site at: http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf

risks of material misstatement, including fraud risks.[52/] The higher risk areas of the audit, including the areas of fraud risk, require more supervisory attention from the engagement partner. When the auditor uses the work of accountants outside the auditor's own firm, the auditor should take into account the knowledge, skill, and ability of each engagement team member from outside the firm.[53/] Through the Board's oversight activities, the Board's staff has observed instances in certain audits of emerging market companies in which the engagement partner or other engagement team members inappropriately delegated to junior assistants the identification of audit issues, analysis of documents provided by the company, and certain communication with management and third parties; additionally, supervision by the auditor of the junior personnel was not in compliance with PCAOB standards.

In some situations, another independent accounting firm (including accounting firms affiliated with the same network as the auditor) performs an audit of and issues a report on one or more of the company's subsidiaries, divisions, branches, components, or investments. The auditor should inquire about the professional reputation of the other auditor and adopt other appropriate measures, e.g., ascertaining that the other auditor is familiar with the relevant financial reporting requirements and PCAOB standards.[54/] PCAOB inspection reports, when available, may provide the auditor with relevant information.[55/] The

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[52/] See paragraph 6 of Auditing Standard No. 10 and paragraph 5 of Auditing Standard No. 13. If the auditor uses as assistants personnel of another accounting firm or individual accountants not employed by an accounting firm, the auditor should follow the same requirements as for supervising assistants from the auditor's own firm.

[53/] See paragraph 6 of Auditing Standard No. 10.

[54/] See paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

[55/] According to PCAOB Rule 2100, each public accounting firm that (a) prepares or issues any audit report with respect to any issuer; or (b) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer must be registered with the Board. The Board publishes on its Web site a list that names every registered firm that has triggered an inspection requirement under PCAOB Rule 4003 and notes whether the firm has ever been inspected. See http://pcaobus.org/Inspections/Pages/InspectedFirms.aspx. In addition, the Board has published on its Web site a listing of issuer audit clients of non-U.S. registered firms in jurisdictions where the PCAOB had been denied access to conduct inspections. See

auditor should adopt appropriate measures to assure the coordination of the auditor's activities with those of the other auditor, including the audit procedures performed in response to fraud risks.[56/] Through the Board's oversight activities, the Board's staff has observed instances in certain audits of companies in emerging markets in which the auditor did not properly coordinate the audit with another auditor. When significant parts of the audit are performed by other auditors, the auditor must decide whether the auditor's own participation in the audit is sufficient.[57/]

Making appropriate engagement assignments and coordinating the auditor's response with another auditor necessarily entails overcoming any language barriers. In some audits of companies in emerging markets, key engagement team members[58/] might be from outside the country in which substantially all of the company's operations, its top management, or the other auditor is located. In those circumstances, the auditor should take the necessary steps to enable effective communication among the engagement team members, effective communication between the auditor and the company's personnel or the other auditor, and effective review of documentation prepared in a foreign language.[59/]

Individual accountants or accounting firms that participate in the audit from the same region where the company is located (the "local accountants") may be aware of local customs, cultural norms, and business practices that have an impact on the company's corporate governance and business activities. When planning and performing the audit, the auditor should discuss such matters with the local accountants and determine whether any of these matters affect fraud

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http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx.

[56/] See AU sec. 543.10, and AU sec. 316.53.

[57/] See AU sec. 543.02.

[58/] The term "key engagement team members" includes all engagement team members who have significant engagement responsibilities, including the engagement partner. See paragraph 50 of Auditing Standard No. 12.

[59/] See paragraph 5 of Auditing Standard No. 10 and AU sec. 543.10.

risks. The auditor should discuss with the local accountants identified fraud risks and determine that appropriate steps are taken to respond to these risks.[60/]

Illegal Acts

During the course of an audit, the auditor may determine that violations of laws or government regulations by company management or employees may constitute illegal acts, as defined by AU sec. 317, *Illegal Acts by Clients,*[61/] and section 10A of the Exchange Act.[62/] AU sec. 317 describes the considerations an auditor should give to the possibility of illegal acts as well as the auditor's responsibilities when a possible illegal act is detected. In addition, pursuant to section 10A(a)(1) of the Exchange Act, auditors are required to perform procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of the financial statement amounts.[63/] The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud.[64/]

When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements, as well as the implications for other

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[60/] See paragraph 5 of Auditing Standard No. 10, paragraphs 51-52 of Auditing Standard No. 12, and AU sec. 316.53.

[61/] See AU sec. 317.02. For example, even though not fraud, a violation of the books and records provisions of the Foreign Corrupt Practices Act ("FCPA"), Exchange Act sections 13(b)(2) through (b)(7), would be an illegal act as defined in AU sec. 317. These FCPA provisions generally require issuers with securities registered under section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act, among other things, to make and keep books and records that fairly reflect the transactions and assets of the issuer and to devise and maintain internal accounting controls sufficient to permit the preparation of financial statements in conformity with the applicable financial reporting framework.

[62/] See 15 U.S.C. §78j-1(a).

[63/] Ibid.

[64/] See AU 317.05.

aspects of the audit, such as the reliability of representations of management.[65] The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures, and the level of management or employees involved.[66] The auditor should also evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations.[67] If the illegal act results in uncorrected misstatements of even relatively small amounts, it further could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.[68] If the auditor concludes that an illegal act has or is likely to have occurred, AU sec. 317 requires that the auditor, among other things, determine "that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to [the] illegal acts."[69]

Section 10A(b) of the Exchange Act imposes additional requirements that apply when the auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred."[70]

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, describes procedures that "should be followed by the auditor who, subsequent to the date of the [audit report], becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts."[71] The auditor should follow the requirements of AU sec. 561 if, subsequent to the date of the audit report, the auditor becomes aware of information indicating the possibility of fraudulent financial reporting.

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[65] See AU sec. 317.10 and .16. See also section 13(b)(2) of the Exchange Act.

[66] See AU sec. 317.16.

[67] See AU sec. 317.15.

[68] Paragraph 17 of Auditing Standard No. 14.

[69] AU sec. 317.17.

[70] See 15 U.S.C. §78j-1(b).

[71] AU sec. 561.01.

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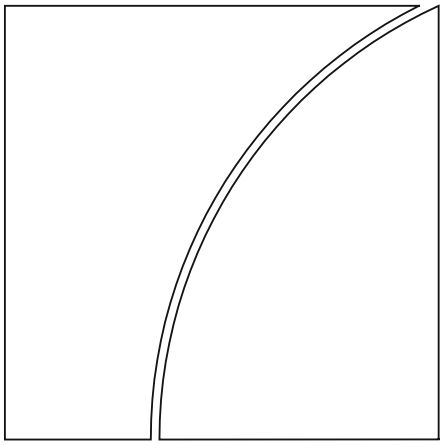
Basel Committee on Banking Supervision



External audits of banks

March 2014

BANK FOR INTERNATIONAL SETTLEMENTS

This publication is available on the BIS website (www.bis.org).

ISBN 978-92-9131-275-7 (print)

ISBN 978-92-9131-276-4 (online)

Contents

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. External auditors of banks can play an important role in contributing to financial stability when they deliver quality bank audits which foster market confidence in banks' financial statements. Quality bank audits are also a valuable input in the supervisory process. The Basel Committee on Banking Supervision (the Committee, or BCBS) is issuing this document on external audits of banks to improve external audit quality of banks and enhance the effectiveness of prudential supervision, which contribute to financial stability. This document replaces the documents *The relationship between banking supervisors and banks' external auditors* (January 2002)[1] and *External audit quality and banking supervision* (December 2008).[2]

2. This document elaborates on Basel Core Principle 27[3] by setting out guidelines regarding:

- the audit committee's responsibilities in overseeing the external audit function; and
- the prudential supervisor´s relationships with external auditors of banks and the audit oversight body.

3. These guidelines reinforce the key role the audit committee plays in promoting quality bank audits through effective communication with the external auditor and robust oversight of the external audit process.

