Committee of European Banking Supervisors

8 November 2010

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Technical Director
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Dear Sir,

Proposed International Standards on Auditing 315 (revised), identifying and assessing the risk of material misstatement through understanding the entity and its environment and 610 (revised), using the work of internal auditors

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union welcomes the opportunity to comment on the proposed revisions to the International Standards on Auditing (ISA 315 and ISA 610).

The relationship of external auditors with internal auditors is a topic of importance to the supervisory authorities. This is because audited annual reports are a significant source of information used in exercising banking supervision, and also because Article 22 of the European Capital Requirements Directive requires institutions to implement adequate internal control procedures, which we understand includes the existence of a permanent internal audit function within each bank.

The financial crisis has highlighted that strong internal controls, supplemented by an effective internal audit function, and an independent external audit are crucial parts of sound corporate governance. Through their opinions on annual accounts and annual reports, external auditors contribute to the public oversight model and to the financial stability of the market. As banking supervisors we therefore have an interest in ensuring that auditing standards are of a high quality and are clear and capable of consistent application.

We welcome the Exposure Draft and its clarification on how external auditors should interact with the internal audit function (including directly addressing the matter of direct assistance), and believe this framework will improve the current standards. However, we would suggest distinguishing clearly between the external auditor relying on the work of internal audit and the external auditor directly being assisted by internal audit. We would not encourage direct assistance, as this practice may reduce the perception by the public of the independence and objectivity of external auditors. If at all, we strongly suggest that direct assistance should be clearly and specifically restricted to areas of low inherent audit risk and requiring no or very little judgment. This is important to prevent the undermining of the independence of the external auditor's work.

When external auditors would rely on the work of internal audit, they should evaluate and take into account the risk of material misstatements.

In some sections (e.g. paragraphs 14, 21 and 23 of ED ISA 610), we believe it would be clearer to express the requirements more directly and in the positive rather than negative form. For example the ISA should read "T*he external auditor shall only use the work of the internal audit function if it has both a high degree of objectivity and a high level of competence*" rather than "*The external auditor shall not use an internal audit function where there is either a low degree of objectivity or a low degree of competence*". In addition minimum criteria should be developed to define a threshold, above which reliance could be placed on internal auditors.

There would also be value in adding more specific examples of audit procedures to the application guidance in paragraphs A22-A28. Please find more specific comments and drafting suggestions in the Annex to this letter.

Our comments were coordinated by our Expert Group on Financial Information (EGFI), and especially by its Subgroup on Auditing, which is chaired by Patricia Sucher, from the UK FSA.

If you have any questions regarding our comments, please feel free to contact the chairman of EGFI, Mr. Didier Elbaum from the French Autorité de Contrôle Prudentiel (+33 1 4292 5801) or Ms. Sucher (+44 20 7066 5644).

Yours sincerely

Giovanni Carosio

Annex

Comments on ISA 315

Paragraph A6d

Useful information may also be obtained by the external auditor from the independent risk control function in banks, which is responsible for identifying, assessing, monitoring, reporting and mitigating risks, including operational risks. In particular larger institutions would have a dedicated operational risk function, responsible inter alia for collecting operational risk loss data, including so called "timing losses"[1]. We suggest adding the following bullet point to paragraph A6d: *Inquiries directed to the risk control function may provide information on operational risks within the accounting procedures and on the severity and frequency of losses (including so called "timing losses") caused by accounting and valuation errors.*

Paragraph A101-103b

The requirements that relate to the external auditor obtaining an understanding of the nature of the internal audit functions responsibilities, how it fits in the entity's organisational structure, and the activities performed or to be performed should include the obligation for the external auditor to assess the existence and content of an approved internal audit charter, where one exists, to obtain knowledge of the organisational status and scope of the internal audit function. Such a charter would be approved by the Board of Directors (or equivalent). We also believe that the process to obtain knowledge of the organizational status of the internal audit function should include a requirement that the external auditor consider how management has responded to the findings and recommendations of the internal audit function.

[1]Within the CEBS Compendium of Supplementary Guidelines on implementation issues of operational risk "timing losses" are defined as follows: "Timing losses" can be defined as the negative economic impacts booked in a fiscal period, due to events impacting the cash flows (lower cash in / higher cash out) of previous fiscal periods. Timing impacts typically relate to the occurrence of operational risk events that result in the temporary distortion of an institution's financial accounts (e.g. revenue overstatement, accounting errors and mark-to-market errors). While these events do not represent a true financial impact on the institution (net impact over time is zero), if the error continues across two or more accounting periods, it may represent a material misstatement of the institution's financial statements. This in turn may result in legal censure of the institution from its counterparts, customers, supervisory authorities, etc.

Comments on ISA 610

Paragraph 14 and A6-A7

We would encourage the IAASB to expand the application material on the principle in paragraph 14, considering in particular whether there need to be specific criteria and minimum conditions when applying the concepts of objectivity and competence in practice. These would provide a threshold above which reliance could be placed on internal auditors.

