BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA e-mail: EDComments@ifac.org

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Re-exposure draft on the audit of group financial statements; exposure drafts on auditor communications with those charged with governance and on modifications to the opinion in the independent auditor's report/emphasis of matter and other matter paragraphs in the independent auditor's report

Dear Mr Sylph

The Basel Committee on Banking Supervision welcomes the opportunity to comment on your recent exposure drafts:

- Proposed ISA 600 *The audit of group financial statements* (revised);
- Proposed ISA 260 *The auditor's communication with those charged with governance* (revised); and,
- Proposed revised ISA 705 *Modifications to the opinion in the independent auditor's report* and ISA 706, *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*.

The Committee has a strong interest in promoting high quality international standards for audits, and believes that these re-exposure and exposure drafts include many useful proposals.

Please find our detailed comments in the three appendices attached. These comments have been prepared by the Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, and approved by the Basel Committee. The Committee trusts that you will find its comments useful and constructive.

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If you have any questions regarding our comments, please feel free to contact Prof Schilder (+31 20 524 3360), or Donna Bovolaneas at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

Jaime Caruana

Appendix One

Basel Committee comments on IAASB revised exposure draft ISA 600 (revised), *The audit of group financial statements*

1. Introduction

The Basel Committee on Banking Supervision[1] has a strong interest in high quality and independent audits of banks and has carefully analysed the revised proposals pertaining to the audit of group financial statements. We commend the IAASB for having responded to stakeholder comments on the December 2003 Exposure Draft of ISA 600 (Revised) by eliminating the divided responsibility option and further clarifying and strengthening the group auditor's responsibilities. While the balance of this appendix highlights certain issues, questions and suggestions for the Board's consideration, the Committee wishes to express its broad support for the approach taken in this revised exposure draft.

Our comments in Section 2 refer to the questions contained in the explanatory memorandum to the exposure draft. Additional specific comments are grouped under Section 3.

2. The revised exposure draft

Question 1: Is the approach to the work of other auditors practical, having regard to the elimination of the divided responsibility option?

While we understand and support the intent of the revised proposals, we note that the new ISA is written from the perspective of the group auditor. As a consequence, what is expected of the other auditor is an implied corollary to the group auditor's expectations, an approach that may not be altogether helpful for related and unrelated auditors who wish to understand their roles and responsibilities clearly and may be looking for material addressed directly to them. A more effective approach might be to assemble a complete list of such expectations in a separate section of (or appendix to) the standard and to give these references greater prominence. At the moment the key expectations for the other auditor are set out only in paragraph 98, supported by related Appendix 6 that illustrates certain assertions that would be made by the other auditor as part of formal communications with the group auditor. We believe these references capture the substance of what the other auditor would be looking for, but they need to be made more user-friendly.

We also understand and agree with the objective of removing references to "sole" and "divided" responsibility. However, we believe that the key message about "who does what" from a process point of view is not conveyed early enough in the document to be meaningful. Elements of this message are included in various definitions ("related auditor", "type of work"

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and “unrelated auditor”) but a high-level statement setting out the respective roles and responsibilities of each player does not appear until paragraph 7. Therefore, in addition to our earlier recommendation, we would urge the IAASB to move the grey-lettered sentences of paragraph 7 to the Introduction.

Strengthening the group auditor’s responsibilities is a positive step (and in line with the Committee’s comment letter of 8 April 2004 on the December 2003 Exposure Draft of ISA 600 (Revised)) but some additional checks and balances may be welcome.

For example, it may be appropriate to state that the group auditor should explain to the other auditor(s) of (a) significant component(s) how he/she arrived at conclusions on a group level, and how the group auditor took (or did not take) into account any comments made and actions recommended by the other auditor. This could be achieved by adding some wording in paragraph 62 or by introducing additional wording in the section *Communications with Another Auditor* (paragraphs 95 through 104).

A further check and balance can be created through strengthening the responsibilities of the group auditor versus those charged with governance. It is advisable that the group auditor communicate to those charged with governance any matters that have been brought to the attention of the group auditor by other auditors that the latter judge to be significant to the responsibilities of those charged with governance of the group. This approach would require some modification of paragraphs 93 and 94. Alternatively, this issue could be addressed through a cross reference to ISA 260 paragraph 16 as revised.

Finally, in addition to the various items required from another auditor under *Communications with Another Auditor* (paragraphs 95 through 104), we believe that the group auditor should be made aware of potential restrictions imposed on another auditor that would constitute a limitation of scope with respect to the audit of the component. This situation would become evident from the group auditor’s review of the other auditor’s terms of engagement and we recommend a revision to this section of ISA 600. Some conforming revisions might also be required to paragraphs 25 and/or 26 to reflect this change.