4. Building effective relationships between prudential supervisors and external auditors, and between prudential supervisors and audit oversight bodies, can enhance banking supervision. These guidelines underpin effective communication between prudential supervisors and external auditors. They also foster supervisory cooperation between prudential supervisors and audit oversight bodies in the discharge of their respective duties.

5. This document includes supervisory expectations and recommendations relevant to external audits of banks that the Committee believes will enhance the quality of these audits. The Committee does not have the authority to set professional standards for external auditors. However, as internationally accepted professional standards for external auditors are principles-based, the Committee expects the proper application of the standards to audits of banks to include appropriate tailoring of audit work in response to the risks and issues applicable to banks. For some areas of banks' audits, the Committee's recommendations go beyond what is currently required by the standards. The Committee sent a letter to the IAASB in March 2013 recommending enhancements to the international auditing standards and the international standard on quality control.[4]

[1] BCBS website: www.bis.org/publ/bcbs87.pdf

[2] BCBS website: www.bis.org/publ/bcbs146.pdf

[3] Core Principle 27 of the Basel Committee's *Core Principles for Effective Banking Supervision* (September 2012) states that "[t]he 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".

[4] BCBS website: www.bis.org/bcbs/commentletters/ifac45.pdf

6. The supervisory expectations and recommendations contained herein also provide a frame of reference to assist audit committees in the governance and oversight of the external audit function.

2. Introduction

7. The Committee's *Core Principles for Effective Banking Supervision* (September 2012) provide a framework of minimum standards for sound supervisory practices and are considered universally applicable.[5] Basel Core Principle 27 focuses on prudential regulations and requirements for banks in relation to financial reporting and external audits.

8. A bank's board and management are responsible for ensuring that financial statements are prepared in accordance with the applicable financial reporting framework. They are also responsible for ensuring that annual financial statements have been audited and bear an independent external auditor's opinion.[6]

9. Under internationally accepted auditing standards, an audit is conducted on the premise that management and, where appropriate, those charged with governance 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.

10. An external auditor conducts the audit of a bank's financial statements to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, and to report on the financial statements, and communicate as required by internationally accepted auditing standards, in accordance with the auditor's findings.[7]

11. External auditors play a vital role in maintaining market confidence in audited financial statements. In the case of the banking industry, this public role is particularly relevant to financial stability given banks' financial intermediation function within the economy as a whole. Audit quality[8] is key to the effectiveness of such public role. In addition, the external auditor has a duty to report directly to the supervisor (or, where not permitted, indirectly through the bank) on matters of material significance[9] arising from the audit of the bank.[10]

12. For these reasons, together with the usefulness of quality audits as an input in the supervisory process, supervisors have a keen interest in the quality with which external auditors perform bank audits. This document aims to enhance the quality of external audits of banks and the effectiveness of prudential supervision, which contribute to financial stability.

[5] BCBS (September 2012), *Core Principles for Effective Banking Supervision*, paragraph 39.

[6] Core Principle 27, Essential Criterion 1 and Essential Criterion 2.

[7] 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.

[8] IAASB (February 2014), *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*, highlights the importance of audit quality, and describes the key elements for the framework for audit quality, and the relevant interactions and the contextual factors for quality audits.

[9] The term "material significance" requires interpretation in the context of the specific legislation relevant to the regulated entity. A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator.

[10] Core Principle 27, Essential Criterion 9. This Essential Criterion provides examples of matters of material significance.

13. A bank's audit committee has a key role in fostering a quality bank audit through the effective exercise of its responsibilities with respect to the external auditor and the statutory audit. The guidelines in this document promote an effective two-way communication between the audit committee and the external auditor to enable the audit committee to carry out its oversight responsibilities and to contribute to the effectiveness of the audit process. The guidelines also form the basis for the supervisor's assessment of the audit committee's oversight of the bank's external audit.

14. Building effective relationships with external auditors can enhance banking supervision. For example, the audit of a bank's financial statements may help identify weaknesses in internal controls relating to financial reporting which may, therefore, inform supervisory efforts in this area and contribute to a safe and sound banking system. These guidelines promote the establishment of open communication channels between the supervisor and the bank's external auditor.

15. In addition, the guidelines in this document should support the building of effective relationships between prudential supervisors and audit oversight bodies which are responsible for monitoring the quality of statutory audits, thereby promoting cooperation in the discharge of their respective legal duties.

16. This document also includes supervisory expectations and recommendations regarding what constitutes a quality audit, which provide a framework for the supervisor's interactions with the audit committee, the external auditor and the audit oversight body.

3. Key topics covered

17. This document is divided into two parts. Part 1 of the document (pages 10–23) provides guidelines[11, 12] on the role and responsibilities of bank audit committees in relation to external audits, and the engagement of supervisors with auditors and audit oversight authorities. It underpins the criteria for Basel Core Principle 27, which relate to financial reporting by banks and external audits of banks' financial statements. The principle also states that banks, and parent companies of banking groups, should have adequate governance and oversight of the external audit function. Part 1 also provides a framework for supervisors to assess the effectiveness of audit committees in their monitoring and assessment of external audits, and to establish an effective relationship with external auditors and audit oversight authorities. Part 2 of the document (pages 24–38) sets out the Committee's expectations and recommendations for enhancing the quality of external audits, which will assist audit committees in carrying out their responsibilities for monitoring and assessing external audits and facilitate supervisors' engagement with external auditors and audit oversight bodies.

[11] To enhance clarity, Part 1 is organised around nine principles, together with associated guidance. There is no difference in the status of the principles and the associated guidance. They all constitute guidelines which underpin the criteria for Basel Core Principle 27.

[12] Under the BCBS charter, guidelines elaborate the Committee's standards for the prudential regulation and supervision of banks, in particular internationally active banks. In areas where they are considered desirable, guidelines generally supplement the Committee's standards by providing additional guidance for the purpose of their implementation.

Part 1 (pages 10–23)

Section A – Audit committee's responsibilities in relation to the external audit and its relationship with the external auditor

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

19. Amongst its other responsibilities, the audit committee is responsible for overseeing the bank's external auditor.[13] A soundly constituted audit committee can play a key role in contributing to audit quality. Section A of Part 1 provides guidelines[14] for the audit committee's responsibilities in relation to the oversight of, and its relationship with, the external auditor.

Section B – Engagement between the supervisor and the external auditor

20. 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.

21. 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 B of Part 1 provides guidelines 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.

Section C – Engagement between the banking supervisory authority and the audit oversight body

22. 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 C of Part 1 provides guidelines for facilitating effective communication between these bodies.

23. As part of their work, supervisors may 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, be able to take action to address issues raised by the audit oversight body.

Overview of the principles in Part 1

Principle 1: 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 2: The audit committee should monitor and assess the independence of the external auditor.

Principle 3: The audit committee should monitor and assess the effectiveness of the external audit.

Principle 4: 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.

[13] BCBS (June 2012), *Internal audit function in banks*.

[14] See footnote 12.

Principle 5: 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 6: The supervisor 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 7: The supervisor should require the external auditor to report to it directly[15] on matters arising from the audit that are likely to be of material significance[16] to the functions of the supervisor.

Principle 8: There should be open, timely and regular communication between the banking supervisory authority, audit firms and the accounting profession as a whole on key risks and systemic issues as well as a regular exchange of views on appropriate accounting techniques and auditing issues.

Principle 9: There should be regular and effective dialogue between the banking supervisory authority and the relevant audit oversight body.

Part 2 (pages 24–38)

Supervisory expectations and recommendations relevant to the external auditor and the external audit of financial statements

24. Internationally accepted auditing standards provide an important foundation for audit quality, and for auditors to deliver an appropriate, independent professional opinion on the financial statements. Internationally accepted auditing standards require the external auditor to possess and demonstrate certain attributes while applying a rigorous audit process.

25. Internationally accepted auditing standards are principles-based and do not focus specifically on external audits of banks. Accordingly, Part 2 of this document describes the Committee's expectations and recommendations on how those standards should be tailored to the audit of a bank in response to the risks and issues applicable to a bank. Specifically, it describes the Committee's expectations with respect to the external auditor's knowledge and competence, objectivity and independence, professional scepticism and quality control over the bank's audit. In some areas in Part 2, the Committee has recommendations which go beyond current professional standards. Moreover, Part 2 of this document highlights the key areas where significant risks of material misstatement in banks' financial statements often arise. To achieve a quality audit, the Committee expects the external auditor to pay particular attention to these key areas, which include, but are not limited to, loan loss provisioning, financial instruments measured at fair value, liabilities (including contingent liabilities), disclosures and the assessment of going concern.