The requirements that relate to determining whether the work of the internal audit function can be used by external auditors include a prohibition, stated in §14 on using the work of the internal audit function if it has either a low degree of objectivity or a low degree of competence. We believe this requirements needs to clarify the notion of low degree (§A7 of the application and other explanatory material does not expand on this notion either). We suggest setting a threshold above which reliance could be placed on the degree of objectivity and competence of the internal audit function. Such a threshold could be composed of a combination of several specific minimum criteria to be met and should be sufficiently detailed as there will always be some judgment involved. Criteria set in §A6 regarding objectivity and competence could be used as a starting point.

Also, as noted in the cover letter, we believe it would be clearer to express the requirement in paragraph 14 more directly and in the positive form.

Paragraph A6 (4th bullet) and subheading "Objectivity"

Recent supervisory regulation and guidelines based on the lessons learned of the financial crisis highlight the importance of an appropriate remuneration policy within the control functions. Therefore we recommend adding "*including appropriate remuneration policy*" to that bullet point.

In addition, under the subheading "Objectivity", it may be useful to add that an institution should also have policies in place regarding staff transferred from the business or support functions to internal audit as this may limit their independence.

Paragraph 15 and A12-A13

In determining the planned use of the work of the internal audit function paragraph 15 only focuses on the degree of objectivity and level of competence (para. 15 a), the nature and scope of the work performed (para. 15 b) and the amount of judgment involved in performing the audit procedures and evaluating the audit evidence (para. 15c).

ISA 315.4e states that the risk of material misstatements is a significant risk that requires special audit consideration. However, the draft ISA 610 does not require explicitly external auditors to take areas of significant risks into account in determining whether and to what extent the work of the internal audit function may be used. Even though often a lot of judgement is needed in auditing significant risk areas, it is possible that some significant risk areas do not involve substantial judgment.

We believe that application guidance in paragraphs A12-13 is not sufficiently strict to ensure that areas exposed to the risk of material misstatements are reviewed by the external auditor itself. Therefore we recommend requiring in para 15 (c) that the external auditor shall consider the risk of material misstatements. While work performed by the internal audit function in relation to areas of significant risk may be taken into account, we believe that there should be a requirement for the auditor to perform its own audit procedures in those areas. Such a requirement would reduce the external audit risk considerably.

Paragraphs 19 and A18 (3rd bullet)

External auditors should also evaluate the processes and systems used for tracking internal audit findings as this would be consistent with paragraph A21 where the follow up is mentioned. A new Paragraph 19 (d) could read: *Internal audit findings and related corrective actions are appropriately tracked and followed up by the internal audit function.*

A fourth bullet point under A 18 could read: *Reviewing the tracking system of internal audit findings and its follow-up by internal audit*.

Paragraph 23 and related paragraphs A23-A27,

We would not encourage direct assistance of external auditors by internal auditors, as this practice may reduce the independence and objectivity of external auditors. If at all, we strongly suggest that direct assistance should be clearly and specifically restricted to areas of low inherent audit risk and requiring no or very little judgment, to prevent the undermining of the independence of the external auditor's work. When external auditors would rely on the work of internal audit, they should evaluate and take into account the risk of material misstatements. In high risk areas and where a high level of judgement is used, external auditors should not rely on internal auditors.

We believe the standard should make a clear distinction between the external auditor relying on the work done by the internal auditor and the external auditor obtaining direct assistance from the internal auditor. For example, we believe that the guidance in application material in paragraphs A23, A25 and A26 may be too general and not helpful in guiding the external auditor. The current drafting would allow for a wide range of practices, which goes beyond the acceptable level of assistance by internal auditors. More examples and specific criteria should be added to enhance the clarity of the standard.

We also believe that the requirements concerning direct assistance should be clarified in order to provide the external auditor with a stronger framework as regards the circumstances when the external auditor can obtain direct assistance from the internal auditor and the supervision to be exercised by the external auditor over the work done by the internal auditor. This recommendation particularly applies to paragraph 23 and related application guidance in paragraph A27. Specifically, we recommend that the wording of paragraph 23 be modified in order to strengthen and clarify the requirement. We believe that the current wording, that states in the negative form that the external auditor shall not obtain direct assistance from internal auditors under circumstances (a) and (b), should instead read as "*the external auditor shall only obtain direct assistance*" under specified circumstances.

In addition, we believe that the requirements specific to direct assistance that are set in paragraphs A27-A28 do not expand sufficiently on the notion of supervision and review by the external auditor of the work done by the internal auditor. In particular, we question the need for the word "ordinarily" in paragraph A27; we would assume that supervision or review of audit procedures performed by internal auditors providing direct assistance should be more extensive than if members of the engagement team perform the work.