



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

**VIA ELECTRONIC MAIL:**

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Mr Jim Sylph  
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Standards Board  
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USA

14 February 2007

**IAASB exposure draft ISA 260 (revised), Communication with those charged with governance, ISA 320, Materiality in planning and performing an audit, and ISA 450, Evaluation of misstatements identified during the audit**

Dear Mr Sylph

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the captioned exposure drafts. The Committee has a strong interest in high quality and independent audits of banks and has carefully analysed these proposed redrafted standards.

Please find our detailed comments in the attached appendixes. While nearly all of the Committee's comments and suggestions fall within the scope of the guidelines outlined for respondents, one recommendation concerning ISA 450 falls outside of those guidelines. We believe our recommendation would strengthen the clarity of the ISA, and we would appreciate your consideration of this suggestion. These comments have been prepared by the Committee's Accounting Task Force, chaired by Ms Sylvie Mathérat, Director of the Commission Bancaire in France, and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Ms Mathérat (+33 1 4292 6579), Marc Pickeur, who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253), or Linda Ditchkus at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized flourish at the end.

Nout Wellink



## Appendix One

### **Basel Committee comments on IAASB exposure draft ISA 260 (revised), Communication with those charged with governance**

#### **1. Introduction**

The Basel Committee on Banking Supervision<sup>1</sup> (the Committee) has a strong interest in high quality and independent audits of banks and has carefully analysed the proposed redrafted International Standard on Auditing (ISA) pertaining to communication with those charged with governance. While the remainder 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 redrafted standard. Furthermore, the Committee appreciated the publication of the supplemental mapping information, which provided explanations for decisions regarding requirements and application materials and changes to the proposed text.

#### **2. Responses to the IAASB's questions**

##### **1) Is the objective to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?**

The Committee understands that the International Auditing and Assurance Standards Board (IAASB) has revised this standard's objective in order to more clearly define the auditor's responsibilities regarding communication. The Committee believes that the objective should be more outcome oriented. In this case, the desired outcome would be for the auditor to establish a *mutual understanding* with those charged with governance, which is not explicitly mentioned in the proposed objective, though this concept is alluded to in the explanatory information. The Committee would support revising the objective as follows, which is consistent with the draft objective provided to the IAASB's Consultative Advisory Group during its May 2006 meeting:

‘The objectives of the auditor are to (a) establish a mutual understanding with those charged with governance of (i) the respective responsibilities of the auditor, those charged with governance and management in relation to the financial statement audit, and (ii) the scope and timing of the audit; (b) provide

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<sup>1</sup> The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

those charged with governance with timely observations arising from the audit that are relevant to their responsibility to oversee the financial reporting process; and (c) obtain from those charged with governance information relevant to the audit.'

The Committee also believes the objective should stand on its own, ie without the need for application or other explanatory material. Therefore, the references to paragraphs A1-A5 should be tied to the appropriate requirement paragraphs and should not be tied to the objective. Moving these references, without changing the wording of the objective might diminish an emphasis on creating a mutual understanding, further supporting the adoption of the text, which was proposed above.

Once the objective has been modified, the requirement for '**The Communication Process – Establishing the Communication Process**' should be modified to include the concept of 'two-way communication' and 'mutual understanding'. One way to approach this suggestion is to modify paragraph 16 as follows:

The auditor shall communicate with those charged with governance the form, timing, and expected general content of communication, and shall communicate expectations regarding two-way communication and the establishment of a mutual understanding.

**2) Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?**

The code of ethics is currently being revised by the International Ethics Standards Board for Accountants. The revised code extends the listed entity independence provisions to all entities of significant public interest. In order for the independence requirements of this standard to be consistent with the anticipated requirements of the revised code of ethics, paragraph 15 should apply to public interest entities in addition to being applicable to listed entities. Once this change is made, the IAASB should also modify the application information in paragraphs A26 and A27 to be consistent with this position.