Overview of the expectations in Part 2

Expectation 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.

Expectation 2: The external auditor of a bank should be objective and independent in both fact and appearance with respect to the bank.

[15] Reporting should be conducted directly from the auditor to the supervisor, unless not permitted, in which case reporting should be conducted indirectly through the bank.

[16] See footnote 9.

Expectation 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.

Expectation 4: Audit firms undertaking bank audits should comply with the applicable standards on quality control.

Expectation 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 the bank's activities and the effectiveness of its internal control environment.

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

4. Application

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

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

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

27. This document has been prepared with the full awareness that significant differences exist in national, institutional, legislative and regulatory frameworks amongst jurisdictions, including accounting and auditing standards, supervisory techniques and institutional corporate governance structures. 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 guidelines contained in this document, 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 promoting legislative or other reforms that would enhance their authority and allow them to fully implement these guidelines.

28. Supervisors should clearly communicate the guidelines contained in Part 1 and the expectations and recommendations in Part 2 of this document to the banks they supervise and their respective external auditors and audit standard-setting bodies, as applicable. However, the implementation of these guidelines, expectations and recommendations should be proportionate to the size, complexity, structure, economic significance, risk profile and other facts and circumstances of the bank and the group (if any) to which it belongs. Furthermore, the guidelines in Part 1 and the expectations and recommendations in Part 2 should be applied in accordance with the national legislation and corporate governance structures applicable in each country. 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 guidelines, expectations and recommendations set forth herein.

29. The Committee does not have the authority to set professional standards for external auditors. Part 2 of this document includes references to existing internationally accepted auditing standards (eg ISAs), quality control standards (eg ISQC 1), ethical standards (eg IESBA's *Handbook of the Code of Ethics for Professional Accountants*)[17] and expectations of how proper application of these principles-based standards should include appropriate tailoring of audit work in response to the risks and issues applicable to banks. In areas where the expectations are beyond what is required by the applicable international auditing, quality control and ethical standards, these are noted as the Committee's

[17] As of March 2014.

recommendations ("the Committee recommends") for how the standards could be enhanced for banking audits. These recommendations should be considered by independent external auditors when planning and performing bank audits, as they may enhance the quality of their work and be referred to by audit committees in assessing the external audit process. The recommendations on enhancements to the international auditing standards and the international standard on quality control were included in the Committee's March 2013 letter to the IAASB.[18] The Committee encourages other independent auditing standard-setting bodies to consider the recommendations and determine whether changes should be made to existing auditing and quality control standards to enhance the quality of bank audits.

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

- **Financial statement audit**[19] – An audit of a bank's financial statements by an external auditor in accordance with internationally accepted auditing standards.[20]
- **Statutory audit** – An audit carried out to comply with the requirements of particular legislation or regulations. In some jurisdictions, this may entail 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.[21]
- **External auditor** – The audit firm and the individual audit engagement team members conducting the audit. 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 or group of jurisdictions, including the persons who are involved with supervisory policy setting and policy issues, including policies regarding accounting and auditing.
- **Supervisor**[22] – The group of supervisory personnel at a banking supervisory authority who are directly involved with the supervision/examination of a specific institution.
- **Board and senior management**[23] – 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

[18] See footnote 4.

[19] 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.

[20] 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.

[21] See Annex 1 for more examples of the contents of extended reports which form part of the statutory audit in certain jurisdictions.

[22] See also BCBS Core Principle 27, footnote 83, where, for the application of Principle 6, the meaning of "supervisor" is broader than the meaning specified in paragraph 30 above.

[23] BCBS (October 2010), *Principles for enhancing corporate governance*, paragraph 12.

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 Committee's *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 October 2010 document 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.[24]
- **Those charged with governance** – As defined by internationally accepted auditing standards, 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.[25] Such person(s) or organisation(s) is (are) typically the board of directors.[26] Where the board of directors of a bank establishes an audit committee to assist it in meeting its responsibilities by charging the audit committee with specific tasks and responsibilities, the audit committee can be viewed as taking on the role of those charged with governance in relation to those specific tasks and responsibilities.[27]

5. The Committee's international engagement on external auditing

31. Approaches for dealing with supervisory concerns about the quality of the audit of an individual bank may differ across jurisdictions. In its effort to promote audit quality, the Committee will continue to engage in regular dialogue and discussion with the relevant international stakeholders (see paragraph 33)[28] on external audit matters.

32. The objective of this dialogue is to enable the Committee and the relevant international stakeholders 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.

33. These stakeholders include, but are not limited to, the following:

- the Financial Stability Board (FSB), whose objectives include the enhancement of the effectiveness of banking supervision;

[24] BCBS (October 2010), *Principles for enhancing corporate governance*, paragraphs 50–51.

[25] ISA 260, *Communication with those Charged with Governance*, paragraph 10(a).

[26] See the meaning of "board" within this paragraph.

[27] 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."

The existence of both a board of directors and an 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.

[28] The Committee is a member of the FSB, the Monitoring Group and the consultative advisory groups of the IAASB and IESBA, and is an observer at the IFIAR. It also nominates one member to the PIOB.

- 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 Monitoring Group, which is a group of regulatory and international organisations committed to advancing the public interest by supporting the development of high-quality international standards on auditing and assurance, accountant ethics and education, and which exchanges views relating to international audit quality and regulatory and market developments which have an impact on auditing;
- the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) as well as their consultative advisory groups, which are responsible for developing international auditing and ethics standards respectively;
- the International Forum of Independent Audit Regulators (IFIAR), which discusses issues and shares views relating to international audit quality and regulatory and market developments having an impact on auditing; 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.

Part 1
Supervisory guidelines with regard to a bank's audit committee in relation to external audit, and the engagement of supervisors with auditors and audit oversight authorities

Section A – Supervisory guidelines with regard to a bank's audit committee and its relationship with the external auditor

34. The Committee's documents *The internal audit function in banks* (June 2012)[29] and the *Principles for enhancing corporate governance* (October 2010)[30] 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.

35. 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 senior management to take the necessary corrective actions to address the findings and recommendations of the external auditor in a timely manner.

36. The guidelines in this section focus on the audit committee's responsibilities in relation to the oversight of, and its relationship with, the external auditor, which include promoting and supporting the integrity, objectivity and independence of the auditor; the quality of the external audit; and the competencies that underpin that quality. To enable the audit committee to carry out its oversight responsibilities, which also contribute to the effectiveness of the audit process, these guidelines 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: there should be a frank, open working relationship and a high level of mutual respect amongst all parties involved.

37. These guidelines also 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 1: The audit committee should have a robust process for approving, or recommending for approval, the appointment, reappointment, removal and remuneration of the external auditor.

38. The audit committee should have 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 should regularly assess the knowledge, competence and independence of the external auditor (see Principle 2 below) and the effectiveness of the external audit (see Principle 3 below),

[29] BCBS website: www.bis.org/publ/bcbs223.pdf

[30] BCBS website: www.bis.org/publ/bcbs230.pdf

having due regard to the supervisory expectations and recommendations for external auditors and the external audit of a bank as set out in Part 2 of this document.

39. 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.

40. The bank's annual report should include a section that explains the approach the audit committee has taken regarding the recommendation of the appointment or reappointment of the external auditor, and include supporting information on the tenure of the incumbent auditor.

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

42. The audit committee should assess the overall quality of the external auditor, before its first appointment and at least annually thereafter. The audit committee should consider the quality control standards applicable to the external audit and request that the external auditor report on its own internal quality control procedures, including the audit firm's engagement quality control process, and any significant matters of concern arising from these procedures. To that end, the audit committee should consider whether, as well as complying with the applicable jurisdictional quality control standards, the audit firm also complies with the quality control requirements applicable to listed entities in internationally accepted quality control standards (see paragraph 147). 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 audit oversight body.