Question 2: Are the revised standards and guidance on accepting or continuing an engagement to audit group financial statements appropriate?

We would prefer an approach where the section on Acceptance and Continuance as Group Auditor (paragraphs 6 through 26) starts with a modified version of the bold lettered paragraph 11. This paragraph is about information gathering which, in our view, is the first of the several steps required to support a final decision on whether to accept or continue an engagement. An appropriate subheading should be inserted at the beginning of this discussion, similar to the structure proposed for subsequent discussions in this section of the ISA on “Access to Information” and “Terms of Engagement”.

The information-gathering process should also take into account the group’s attitude and policy towards auditing. Group management should be able to identify significant components and should also be able to explain why certain components, in particular the significant ones, are not audited by the group auditor or related auditors. Paragraph 11 should be modified to take this into account and, for example, could read as follows:

> *For purposes of determining whether to accept or continue an engagement to audit group financial statements, the group auditor should obtain an understanding of the group, its components, their environments, and the group’s auditing policy, including who audits the various components of the group and how these determinations have been made. After obtaining this*

understanding, the auditor should also be able to identify components that are likely to be significant.

Paragraph 13 would also benefit from some elaboration on the issue of the group's audit policy.

We support the need for proposed paragraphs 7 through 10 based on concerns raised by the IAASB Consultative Advisory Group ("the CAG"). However, the CAG's objective has not been fulfilled by the text of these paragraphs or by where the text has been positioned in the document. We believe that the ISA would benefit from explaining that the obligation to obtain sufficient appropriate audit evidence requires the group auditor to do what is stated in paragraph 10 and to remind him/her of this obligation in the section of the ISA about acceptance. Therefore, it would be preferable to make the third sentence of paragraph 7 (after replacing *", however, takes" with "should take"*) the introductory sentence in bold lettered paragraph 4. The same paragraph 4 should also refer to the separate work that the group auditor should do on the consolidation. Paragraph 10 then becomes a logical continuation of paragraph 4.

In summary, we would recommend moving paragraph 10 after paragraph 4 and modifying paragraph 4 to read as follows:

> *The group auditor should take responsibility for the audit opinion on the group financial statements. Therefore the group auditor should obtain sufficient appropriate audit evidence on which to base the group audit opinion. To obtain such audit evidence, the group auditor should determine (a) the audit procedures to be performed on the consolidation, and (b) the type of work to be performed by the group auditor or other auditors on the financial information of the components. The group auditor should perform the work on the consolidation.*

In addition, some thought may need to be given to reordering important related references such as paragraphs 59 through 68 to ensure that there is a complete understanding of important concepts such as "involvement" in the work of other auditors.

Furthermore, paragraphs 6 through 17 of this section of the ISA should be clarified by explicitly stating that the group auditor can accept or continue the engagement to audit group financial statements only when in a position to obtain sufficient appropriate audit evidence. This section should provide guidance in this respect by, for example, referring to paragraphs 77 through 85.

Question 3: Do the revised standards and guidance on access to information, given various laws of jurisdictions, give rise to any unnecessary foreseeable difficulty?

We observe that this issue was also raised within the CAG and wish to express our support for the important principle set out in bold lettered paragraph 18. This principle emphasises the necessity of a free flow of information between all auditors involved in the group audit.

At the same time we recognise the reality that national laws or regulations may pose limitations on either the free flow of information or the group auditor's degree of involvement in the work of another auditor, and we believe that the suggested alternative approach set out in paragraph 21 is helpful to mitigate these risks. We also agree with the consequences to the group audit opinion set out in paragraph 24, although we would recommend that the new term "pervasive" in paragraph 24 be defined in the Glossary of Terms. Please refer to our more extensive discussion of "pervasiveness" in the Appendix Three comments on the ISA 705 exposure draft.

We would also be in favour of strengthening paragraphs 105 and 106 by referring explicitly to the other auditor in bold lettered paragraph 105.

Question 4: Is the proposal to move the guidance originally contained in the proposed IAPS to the proposed ISA appropriate? (Any suggestions to the contrary would have to be accompanied by a description of an alternative, and how that alternative maintains the requirements of the proposed ISA.)

We believe this approach is appropriate.