### **3. Additional specific comments**

Paragraph 11 does not contain the word 'shall' and therefore is not a *requirement* in its current form. Additionally, the concepts within this paragraph do not appear to be an introductory paragraph for the materials that follow it. Therefore, we recommend that this paragraph be moved to the application material and an introduction paragraph be included for the 'Matters to be Communicated' section, as needed.

The application material for paragraph 13 (ie paragraphs A15-A18) includes information that the auditor will receive from those charged with governance and should be considered by the auditor in planning the scope of the audit. These matters are outside the scope of the requirement identified in paragraph 13, which is only about the auditor communication plans and not about receiving and responding to information from those charged with governance. One solution would be to include a requirement for the auditor to have a two way dialogue with those charged with governance and to rely upon information gained in those discussions to appropriately plan the scope of the audit. If this solution is adopted, an additional reference to paragraph A1 may be appropriate.

In paragraph 15(a) the words 'a statement' should be deleted, because the form of the communication is already included in paragraph 17.

A suggested change to paragraph 16 is included above, in the discussion about the objective.

In paragraph 17 the default form of communication should be *written* communication. To clarify this requirement, the text should include a period at the end of "when required by paragraph 15" and the next sentence should be changed to 'Significant findings from the audit should also be in writing except when, in the auditor's professional judgement, oral communication would be sufficient.' Due to this change, the order of the two sentences in paragraph 21 should be reversed (ie the sentence about written communication should be placed first and the first sentence should be put second).

While paragraph 20 is in the requirements section it does not include the word 'shall.' Additionally, this paragraph seems to clarify concepts within paragraph 19. One potential solution would be to include the two sentences in paragraph 20 as introductory material for paragraph A46.

As currently written, paragraph 21 does not include *when* matters should be communicated. To add the concept of time and to clarify the language within this requirement, the following alternative wording is proposed: '...the auditor shall document these matters and document when, how, and to whom these matters were communicated.'<sup>2</sup>

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<sup>2</sup> Also, please see the additional suggestion about paragraph 21 in the discussion about paragraph 17, above.



## Appendix Two

### **Basel Committee comments on IAASB exposure drafts ISA 320 (revised), Materiality in planning and performing an audit and ISA 450, Evaluation of misstatements identified during the audit**

#### **1. Introduction**

The Basel Committee on Banking Supervision<sup>1</sup> (the Committee) has a strong interest in high quality and independent audits of banks and has carefully analysed the proposed redrafted ISAs pertaining to materiality in planning and performing an audit and evaluation of misstatements identified during the audit of financial statements. While the remainder 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 these redrafted standards. Furthermore, the Committee appreciated the publication of the supplemental mapping information, which provided explanations for decisions regarding requirements and application materials and changes to the proposed text.

#### **2. Responses to the IAASB's questions**

##### **1) Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISAs, appropriate?**

The Committee believes that the objective for ISA 320 should be outcome oriented. Additionally, the Committee strongly believes that the objective for ISA 320 should be more clearly linked to the overall objective for the audit, as specified in ISA 200. For example, the objective for ISA 320 could refer to the overall objective of assessing the risks associated with material misstatements. Additionally, we believe the objective should stand on its own without the need for application or other explanatory material. Therefore, the reference to paragraph A2, in the objective for ISA 320, should be tied to the appropriate requirement paragraphs rather than to the objective.

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**2) Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?**

The Committee believes the content of ISA 320 paragraphs 5 and 6, which are currently included as introductory material, should be identified as requirements. Therefore, we suggest paragraph 5 be reworded as follows:

‘The concept of materiality shall be applied by the auditor both.....’

Paragraph 6 should be reworded as follows:

‘In planning the audit, the auditor shall make judgments about.....’

Once these wording changes have been made, ISA 320 paragraph 5 and the first two sentences of paragraph 6 could be moved into the requirements section before paragraph 9. The remaining sentences of paragraph 6 could be moved into the application section. Once the concept of paragraph 5 is identified as a requirement, this new requirement paragraph could reference the application material contained in paragraph A2.