43. 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 in jurisdictions abroad where the bank operates;
- significant issues and concerns raised by the relevant audit oversight body regarding the audit firm, and the auditor's actions in addressing these concerns, to understand how these issues/concerns 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, and any 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 auditor, and other audit firms and how the audit firms have dealt with them so that similar audit risks are appropriately identified and limited.

44. The audit committee should 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 an inappropriate narrowing of the external auditor's proposed scope of the audit, or an inappropriate reduction in the attention which will be given to each business component and the significant audit risks identified.

45. 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.

46. 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 it needs to take any action in response to those reasons.

Independence of the external auditor

Principle 2: The audit committee should monitor and assess the independence of the external auditor.

47. 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, and 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 also involves a consideration of all relationships between the bank and the audit firm (including the provision of non-audit services), any inadvertent violations, and any safeguards established by the external auditor. To that end, the audit committee should consider whether, as well as complying with the applicable jurisdictional independence standards, the audit firm also complies with the independence standards applicable to listed entities in internationally accepted ethical standards (see paragraph 139).

48. Where the audit firm has been the external auditor of the bank for many years, there may be a risk 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.

49. The audit committee should have a policy in place that stipulates the criteria for tendering the external audit contract. The policy should also call for the audit committee to consider periodically whether to put the audit firm contract out for tender. When making such considerations, the audit committee should take into account the length of the current audit firm's tenure and the risks it may pose to its objectivity and independence.

50. The audit committee 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 independence requirements in this regard.

51. The audit committee should seek assurance that the audit engagement team members and their firm and, when applicable, the network external auditors have no personal, family, business, financial 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.

52. The audit committee should develop a formal policy which governs the acceptance of non-audit services provided by the auditor, within the local jurisdictional framework.[31] 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

[31] BCBS (June 2012), *The internal audit function in banks*, paragraph 67, 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.

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 A of Part 2 of this document.

53. Where non-audit services are provided by the external auditor, the audit committee should monitor the provision of such services to ensure that their performance 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.[32]

54. Where the external auditor provides non-audit services to the bank, the bank's annual report (or other relevant publications) 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 3: The audit committee should monitor and assess the effectiveness of the external audit.

55. Audit committees have a key role in contributing to audit quality by monitoring and assessing the effectiveness of external audits. At the start of each audit, the audit committee should consider whether the audit approach is appropriate, including considerations relating to the audit scope, the level of materiality, areas of focus and how the auditor proposes to address the areas of significant risks,[33] in particular those areas described in Section B of Part 2 of this document.

56. 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 to which the external auditor intends to use audit work performed by network firm personnel and other audit firms.

57. 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.[34]

58. 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 significant matters that arose during the audit (including those matters 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 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 its peer group (on an anonymous basis), including a comparison with previous periods;

[32] As set out in BCBS (June 2012), *Internal audit function in banks*, Annex 2.

[33] ISA 260, *Communication with Those Charged with Governance*, paragraph 15, requires the auditor to communicate with those charged with governance an overview of the planned scope and timing of the audit. Paragraph A13 presents examples of matters the auditor may communicate with those charged with governance, including how the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.

[34] The Preface to the *International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, paragraph 3, states that "[i]n the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards".

- obtain an understanding of the rationale behind the final conclusions drawn by the audit engagement partner on significant accounting and auditing matters; 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.

59. The audit committee should also discuss with the external auditor the statements provided by management in the representation letter to the auditor,[35] giving particular attention to any matters for which the external auditor requested specific written representations from the board of directors/senior management. The audit committee should consider whether the information provided for each item in the representation letter is complete and appropriate based on its own knowledge.[36]

60. As part of the ongoing monitoring process, the audit committee should discuss with the auditor the audit-related reports,[37] including any management letter (or equivalent), which the external auditor has provided to the bank. Such reports include, but are not limited to, written communications regarding matters that internationally accepted auditing standards require the auditor to communicate in writing to those charged with governance. In particular, the audit committee should discuss with the external auditor any significant deficiencies identified during the audit in the bank's internal control over financial reporting, which must be communicated in writing.[38]

61. Upon completion of the audit fieldwork, but before the external auditor issues the audit report, the audit committee should consider whether the audit firm has followed its audit plan and understand the reasons for any changes in the plan, including those resulting from changes in the identified risks of material misstatement and the work undertaken by the external auditor to address those risks. Promptly after the completion of the audit, if not done earlier, the audit committee should obtain feedback about the conduct of the audit from key bank personnel involved, eg the heads of finance and internal audit.

62. The audit committee should then assess the effectiveness of the external audit process, report on the effectiveness of the process to the board of directors, and discuss its findings and any recommendations with the board.

63. The audit committee should seek to obtain information from the external auditor, where relevant, 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.

[35] ISA 580, *Written Representations*, requires the auditor to request management (ie management and, where appropriate, those charged with governance) to provide written representations that it has fulfilled its responsibilities for the preparation of the financial statements, for providing the auditor with all relevant information and access to the books and records, and for recording all transactions and reflecting them in the financial statements. Other ISAs require the auditor to request additional written representations from management if the auditor determines that it is necessary to support other audit evidence. The written representations must be in the form of a representation letter addressed to the auditor. It may therefore be appropriate for the audit committee to make management aware that the submission of such written representations to the external auditor will be expected.

[36] ISA 260, *Communication with Those Charged with Governance*, paragraph 16(c)(ii), requires the auditor to communicate to those charged with governance the written representations the auditor is requesting.

[37] As mentioned in paragraph 87, these reports 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.

[38] ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 9.

Relationship between the audit committee and the external auditor

Principle 4: 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.

64. 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.

65. While both cooperation and challenge 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.

66. 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 the bank's 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.

67. 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.

68. The audit committee should discuss with the auditor any matters arising from the statutory audit that may have an impact on regulatory capital or regulatory 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 prudential information (eg Pillar 3 reporting) with its annual report.

69. The audit committee should discuss with the external auditor any significant issues identified in the course of the audit, particularly 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 for the financial reporting processes and performance of the bank.

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

Reporting by the external auditor to the audit committee

Principle 5: 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.

71. In some jurisdictions, as part of the statutory audit, the auditors are also required by law or regulation to express an opinion on the effectiveness of internal control over financial reporting and

provide additional reporting of matters identified in the audit of internal control. The text in the following paragraphs covers only reporting to the audit committee in the context of the financial statement audit.

72. Under internationally accepted auditing standards, an objective of the external auditor is to provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process.[39] The reporting by the external auditor should be aligned with the requirements set by internationally accepted auditing standards for matters to be communicated to those charged with governance,[40] the expectations and recommendations set forth in this document, and any additional requirements under applicable laws and regulations.

73. As part of the above, the audit committee should request that the external auditor report to it on certain significant matters, including the following:

- Significant difficulties encountered during the audit.[41]
- 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 judgment, including judgments pertaining to the recognition, de-recognition, measurement or disclosure of relevant items within the financial statements, judgments about events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern[42] (including consideration of liquidity/funding issues of the entity), and the auditor's view on these areas.
- The extent of requests made by the group auditor to another audit firm or member firm with respect to the performance of a group audit.
- Use of external experts to assist with the external audit.
- The auditor's approach to internal control.[43]
- The extent to which the auditor uses the work of internal audit.[44]
- Significant internal control[45] deficiencies identified in the course of the statutory audit.[46]
- Matters noted arising from the audit 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, including significant decisions or actions by senior management that lack appropriate authorisation.[47]

39 ISA 260, *Communication with Those Charged with Governance*, paragraph 9(c).

40 ISA 260, *Communication with Those Charged with Governance*, paragraphs 14–17.

41 ISA 260, *Communication with Those Charged with Governance*, paragraphs 16(b) and A18.

42 ISA 570, *Going Concern*, paragraph 23.

43 ISA 260, *Communication with Those Charged with Governance*, paragraph A13.

44 ISA 260, *Communication with Those Charged with Governance*, paragraph A14.

45 Including the control environment, risk assessment process, information and communication systems and processes, control activities and monitoring of controls in the bank.