3. Additional specific comments

Paragraph 16 sets out a presumption that any group component comprising at least 20% of a group financial statement benchmark is financially significant. Although additional qualifying language has been added that would incent auditors to take lower percentages into consideration, we do not believe this approach is appropriate. In addition to our general views about the risk that "bright lines" will be seen as substitutes for the exercise of sound audit judgment, we believe that 20% itself may be too high a threshold. Furthermore, we note that the significance of certain components such as special purpose entities would rarely be identified through application of the types of benchmarks suggested, although the language of paragraph 15 might be intended to cover such situations. Finally, paragraph 16 would be improved by adding language requiring the group auditor to document the rationale applied in selecting quantitative benchmarks.

Paragraph 34 sets out the group auditor's responsibility to determine the competence of an individual related auditor if that auditor is not already known to the group auditor. We believe that the intent is for the group auditor to make appropriate inquiries with the related audit firm about the other auditor, after having already determined that no quality control concerns exist at the other auditor's firm level, and that this firm would respond to the group auditor's inquiries. However, the language in paragraph 34 is brief and could be construed as requiring the group auditor to make these assessments personally. Therefore, we recommend that the language of paragraph 34 be amended to remove the words "working with the related auditor's firm determines" and replace these with "makes appropriate inquiries with the related auditor's firm to determine".

In isolation, the last sentence of proposed paragraph 58 could be interpreted to mean that the group auditor is able to fulfil the full requirements of paragraphs 59 through 68 by completing only the three explicit steps described in this last sentence. This interpretation would suggest that in the case of a component described in paragraph 57, the group auditor would not consider the need for three of the five types of involvement set out in paragraph 59, and in particular the review of relevant parts of the other auditor's documentation, which we see as an essential part of the group auditor's procedures. We believe that this ambiguity can be eliminated by changing the numerical reference in the last sentence of paragraph 58 to read paragraphs 61 through 68.

We believe that the discussions in paragraphs 60 and 66 are incomplete in that there is no explicit reference to the need for the group auditor to consider "independence". We recommend that in both these paragraphs ", independence," should be inserted following "professional qualifications", similar to the approach already taken in paragraphs 31 and 78.

Finally, in view of how frequently the term "material" appears in this standard, we would recommend that revised ISA 600 make explicit reference to ISA 320 (Revised) "Materiality in the Identification and Evaluation of Misstatements".

Appendix Two

Basel Committee comments on IAASB exposure draft ISA 260 (revised), *The auditor's communication with those charged with governance*

1. Introduction

The Basel Committee on Banking Supervision[1] has a strong interest in high quality and independent audits of banks and has carefully analysed the proposals in the revised ISA for the auditor's communication with those charged with governance. Although several detailed comments are set out below, the Committee wishes to express its broad support for the approach taken by the IAASB in this exposure draft. This approach will improve the general quality of audits and enhance the degree of reliance that can be placed by banking supervisors on audit opinions.

In addition to considering the Committee's views on proposed ISA 260 (Revised) that are expressed in this appendix, the IAASB may find useful some of the Committee's perspectives on sound governance systems found in our guidance on internal audit.[2]

2. General comments

As suggested in the introductory comments, our primary consideration when evaluating proposed new or enhanced auditing standards is the impact these standards are likely to have on a banking supervisor's ability to rely on audit opinions. This reliance-based approach recognises the need in the case of a regulated bank for well-defined and effective relationships among the supervisor, the auditor and those charged with governance. For this reason, we believe that the message set out in the second sentence of paragraph 6 on the importance of two-way communication should be given more emphasis in the exposure draft. We therefore suggest modifying the first sentence of paragraph 6 and moving it forward as the final sentence of bold letter paragraph 4. This modified and moved sentence would then read as follows:

> *Although this ISA focuses primarily on communications from the auditor to those charged with governance, the auditor should stress the importance to those charged with governance of effective two-way communication.*

Paragraph 6 would then begin with "Effective two-way communication assists the auditor…".

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2 See the Committee's paper on "Internal audit in banks and the supervisor's relationship with auditors", August 2001.

3. Additional specific comments

Paragraph 10 is not particularly clear and would benefit from rationalising the apparent overlaps between bullets one and three and clarifying somewhat the descriptions within bullet two.

In addition to the suggestion in paragraph 12 that the auditor use governance knowledge gained through the application of ISA 315 requirements in identifying a person or persons with whom to communicate, paragraph 13 should be revised to provide guidance on the basic criteria the auditor should apply in making this determination.