### **3. Additional specific comments on ISA 320**

The concept of materiality is currently under consideration within the conceptual framework project, which is being developed through collaboration between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB). The IAASB’s proposed concept of materiality is different from the one that is currently being discussed by the IASB and FASB. Therefore, the Committee recommends that the final version of the ISA should refer to the proceedings of the IASB conceptual framework, with respect to materiality.

Footnote 3, which is a reference for paragraph 2, describes principles contained within the IASB’s existing conceptual framework. As noted above, this framework is currently being evaluated and revised, and changes have been suggested to the principle contained within footnote 3. Therefore, the IAASB should consider either deleting this reference or mentioning the work of the IASB and FASB to revise their accounting frameworks.

Paragraph 9(c) contains a reference to paragraphs A3-A10. This reference should be moved to the end of the introductory sentence in paragraph 9, because its current placing seems to indicate that the reference only relates to paragraph 9(c).

In the second line of paragraph 11, the word ‘level’ should be plural, ie ‘levels’.

To avoid creating application material for the introduction, paragraph A1 could be changed into a footnote for the introductory section.

The concept of probability is explained within paragraph A13. The Committee believes this concept should be more prominent. One way to accomplish this is to move the following sentence from paragraph A13 into paragraph A2:

‘The amount or amounts the auditor determines for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks is set to reduce to an appropriately low level the

probability that the total of uncorrected and undetected misstatements in the financial statements exceeds the materiality level or levels.’

#### **4. Additional specific comments on ISA 450**

The Committee offers one comment for consideration that is beyond the scope of the exposure draft guidelines for respondents. This relates to the evaluation of the effect of uncorrected misstatements related to prior periods. We strongly believe this comment should be considered because, in some cases, industry practice has evolved towards inappropriate approaches to establish materiality thresholds.

As mentioned in the IAASB’s *Basis for conclusions for ISA 320 (revised) and ISA 450 (Basis for conclusions)*, in paragraphs 25 through 27, industry practice, at times, relies upon one of two common approaches for quantifying materiality thresholds. One approach adopts more of a *balance sheet view* and is sometimes referred to as the ‘iron curtain method’ while the other takes more of an *income statement view* and is sometimes referred to as the ‘rollover method.’ As described in the *Basis for conclusions*, the IAASB decided not to choose between the two common methods. The Committee believes, to avoid potential material misstatements, financial statement preparers should be required to determine materiality thresholds based on *both* a balance sheet and income statement approach. One possible solution is to modify the requirement in paragraph 14 to include quantification of a misstatement based on the amount of the error originating in the current year income statement *and* quantification of the misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement year of origination. This requirement could ensure that the cumulative effect of nonmaterial misstatements in the income statement does not create a material misstatement on the balance sheet.

The Committee recommends adding the words ‘with management’ after the word ‘Communication’ in the heading before paragraph 9. This addition would clarify that this section is about communication with management and is not about communication with those charged with governance.

In paragraph 15, the word ‘all’ should be added between ‘governance’ and ‘uncorrected.’ This addition should help to clarify this requirement, which is particularly important since this paragraph is located immediately following guidance on evaluating the effect of uncorrected misstatements and the reader could assume that only material misstatements need to be communicated.

Paragraph 20(c) contains a reference to paragraph A25. This reference should be moved to the end of the introductory sentence in paragraph 20, because its current placing seems to indicate that the reference only relates to paragraph 25(c).

To be consistent with the documentation requirements of paragraph 20(c), paragraph 15 should include the words ‘and in the aggregate’ after the word ‘individually.’ Also, in paragraph 20(c) the word ‘or’ should be changed to the word ‘and’.

One final, technical suggestion is to potentially enhance readability and clarity of the standards, by establishing a threshold for maximum words within the standard’s sentences. Alternatively, a tool (eg *plain English* or *plain language* computer tools) could be used to evaluate whether the standards are written in the simplest, most straightforward way.