46 ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 9.

47 ISA 260, *Communication with Those Charged with Governance*, paragraph A25.

- Significant qualitative aspects of financial statement disclosures, eg how the bank's disclosures compare with those of its peers, and where the auditor believes they could be improved, including the results of discussions with management.
- Feedback on the auditor's relations with management, the internal audit function and the risk management function, where relevant.
- Any other significant matters discussed with or considered by the engagement quality control reviewer.

74. For the purposes of complying with the requirements of internationally accepted auditing standards, where significant matters are communicated to the audit committee, the external auditor should also determine if these matters need to be communicated to the governing body of the bank.[48]

75. Banking regulators often have access to written communications between the auditor and the bank. However, internationally accepted auditing standards (in particular, ISA 260) currently do not mandate that the auditor should always communicate in writing with those charged with governance. Given the importance of the auditor reporting to those charged with governance in contributing to audit quality, and to the work of the banking regulator, but without wishing to limit oral communications, the Committee recommends that the auditor always communicate in writing to those charged with governance all significant audit findings and reportable matters.

Section B – Supervisory guidelines: the relationship between the supervisor and the external auditor

76. This section sets out guidelines 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 (Principles 6 and 7); and
- the banking supervisory authority and the audit firm, and the accounting profession as a whole where the information is not specific to an individual bank (Principle 8).

77. From a supervisory perspective, 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 also contribute to the quality of external audits.

78. 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

79. The external auditor can provide the supervisor with valuable insight into various aspects of a bank's operations and management's attitude towards the application of key accounting policies, including the judgments made by, and any valuation models adopted by, management in carrying out these policies. 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,

[48] ISA 260, *Communication with Those Charged with Governance*, paragraph 12.

the supervisor may also request the external auditor to perform specific assignments that go beyond the statutory audit work of the auditor.

Principle 6: The supervisor[49] 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.

80. Supervisors and external auditors should have an open and constructive relationship. Information exchanged should be treated appropriately and confidentially.[50]

81. 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.

82. 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, neither party should 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.

83. The scope and terms 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 communications with the bank

84. The external auditor's work gives rise to the auditor's report on the annual/consolidated financial statements which is also used for prudential supervisory purposes. When performing a financial statement audit in accordance with internationally accepted auditing standards, the external auditor should communicate 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.[51] In the same manner, in certain jurisdictions, the external auditor may also have access to the supervisor's communications to the bank.[52]

85. 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 with the bank in writing about matters that may also be of interest to each other. These written communications would then form part of the bank's records to which the other party should have access.

Direct communication at the supervised bank level

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

[49] In the context of Principle 6, see BCBS Core Principle 27, footnote 83, for the meaning of "supervisor", which is broader than the meaning specified in paragraph 30.

[50] See paragraphs 95–98.

[51] In certain jurisdictions, the supervisor may also have access to the external auditor's working papers.

[52] The external auditor should review the supervisor's communications to the bank to help identify instances of non-compliance with laws and regulations that may have a material effect on the financial statements as required by ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 14(b): "The auditor shall perform the 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."

87. 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.[53] 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.

88. 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 the chair of the audit committee (or an alternate independent non-executive director) at the supervised bank can also be held.

89. Whilst not excluding any other effective communication channels, bilateral and trilateral meetings are examples of sound practice communication channels, particularly for systematically important banks (SIBs).

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

90. The communication channels described in paragraphs 86–89 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 (see Principle 7) which external auditors may consider as important and of interest to the banking supervisors. Such issues may include current, emerging and thematic issues, and entity-specific and sector-wide issues.

91. In addition to discussing with the supervisor areas where there is often a significant risk of material misstatement in the financial statements, this document 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 are therefore 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 that exhibit a pattern of optimism or pessimism within a range of acceptable valuations or other indications of possible management bias.[54]
- Significant deficiencies in internal control processes and the external auditor's 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, 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 that are likely to be of significance.[55]
- Indications that disclosures in financial statements are not consistent with published prudential information (eg Pillar 3 reporting).

[53] 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).

[54] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21.

[55] The external auditor should apply professional judgment in determining whether the identified breach is likely to be of significance to the supervisor. The Committee recommends that the external auditor report significant breaches directly to the supervisor (or, where not permitted, indirectly through the bank). However, if the breach is of material significance, it should be reported immediately as described in paragraph 99.

92. Annex 1 to this document provides examples of the potential content of the extended audit reports described in paragraph 87. Annex 2 to this document provides guidelines on the timing and examples of the potential content of the meetings between the supervisor and the external auditor, as circumstances may dictate.

93. 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 significant risks and significant findings of the audit.

94. 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

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

96. On matters that fall outside the scope of the duty to report/alert discussed in Principle 7 but which may be of interest to the supervisor, where a safe harbour does not exist,[56] the external auditor communicates these matters indirectly through the bank to the supervisor or directly with the bank's consent.

Gateways available to supervisors

97. Subject to the confidentiality rules that are in place, the supervisor may 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.

98. Before disclosing any information to the external auditor, supervisors consider the sensitivity of the information and the extent to which disclosing the information to the external auditor would support the supervisor discharging its duties.

Principle 7: The supervisor should require the external auditor to report to it directly[57] on matters arising from an audit that are likely to be of material significance[58] to the functions of the supervisor.

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

99. When required by the legal or regulatory framework or by a formal agreement or protocol, the external auditor should promptly communicate matters arising from the audit that may be of material

[56] In jurisdictions where one does 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.

[57] Reporting should be conducted directly from the auditor to the supervisor, unless not permitted, in which case reporting should be conducted indirectly through the bank.

[58] See footnote 9.

significance to the supervisor (referred to as "duty to report/alert" matters). In jurisdictions with such a requirement, the disclosure in good faith to the supervisors by an external auditor of matters of material significance does not constitute a breach of the auditor's duty of confidentiality.[59]

100. 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, when there is a duty on the part of the external auditor to report to/alert the supervisor directly on such matters, it is not sufficient for the external auditor to rely on the bank to notify the supervisor.

101. The following are examples of significant matters arising from an audit that many jurisdictions prescribe as within the scope of the external auditor's duty to report/alert:

- 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[60] 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;[61] and
- circumstances requiring modifications to the auditor's opinion on the financial statements.

102. It is also a usual practice for the external auditor to notify the supervisor of the external auditor's resignation (or intent to resign) or the bank's removal of the external auditor from office.

(b) Effective relationships at the levels of the audit firm and the accounting profession as a whole

103. To assist in effective supervision of banks, it is important for the banking supervisory authority 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.

104. Audit firms may also identify emerging issues regarding inconsistent or inappropriate application of accounting standards which, if identified at an early stage, will permit external auditors and supervisors to take timely remedial action at the national level and also at affected banks to ensure the fair presentation of their financial statements.

Principle 8: There should be open, timely and regular communication between the banking supervisory authority, the audit firms and the accounting profession as a whole on key risks and systemic issues as well as a regular exchange of views on appropriate accounting techniques and auditing issues.

105. 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 take place in an environment

[59] BCBS (September 2012), *Core Principles for Effective Banking Supervision*, Principle 27, Essential Criterion 9.

[60] See paragraph 177.

[61] See paragraph 189.

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.

106. 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.[62]

107. Key risks may be identified from discussions concerning:

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

These discussions could be useful for identifying systemic issues. They could also help achieve banks' adoption of the most appropriate accounting policies and their consistent application.

108. It may be beneficial for banking industry associations to be involved in discussions on these topics.

Section C – Supervisory guidelines: the relationship between the banking supervisory authority and the audit oversight body

109. 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 audit firms.

110. 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.

111. 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 confidentiality 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.

Principle 9: There should be regular and effective dialogue between the banking supervisory authority and the relevant audit oversight body.

112. Where there is a relevant audit oversight body, the banking supervisory authority should establish regular dialogue with this body to deal with issues relevant to the conduct of audits of the banks under supervision.

[62] 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) (as described in Section 5 of this document), the European Banking Authority and the Association of Supervisors of Banks of the Americas.

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

114. 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.

115. 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.

