

June 21, 2013

To the Basel Committee on Banking Supervision

Japanese Bankers Association

Comments on BCBS's Consultative Document "External audits of banks"

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the Consultative Document "External audits of banks" published by the Basel Committee on Banking Supervision ("BCBS") on March 21, 2013.

We believe that the following comments will contribute to your further discussions in finalising the rule.

[Specific issue: Independence of the external auditor]

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

(Summary of our comment)

This paragraph 114 should be changed as follows (*The underlined portion is proposed to be added*):

- **Proposed change:** "Audit committees should have a policy in place that stipulates the frequency with which there should be a tender for the external audit contract unless they assess, among other things, the independence of the audit firm and discuss reappointment, removal and other matters related to such an audit firm at least annually. The policy should also call for the audit committee to consider periodically whether there should be a limit to the length of an external auditor's tenure as the bank's external auditor given the potential impact of audit firm rotation on independence and audit quality."

(Grounds)

- Under general practice in Japan, the Audit & Supervisory Board assesses the accounting auditor¹ for its independence and other aspects when preparing the audit report (per annum), and should there be any doubt as to such independence, etc. considers dismissal or refusal of reappointment. Further, the appointment and dismissal of the accounting auditor is resolved by the general shareholders' meeting. Therefore, a framework is in place whereby the independence of the accounting auditor and other relevant matters are assessed by stakeholders (e.g. shareholders). In this way, Japan has an established framework where the consideration of the dismissal/refusal of reappointment of the accounting auditor (which, when decided, directly leads to a tender for a new accounting auditor contract) is addressed by the Auditor & Supervisory Board and stakeholders based on the annual assessment on such an external auditor's independence, etc. Given such a framework, we consider that Japan substantially "has a policy in place that stipulates the frequency with which there should be a tender for the external audit contract."

Therefore, the Consultative Document needs to specify that those countries which require, by the applicable law or under established practice in their jurisdiction, an assessment of the independence of the accounting auditor and other related aspects on an annual basis, and should there be any doubt resulting from such assessment to consider the replacement etc. of such an accounting auditor, are not required to develop a policy that stipulates the frequency of a tender for the external audit contract.

- U.S. SEC registrants are required to develop an internal framework² (e.g. the prohibition of entering into a contract with the external auditor who is not approved by the audit committee) with the aim of maintaining/enhancing the independence of the external auditor, and the audit committee periodically and as needed assesses the independence of the external auditor. Further, the external auditor is required to certify its independence every year. In this way, the U.S. SEC registrants already have in place a framework to assess annually the independence of their external auditor, and thus it is considered

¹ For the purpose of this document, the term "accounting auditor," which is a term used under the Companies Act of Japan, is synonymous with the terms "audit firm" and "external auditor" used under paragraph 114.

² Specific examples include the U.S. SEC's requirement to establish a framework which ensures that the accounting auditor is independent of the preparer of financial statements ("independence") in order to maintain the appropriateness of financial statements, etc. in compliance with the U.S. Sarbanes-Oxley Act.

unnecessary for them to additionally develop a policy that stipulates the frequency with which there should be a tender for the external audit contract.

- The Consultative Document states that “The policy should also call for the audit committee to consider periodically whether there should be a limit to the length of an external auditor’s tenure...” BCBS is respectfully requested that it specifies in which case such a limit should be set and in which case such a limit is considered unnecessary.

Further, we are concerned that while periodic or frequent audit firm rotation may generate some benefit, it may also give rise to issues as set out below. In addition, the replacement of the external auditor is limited to such a case where there is doubt regarding its independence. We respectfully request that BCBS considers these points in finalising the rule.

<Issues associated with the audit firm rotation and a limit to the length of an external auditor’s tenure >

✓ Decreased audit efficiency and quality, and increased audit fee

Whenever a new audit firm is appointed, a preparation period will be required as they need to accumulate their knowledge and experience of the audited company. The audit of financial institutions in particular involves decisions and judgments on complex accounting treatments and other matters unique to financial institutions and thus requires a longer preparation period compared to the audit of non-financial companies. In particular in the initial audit year after replacement, there is a risk that an effective audit may not be executed as a result of which the efficiency and quality of the audit decreases and the audit fee for the audited companies increases. Further, it is a significant burden on the companies to change audit firms particularly in the case of global companies.

In addition, as the rotation period approaches, there is a concern that in practice the incumbent auditors become conscious of replacement, affecting their audit quality.

✓ Opinion shopping

In jurisdictions where the consistency of the audit firm’s opinion is highly regarded, if periodic or frequent audit firm rotation is implemented without exception, it may provide an incentive to some companies to select an audit firm which will provide an audit opinion that is more favorable for them.

✓ Shortage of external auditor candidates

Replacement is considered difficult from a practical perspective because there are a limited number of large-scale global audit firms. In the case of the U.S. SEC registrants, etc., for independence reasons, the U.S. Sarbanes-Oxley Act limits the type of engagement that a company can enter into with their auditors, consequently they engage firms other than their auditors to undertake non-audit engagements. Given this, when a company changes its auditor, it needs to revoke existing contracts with the newly appointed audit firm, causing a significant impact on the business.

✓ Countries implementing the audit firm rotation are reviewing this system and some have repealed it.

A comment letter sent to the Public Company Accounting Oversight Board (“PCAOB”) by Deloitte Touche Tohmatsu Limited (“Deloitte”)³ refers to a study result which describes that some countries which were implementing audit firm rotation have reviewed and repealed such mandatory rotation, indicating that the audit firm rotation is not necessarily beneficial.

While Japan has not adopted mandatory audit firm rotation, it requires engagement partner rotation which it considers beneficial in ensuring the independence of the external auditor.

✓ Many empirical studies on the audit firm rotation are not supportive of its effectiveness.

According to a comment letter sent to PCAOB by Deloitte⁴, 37 out of 49 empirical studies (i.e. 76%) on audit firm mandatory rotation reached conclusions that were not supportive of such audit firm rotation. This indicates that the effectiveness of mandatory rotation is deemed to be doubtful, even from an academic point of view.

³ See “Countries that adopted mandatory rotation but repealed it in whole or in part.”
(Source: http://pcaobus.org/Rules/Rulemaking/Docket037/163_Deloitte_Touche_LL.Pdf)

⁴ Empirical studies generally not supportive of mandatory rotation: Of the 49 studies we reviewed that were based on empirical data, 37 or 76 percent reached conclusions that were generally unfavorable to mandatory rotation.
(Source: http://pcaobus.org/Rules/Rulemaking/Docket037/163_Deloitte_Touche_LL.Pdf)