The proposed text of revised paragraph 19 appears to be an elaboration of the final thought in paragraph 17 of the existing standard. However, we are concerned that this new paragraph would, under certain conditions, explicitly permit the auditor to devolve to management the auditor's normal responsibility to communicate directly with those charged with governance on any matters set out in subparagraphs 22(c) through (e). In our view, this exception in proposed paragraph 19 could be seen to weaken the auditor's general obligations with respect to communications and may conflict with other parts of the revised standard, in particular the various directions and descriptions set out in bold lettered paragraphs 32, 43 and 46 and related explanatory paragraphs. We would recommend that more robust guidance be provided to auditors on how to determine whether the three conditions set out in the final sentence of proposed paragraph 19 have been satisfied. Alternatively, the entire paragraph could be eliminated.

We question why subparagraph 22(f), and consequently the principle set out in paragraph 49, should apply only to listed entities. As legal frameworks differ between countries, we would recommend that these references to listed entities be enhanced to reflect the potential that, depending on local laws or regulations, the auditors of non-listed entities might also be required to adhere to the same requirements pertaining to communication about auditor independence.

As the circumstances underlying the third bullet of paragraph 25 may not be present in all cases, this issue would be better addressed by combining the third bullet with the language of the first sentence of paragraph 26. This new introductory sentence would then read:

> *26. When applicable, the auditor is also responsible for communicating to those charged with governance matters required by an agreement with the entity or additional external requirements, which may provide for communicating matters broader than those identified in paragraphs 24 and 25.*

In addition to the matters already listed as significant difficulties, paragraph 36 should include a requirement to communicate the nature and extent of scope restrictions imposed by management.

Bold lettered subparagraph 33(a) makes reference to "material", corrected misstatements as well as "other" corrected misstatements. We note, however, that the term "material" does not appear in related paragraph 41 and should be added to the first sentence of that paragraph. It would also be helpful to include information in paragraph 41 on how and by whom any "other" misstatements have been corrected.

The language of bold lettered paragraph 56 would be improved by inserting the word **"other"** between **"Where"** and **"matters"** in the final bolded sentence. To emphasise the importance of documenting oral communication, we would also recommend that "be satisfied" be replaced by "ensure" later in the same sentence.

We recognise that not all communications are important enough to require written confirmations to all parties. Nevertheless, other oral communications that, in the view of the auditor, could be or could become relevant to the audit should at a minimum be documented in the audit working papers.

Paragraph 60 introduces a risk to regulatory authorities that an auditor may inappropriately withhold the prior written consent required by subparagraph 60(c) and therefore restrict a regulatory authority's access to essential information regarding a regulated entity. Therefore, we strongly recommend the removal of the second sentence of paragraph 60 and the addition of an explanatory paragraph that modifies paragraph 60(c) in instances where the disclosure is to regulatory authorities. This additional paragraph should state that those charged with governance may provide copies of a written communication from the auditor to a relevant regulatory authority after providing prior notice to the auditor of their intended action. Subparagraph 60(c) itself should be revised by adding "(other than a relevant regulatory authority)" after "a third party".

Appendix Three

Basel Committee comments on IAASB exposure drafts ISA 705, *Modifications to the opinion in the independent auditor's report* and ISA 706, *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*

1. Introduction

The Basel Committee on Banking Supervision[1] has a strong interest in high quality and independent audits of banks and has carefully analysed these two proposals. Although several comments are set out below, the Committee wishes to express its broad support for the approach taken by the IAASB in this exposure draft. Clarifying and strengthening the standards that help auditors to distinguish what form of audit report is appropriate under given conditions is an important enhancement to the general quality of audits and to the degree of reliance that can be placed by banking supervisors on audit opinions.

The balance of this appendix comprises two sections. Section 2 deals with the specific questions posed by the IAASB[2] while Section 3 provides additional detailed comments.

2. The exposure draft

Question 1: The IAASB would appreciate the views of respondents as to whether paragraph 33 of ISA 705 should be retained.

Although there is a case for deleting paragraph 33, we believe that the problem lies primarily in the language of the paragraph and that, with some improvement, the paragraph could be usefully retained. Our suggestion would be to insert the word "significant" after both instances of the word "multiple" and to replace the word "such" with "so material and pervasive to the financial statements" so that paragraph 33 would read as follows:

> *The existence of one or more significant uncertainties does not in itself result in an inability for the auditor to form an opinion. In extreme cases involving multiple significant uncertainties, the auditor may, however, conclude that the cumulative nature and possible effect of the multiple significant uncertainties are so material and pervasive to the financial statements that it is not possible to form an opinion and, accordingly, the auditor expresses a disclaimer of opinion.*

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[2] In the interest of providing a brief submission, only the summary portion of each question has been reproduced.