116. The banking supervisory authority may also discuss with the audit oversight body areas where there can be a significant risk of material misstatement and, where an appropriate framework for information-sharing is in place, the banking supervisory authority’s 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.

117. 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.

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

119. 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, their external auditors or the professional bodies representing external auditors and encouraging remediation of these issues where appropriate; and
- initiating a thematic review to analyse the impact of issues or topics identified by the audit oversight body from a prudential perspective.

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

Part 2
Supervisory expectations and recommendations relevant to the external auditor and the external audit of financial statements

121. External audits of financial statements performed in accordance with the relevant 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.

122. Though the Committee does not set competence, independence or auditing standards for auditors,[63] it does have expectations and recommendations as to what constitutes a quality audit. The Committee's expectations and recommendations should be referred to by audit committees in assessing the external auditor's knowledge, competence, objectivity and independence as well as the effectiveness of the audit process. These expectations and recommendations also facilitate the supervisors' engagement with external auditors and the relevant audit oversight bodies. The outcome of these interactions will help to inform the supervisors' views as to the quality of the external audit and contribute as such to the supervisory process.

123. Section A of this part of the document describes the supervisor's expectations and recommendations as a user of the bank's financial statements, specifically with respect to the external auditor's knowledge and competence, objectivity, independence, professional scepticism and quality control over the bank's audit. Section B of this part 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 Committee expects the external auditor to pay particular attention when auditing those areas.

124. This part of the document includes references to the existing internationally accepted auditing standards (eg ISAs), quality control standards (eg ISQC 1) and ethical standards (eg IESBA's Handbook of the Code of Ethics for Professional Accountants) for external auditors[64] to draw the reader's attention to specific requirements on certain topics. The Committee does not have the authority to set professional standards for external auditors. However, as internationally accepted professional standards for auditors are principles-based, the Committee expects the proper application of the standards to audits of banks to include appropriate tailoring of audit work in response to the risks and issues applicable to banks. For some areas of bank audits, this part of the document also includes the Committee's recommendations for audit requirements or procedures that could be enhanced in the current standards to address particular risks in audits of banks. These recommendations were included in the Committee's letter to the IAASB in March 2013 suggesting enhancements to the ISAs and ISQC 1.[65]

125. While the primary focus in this part is on the financial statement audit, the external auditor may identify matters in the course of the audit that are of interest to the supervisor and therefore should be considered for communication to the supervisor.[66]

126. 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

[63] Various bodies (eg the International Accounting Education Standards Board, the International Ethics Standards Board for Accountants and the International Auditing and Assurance Standards Board) are responsible for setting standards for these respective areas.

[64] As of March 2014.

[65] See footnote 4.

[66] See paragraphs 141, 145, 166, 177, 183 and 189.

supervisory expectations set out in this part of the document provide a relevant reference for the performance of such additional work.

Section A – Supervisory expectations and recommendations for the external auditor of a bank

Knowledge and competence

Expectation 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.

127. Commensurate with the size, complexity and diversity of banking activities, and the legal and regulatory framework in which banks operate, the Committee expects that the external auditor of a bank has specialised knowledge and competence in auditing banks and uses experts as appropriate.

128. Knowledge and competence are particularly important in 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.

Knowledge

129. Specifically for banking audits, the Committee expects 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 knowledge through specific training, participation in bank audits or work in the banking sector;
- proficient knowledge and understanding of applicable accounting, assurance and ethical standards, industry practice and relevant guidance such as International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*;
- proficient knowledge of relevant regulatory requirements in the areas of capital and liquidity, and a general understanding of the legal and regulatory framework[67] applicable to banks; and
- proficient knowledge and understanding of IT relevant to bank audits.

130. In addition, given the complexity of the requirements of the applicable financial reporting framework pertaining to accounting estimates, the Committee expects the external auditor to consider whether the audit engagement team should involve individuals with specialised skills or knowledge in relation to accounting estimates,[68] including loan loss provisions, fair value measurements, and any areas known to be subject to differing interpretation, diversity in practice or newly developing practices.

[67] ISA 250, *Consideration of Laws and Regulations in the Audit of Financial Statements*, paragraph 12.

[68] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 14.

Competence

131. The Committee expects that audit firms have documented policies and procedures that set minimum competency criteria for a bank's audit engagement team as a whole, which consider the role and experience of different team members.

32. 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.

Use of experts

133. In some instances, expertise in a field other than accounting or auditing may be required to support the audit engagement team. Examples of such areas are certain complex valuations that may affect accounting estimates (eg valuation of complex financial instruments, commercial property valuations), regulatory matters and the evaluation of highly complex IT environments, particularly in areas subject to significant risks of material misstatement.

134. Internationally accepted auditing standards set out requirements for the nature, timing and extent of audit procedures which the external auditor should perform to determine whether to use the work of an auditor's expert and, if using the expert, how to determine whether that work is adequate for the auditor's purposes.[69]

135. For some accounting estimates, banks may use complex valuation models. When these models are used, in addition to those considerations set out in paragraph A8 of ISA 620, *Using the Work of an Auditor's Expert*, the Committee recommends that the external auditor also consider the following when deciding whether to use an auditor's expert:

- whether there are new products or structures for the individual bank or the industry in general; and
- whether recent events either within the individual bank or in the industry in general have highlighted previously unidentified risks.

Objectivity and independence

Expectation 2: The external auditor of a bank should be objective and independent in both fact and appearance with respect to the bank.

Objectivity

136. Objectivity is a fundamental ethical principle and a key element of audit quality. It requires that the external auditor's judgment is not compromised because of bias, conflict of interest or the undue influence of others.[70] 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.

[69] ISA 620, *Using the Work of an Auditor's Expert,* paragraphs 7–15.

[70] IESBA, *Handbook of the Code of Ethics for Professional Accountants*, paragraph 120.1.

Independence

137. Jurisdictional and internationally accepted ethical standards[71] lay out the frameworks to assist external auditors achieve and maintain independence.

138. Independence[72] is freedom from situations and influences, facts and circumstances where a reasonably informed third party would conclude that an external auditor's objectivity is impaired. It is important for the external auditor to be independent in both fact and appearance. In addition, 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.[73]

139. The external auditor of a bank must comply with the applicable jurisdictional ethical standards. Whether or not the jurisdictional ethical standards are drawn from the internationally accepted ethical standards (eg IESBA), the Committee recommends that the external auditor of a bank also comply with the independence standards for public interest entities[74] in internationally accepted ethical standards.

140. When assessing whether any relationship or circumstance poses a threat to an external auditor's independence, the external auditor evaluates 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 non-assurance 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 evaluated for threats to the external auditor's objectivity and perceived independence.[75]

141. The external auditor considers potential threats to the auditor's independence, specifically the self-review threat, when advising management on accounting matters. For example, complex

[71] IESBA, *Handbook of the Code of Ethics for Professional Accountants*, Section 290.

[72] IESBA, *Handbook of the 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."

[73] IESBA, *Handbook of the 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 in this section include related entities of the client (unless otherwise stated). For all other audit clients, references to an audit client in this section include related entities over which the client has direct or indirect control. 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."

[74] Public interest entities are defined in IESBA, *Handbook of the 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."

[75] IESBA, *Handbook of the Code of Ethics for Professional Accountants*, paragraphs 290.156–290.219, provide guidance on the provision of non-assurance services to audit clients and include prohibitions on the provision of certain non-assurance services to audit clients that are public interest entities.

transactions may be structured to achieve a particular accounting treatment and/or regulatory outcome. When an external auditor provides advice and recommendations to management on such matters, the external auditor must exercise care so as not to assume a management role or responsibility.

Professional scepticism

Expectation 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.

142. 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".[76] Professional scepticism should manifest itself not only through the auditor obtaining corroborating evidence for management's assertions, but also challenging management's assertions, considering whether there are alternative accounting treatments that are preferable to those selected by management, and documenting the auditing approach, the evidence obtained, the rationale applied and the conclusions reached. Throughout the audit, the auditor "adopts a questioning approach when considering information and in forming conclusions".[77]

143. 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, especially those measurements involving a wide range of measurement uncertainty;

(b) involve significant non-recurring or unusual transactions; or

(c) are more susceptible to fraud and errors being perpetuated due to weak internal controls.