Question 2: The IAASB would appreciate views of respondents on whether the use of sub-headings is desirable in auditors' reports with modifications to the opinion and auditors' reports with an emphasis of matter paragraph or an other matters paragraph.

We concur with the proposed use of sub-headings in such auditors' reports because sub-headings will promote readers' understanding of these reports, for example, the relative status of emphasis of matters paragraphs and modification of opinion paragraphs. Also, sub-headings are generally helpful for purposes of organising longer and more complex documents.

Question 3: Do you believe that the use of the terms "significant uncertainty" and "material uncertainty" causes confusion? If so, why?

We observe that "significant uncertainty" is widely used in IAS/IFRS, in other accounting frameworks and in other ISAs while "material uncertainty" is used in IAS 1 and in ISA 570 (with a reference to IAS 1).

As "material uncertainty" is being used exclusively in the context of IAS 1, it may be better to retain that term but to explain its meaning in the Glossary of Terms so as to avoid confusion.

3. Additional specific comments

(a) Other comments on ISA 705

The term "pervasive" is introduced first in paragraph 9. We note that, together with "materiality", pervasiveness is an important consideration in the exercise of an auditor's professional judgment. However, while "materiality" is well defined and explained in other ISAs, "pervasiveness" is not. We would therefore recommend the development of a clear definition for this term that deals with the holistic impact of pervasive effects. This will help to distinguish "pervasive" from more focused and identifiable impacts that can be isolated to specific lines or areas of the financial statements.

Also, we wish to express our firm support for the guidance provided by paragraph 16 in view of its consistency with the views expressed previously by the Committee[3] on the need to broaden the defined scope of materiality to include disclosures.

We note that paragraph 20 generally provides helpful guidance to auditors on the appropriate steps to be taken when, after accepting an engagement, the auditor becomes aware of a management-imposed limitation on the scope of the audit that could affect the auditor's ability to issue an unqualified audit opinion. However, we have two recommendations that we believe will clarify and strengthen this guidance. First, in view of the fundamental issues and potentially serious consequences described in paragraph 20, the guidance in ISA 260 should be expanded to address the required communications with those charged with governance when management does not remove such a scope limitation. Second, we note that, under specific conditions and where permitted by law or regulation, an auditor "may consider" whether resignation from the audit is the appropriate response but is not further guided on how to reach this critical conclusion. In our view, this additional guidance is needed. Furthermore, evidence supporting the application of such guidance would be a useful clarification within the preamble to Example Report 6.

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[3] Refer to the Committee's 5 May 2005 comments to the IAASB on Proposed Revised ISA 320 *"Materiality in the Identification and Evaluation of Misstatements"*.

Paragraph 27 states the following:

> *When a disagreement with management clearly relates to specific financial statement line items, and is readily quantifiable, ... the auditor ordinarily expresses a qualified opinion.*

However, if the area of disagreement is not readily quantifiable, for example, an aspect of a disclosure note in the financial statements, it is unclear whether the same consequences would apply. Given the direct references to consideration of disclosure adequacy in paragraphs 11 and 16, we would recommend that disagreements with management about disclosure adequacy, whether “readily quantifiable” or not, also be explicitly mentioned in paragraph 27.

(b) Other comments on ISA 706

While we welcome the tightening of requirements for including an emphasis of matter paragraph in an audit report and guidance to help distinguish when such paragraphs are appropriate and when a qualified opinion should be issued, we wish to comment on certain aspects of this standard.

We believe that paragraph 10 provides more than explanatory guidance for the application of bold lettered paragraph 6 due to the inclusion of fundamental criteria that determine whether the matter should be emphasised in the audit report. Our view is supported by subsequent references in paragraphs 12 and 14 to both paragraphs 6 and 10 that imply they have equal weight. We would therefore recommend that paragraph 10 become a bold lettered paragraph using “should” in place of the present tense. Also, we note that the terms “conditions”, “criteria” and “requirements” are used interchangeably in paragraphs 6, 10, 12 and 14. We would recommend the use of the term “criteria” in these four paragraphs.

We strongly support the thrust of paragraph 9, as this guidance is critical to an auditor’s understanding of the appropriate and inappropriate use of an emphasis of matter paragraph. To ensure that the auditor’s process for dealing with significant uncertainties is sufficiently robust, we recommend that the final sentence of paragraph 14 be strengthened by substituting “evaluating” for “considering”. Also, for consistency, the word “significant” should be inserted between “more” and “uncertainties” in the first sentence of this paragraph.