144. It is of particular importance that professional scepticism is exercised by the external auditor of a bank in the following areas: impairment calculations, fair value measurements and going concern assessments, including assessments of solvency and liquidity (see paragraph 187 for details). Other examples are complex transactions lacking substance or a sound business purpose that management has structured to achieve a particular accounting treatment and/or regulatory outcome 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 Committee expects the external auditor to challenge management's inputs and assumptions and form independent views. This includes challenging evidence obtained from management that corroborates management's view.

145. Where a bank consistently utilises valuations that exhibit a pattern of optimism or pessimism within a range of acceptable valuations, the Committee expects that the external auditor, in reviewing the judgments and decisions made by management of the bank, will consider the risk of management bias.[78] The Committee also recommends that the external auditor consider other areas with the potential to be affected by management bias, such as accounting estimates and classification of financial instruments, that are used in the calculation of banks' regulatory capital measures (see paragraph 157) as

[76] IAASB, *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, Glossary of terms*.

[77] IAASB (February 2012), *Staff Questions & Answers – Professional Skepticism in an Audit of Financial Statements, Question 1*.

[78] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21.

part of the risk assessment. The auditor informs those charged with governance, where appropriate, of any indicators of possible management bias.[79]

146. The evidence of the extent of professional scepticism exercised should be demonstrable and understandable through audit documentation that describes what conclusions were reached by the external auditor and how. In this regard, internationally accepted auditing standards establish minimum requirements for audit documentation.[80]

Quality control

Expectation 4: Audit firms undertaking bank audits should comply with the applicable standards on quality control.

147. Audit firms should comply with the applicable jurisdictional standards on quality control. Whether or not the jurisdictional standards are drawn from the internationally accepted standards on quality control (eg ISQC 1), the Committee recommends that audit firms undertaking bank audits also comply with the quality control requirements applicable to audits of listed entities in internationally accepted quality control standards.

148. The Committee recommends that the audit of a bank be subject to an engagement quality control review (EQCR)[81] and that the EQCR reviewer be involved from the early stages of the audit, rather than only at the end. The EQCR reviewer should have the technical qualifications required to perform the role, including the necessary experience and authority,[82] and should review how the engagement team has demonstrated professional scepticism during the course of the audit. Such considerations should be documented in the audit working papers. It is also important for the EQCR reviewer to address the degree to which the audit engagement team has considered accounting and relevant regulatory information.

149. EQCR is part of a broader firm-level system of quality control that emphasises quality and consultation and creates a culture of compliance with auditing and ethical standards and applicable legal and regulatory requirements (see ISQC 1.11(a)).

150. The Committee recommends that the EQCR reviewer's involvement at the group audit level not be restricted to the review of the audit of the parent or holding company, but that it also consider the quality control procedures performed at the component levels.

151. The involvement of the EQCR reviewer throughout the audit, and the outcome of the EQCR, should be evident in the audit working papers.[83] The Committee also recommends robust documentation of the engagement documentation reviewed and that the discussions between the EQCR reviewer and the audit engagement team on all matters of significant judgment be included in the working papers. Thus in jurisdictions where the supervisor has access to the external auditor's working papers, the extent and results of the EQCR would also be at the supervisor's disposal.

[79] ISA 260, *Communication with Those Charged with Governance*, Appendix 2.

[80] For example, ISA 230, *Audit Documentation*.

[81] ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 35.

[82] ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 39(a) and A47. Also, the technical qualifications of the engagement quality control reviewer should be consistent with supervisory expectations for the audit team as a whole as described in Expectation 1 and related explanatory text.

[83] ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 25.

Section B – Supervisory expectations and recommendations for the audit of a bank's financial statements

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

Expectation 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 the bank's activities and the effectiveness of its internal control environment.

Identifying potential risks

152. 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, regulatory risk and solvency 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.

153. In designing and performing the audit of a bank, the external auditor identifies and assesses the risks of material misstatements at the financial statement and assertion levels. The external auditor also gains an understanding of internal controls that are relevant to the audit, including the control environment of the bank.

154. 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 where appropriate. As a result, the Committee expects the external auditor of a bank to perform appropriate tests on the relevant controls over the significant financial reporting process to assess whether, and to what extent, the auditor can rely on them.

Materiality

155. The external auditor needs to apply the concept of materiality appropriately in planning and performing the audit.[84]

156. 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.

157. 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 reported in the financial statements or are derived from the financial statements. The Committee expects the auditor to consider these ratios as an input to the determination of materiality thresholds for the audit.

158. The external auditor exercises caution when evaluating identified misstatements even if they are below the materiality for planning purposes. These misstatements could be an indicator of more extensive control deficiencies within the bank that could potentially lead to material misstatements in the financial statements as a whole.

[84] ISA 320, *Materiality in Planning and Performing an Audit*, paragraph 8.

Assessing the risks of material misstatement

Internal control and its components

159. According to internationally accepted auditing standards, the components of internal control as they relate to a financial statement audit are the control environment; the entity's risk assessment process; the information system, including the related business processes, relevant to financial reporting, and communication; control activities; and monitoring of controls.[85]

160. As noted in the Committee's March 2013 letter to the IAASB suggesting enhancements to the ISAs and ISQC 1, [86] given the nature of banks' activities, their fiduciary and custodial duties, and the high volume of monetary transactions typically carried out by banks, some of which may be complex, a robust internal control environment is critical to the strength of a bank's governance system and its ability to manage risk. Consequently, when obtaining an understanding of the bank's internal control environment relevant to the statutory audit, the Committee expects the external auditor to, 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;
- assess whether the same or a similar 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;
- 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; and
- assess whether there are any material gaps in the bank's control systems and understand the level of risk tolerance defined by those charged with governance.

161. Compensation arrangements at a bank may be a good indicator of the culture within the organisation because they can influence the attitude towards risks of the bank's personnel and the quality of corporate governance. The Committee expects the external auditor to pay particular attention to the risks of material misstatement in the financial statements due to fraud,[87] especially where banks employ compensation arrangements that may encourage excessive risk-taking or other inappropriate behaviour amongst their personnel.

Control activities

162. Internationally accepted auditing standards require the external auditor to obtain an understanding of control activities relevant to the audit, which are those activities the auditor judges it necessary to understand in order to assess the risks of material misstatement[88] and to establish the audit strategy. An understanding of the control activities over the financial reporting process is critical for the design of further audit procedures in response to assessed risks. The Committee expects the external

[85] ISA 315 (revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, Appendix 1.

[86] See footnote 4.

[87] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

[88] ISA 315 (revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 20.

auditor to take account of the following factors when identifying and assessing risks of material misstatement and assessing controls in a bank:

- 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 estimates of fair value based on significant unobservable inputs;
- 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 the 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 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.

163. Bank management and those charged with governance, such as the audit committee, need to be satisfied that the bank's system of 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 structure of a bank must be robust and reliable in order to cope with stressed environments.

Internal audit

164. The internal audit function is an important element of the overall internal control environment. It supports the board of directors and senior management by helping them to protect the organisation and its reputation through providing independent assurance on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes.[89] The work of internal auditors can help external auditors assess the quality of the internal control processes and identify risks.

165. When, based on the external auditor's preliminary understanding of the internal audit function, the external auditor expects to use the work of the internal audit function in obtaining audit evidence for the purposes of the financial statement audit, internationally accepted auditing standards require the external auditor to determine whether, in which areas, and to what extent, the work of the internal audit function can be used.[90] Irrespective of the external auditor's decision on whether to use internal audit work, the Committee expects the external auditor to engage with, and seek information on key internal audit findings from, the internal audit function. This may provide valuable input into the external

[89] BCBS (June 2012), *The internal audit function in banks*, Principle 1.

[90] ISA 610 (revised), *Using the Work of Internal Auditors*, paragraph 13 - 17.

auditor's understanding of the entity and its environment and aid in identifying and assessing risks of material misstatement. The external auditor reads 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.

166. The Committee recommends that the external auditor provide written feedback about the audit engagement team's relations with the bank's internal audit function, including, where relevant, its observations on the adequacy of the work of the internal audit function, to those charged with governance. This information is also of particular interest to 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

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

167. Having identified and assessed the risks of material misstatement, whether due to fraud or error, at the financial statement level and the assertion level, where the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, under internationally accepted auditing standards, the auditor designs and implements appropriate responses to those risks, including testing controls in the current period that the auditor plans to rely on[91] and performing substantive procedures that are specifically responsive to that risk.[92] Paragraphs 170–191 below set out key areas of a bank's financial statements where there may be a significant risk of material misstatement.

168. In addition to the areas set out in paragraphs 170–191, 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 may be a greater risk of material misstatement of these items in the financial statements. This may lead to the inclusion of inappropriately measured items as inputs when applying regulatory rules 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. The Committee expects external auditors to be alert to any likelihood of the treatment of such items in the financial statements being 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. The Committee expects external auditors to evaluate areas within the financial statements which may be subject to that bias. Further, the Committee expects external auditors to evaluate any identified audit differences, errors and adjustments and consider their impact on regulatory capital or regulatory capital ratios, consistent with paragraph 156.

169. 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 170–191 below are areas where there is often a significant risk of material misstatement. The list is not intended to be comprehensive.

Loan loss provisioning

170. 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

[91] ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 15.

[92] ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 21.

internationally accepted accounting principles involves complex judgments about credit risk which may be subjective in nature.

171. The Committee expects the external auditor to consider the following factors in identifying and assessing the significant risks of material misstatement in relation to loan loss provisioning and the related allowance for loan losses. This list is not intended to be comprehensive.

(a) The estimation techniques used to compute provisions and how the techniques vary within and amongst banks (where possible).

(b) Whether an appropriate degree of caution has been exercised by management in judging anticipated cash flows and making other assumptions.

(c) All known and relevant impairment indicators for loan exposures which include previously unexpected adverse developments in the market or economic environment, adverse movements in interest rates, restructurings, 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) Financial 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 financial accounting purposes and for regulatory purposes. Further, there can be material differences in the application of the same set of financial accounting and regulatory rules by individual banks. Nevertheless, large differences between provisions for financial accounting purposes and for regulatory capital purposes should be investigated by the auditor to ensure there is not a risk of material misstatement of the loan loss provision reported in the financial statements. In addition, whilst for regulatory capital purposes under the Basel framework the accounting loan loss provision for internal ratings-based approach 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 are 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, including fair value measurements

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

173. 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.

174. Accounting standards for financial instruments contain requirements for recognition; initial and subsequent measurement (including impairment); reclassification from fair value to amortised cost; derecognition; presentation; and disclosures.[93] 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 obtain reasonable assurance that the financial statements are not materially misstated. The accounting classification of an individual financial instrument may be particularly important for achieving a favourable regulatory outcome.

175. 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

176. 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.

177. Internationally accepted auditing standards require the external auditor to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on the financial statements may bring instances of identified or suspected non-compliance with laws and regulations to the auditor's attention.[94] As noted in paragraphs 91 and 101 above, if the external auditor identifies any such breaches of material significance[95] to the bank's supervisor, the auditor directly notifies the supervisor immediately (or, where not permitted, indirectly through the bank).

Disclosures

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

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

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

[93] See also BCBS (April 2009), *Supervisory guidance for assessing banks' financial instrument fair value practices*.

[94] ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 8.

[95] See footnote 9.

181. In responding to the significant risks of material misstatement in this area of an audit, the external auditor has an important role to play in evaluating whether the bank's disclosures are consistent and meaningful and, when taken as a whole, present the bank's financial condition in a way that is informative and understandable to users of financial statements.

182. The Committee recommends that the external auditor evaluate whether the disclosures included in the financial statements, both quantitative and qualitative, are sufficient, and are consistent with his/her understanding of the bank's risk profile, activities and strategy, in particular with regard to:

(a) the bank's overall objectives and strategies;

(b) the bank's control framework for managing its key business risks;

(c) the uncertainties associated with its key business risks; and

(d) all other related information included in the financial statements.

183. For banks in some jurisdictions, certain regulatory ratios may be published with the financial statements and are material to a wide range of users in assessing the performance of banks, eg capital ratios. In the course of its audit work, the Committee expects the external auditor to be alert to any indications that the regulatory ratios published with or included in the financial statements may not be consistent with the auditor's understanding of the bank's risk profile, activities and strategy.

Going concern assessment

184. Under internationally accepted auditing standards, the external auditor is responsible for obtaining sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.[96] Accordingly, the external auditor should remain alert throughout the audit for evidence of events or conditions that may cast significant doubt on this ability to continue as a going concern.[97]

185. 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) and the significant exposure to credit risk and the effect that provisioning may have on a bank's profit and loss and capital. In addition, 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, give rise to difficult and sensitive issues related to the reporting and disclosure of the bank's going concern status.

186. 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 adverse impact on projections normally based on the bank's own historical experience and trends such that the historical trends may not reflect the likely results 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 suggest and such deposits may be difficult to replace.

(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. In addition, a significant increase in credit losses

[96] ISA 570, *Going Concern,* paragraph 6.

[97] ISA 570, *Going Concern*, paragraph 11.

due to deteriorating economic conditions may result in the need for substantial additional provisions by the bank. These may contribute to a significant decrease in regulatory capital and may result in a downgrade by rating agencies, making funding more expensive and possibly harder to obtain.

(c) Banks generally derive a significant amount of their funding from short-term deposits and other short-term liabilities. A loss of confidence by depositors and other creditors in a bank's solvency can quickly result in a liquidity crisis.

187. Given these and other risks, banks are required to meet liquidity requirements and capital ratios set by the bank supervisory authority. There should be appropriate 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:[98] 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:[99] 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,[100] the Committee expects the external auditor to consider the robustness of the bank's system for managing capital in response to the credit, market and other risks to which the bank is exposed.[101] In addition, the external auditor considers the capital position in relation to the current and any known future capital requirements, definitions of capital components, and challenges in 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.

188. In responding to the significant risks of material misstatement in this area of the external audit, and in assessing management's assertion that a bank is a going concern, the Committee expects the external auditor to consider at least the following factors:

(a) the effectiveness 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.

189. Given the above risks and the possible systemic implications, if there are any material uncertainties related to events or conditions that may cast significant doubt over the bank's ability to

[98] See BCBS (December 2010, revised June 2011), *Basel III: A global regulatory framework for more resilient banks and banking systems*; and BCBS (December 2010), *Basel III: International framework for liquidity risk measurement, standards and monitoring*. See also the Committee's January 2014 papers on leverage ratio, net stable funding ratio and liquidity coverage ratios.

[99] See footnote 98.

[100] 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.

[101] The bank's system for identifying and measuring its regulatory capital and assessing the adequacy of its capital resources should be applied in relation to the bank's risk exposures and established minimum ratios, including management's process for stress testing.

continue as a going concern, the external auditor should promptly communicate this fact directly (or, where not permitted, indirectly through the bank) to the supervisors.

Securitisations – SPEs

190. 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 may be exposed to risks such as reputational risk in the event that the sponsored entity encounters financial or operational difficulties.

191. The Committee expects that these activities would merit 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 require significant management judgments and 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 sponsoring bank's balance sheet. In these instances, it is necessary for the auditor to evaluate the judgments made by the sponsoring bank's management and consider whether the accounting treatment is appropriate and the disclosures are sufficient.

(b) Regulatory concern – Because of the complexity of many securitisation transactions and the chain of financial intermediation, the sponsoring bank may misstate the real risk transferred or the risk retained on its balance sheet (including reputational risk which might incentivise it to support its securitisations, 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 accounting treatment for the assets underlying these transactions, and may not be required to hold regulatory capital against its securitisation exposures unless specifically required by the supervisor or the relevant regulatory rules.

Annex 1

Examples of the contents of extended reports provided by 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, but the list 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.
- 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.
- Description and assessment of the provisions on conduct of business rules.

Annex 2

Guidelines on the timing and examples of 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 bank'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, and 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.
- Audit issues from previous years and how the firm has 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 the present meeting 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.

Other

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.