BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Mr Ian Ball
IFAC Chief Executive
International Federation of Accountants
535 Fifth Avenue, 26th Floor
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28 February 2003

Exposure Draft "Terms of Reference"

Dear Mr Ball,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Draft *"Proposed Terms of Reference*". The Committee has a strong interest in promoting independent high quality international standard setting for audits, and believes that the Exposure Draft includes many useful proposals.

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

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

Yours sincerely,

William J McDonough

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Mr Jim Sylph
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New York, New York 10017 USA
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28 February 2003

Exposure Drafts "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services" and "Operations Policy No 1 - Bold Type Lettering"

Dear Mr Sylph,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Drafts "*Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services*" and "*Operations Policy No 1 - Bold Type Lettering*". The Committee has a strong interest in promoting independent high quality international standard setting for audits, and believes that the Exposure Draft includes many useful proposals.

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

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

Yours sincerely,

William J McDonough

Appendix

Basel Committee Comments on IFAC and IAASB Exposure Drafts: "Proposed Terms of Reference", "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services" and "Operations Policy No 1 - Bold Type Lettering"

1. General Comments

The Basel Committee on Banking Supervision[1] has a strong interest in high quality and independent audits of banks. Adequate arrangements for the setting of international standards for auditing are therefore important for banking supervisors.

The ongoing reforms of international standard setting for auditing are based on the 2001 Report and Recommendations from the IAPC Review Task Force.

Important progress has already been made. We commend IFAC for having upgraded the IAPC to the International Auditing and Assurance Standards Board (IAASB) and for the transparent manner in which the work is undertaken, with the IAASB meetings held in public and with the agenda papers publicly available on the Internet.

The Basel Committee in 2001 carefully analysed the draft report from the IAPC Review Task Force. Of interest in this context are in particular two comments provided in the resulting comment letter. Firstly, we noted that the terms of reference for the task force's review included having IAPC remain an IFAC committee, i.e., one component of a self-regulatory regime. We therefore explained, "In our opinion, this underlines the importance of making the greatest possible use of opportunities to strengthen the independence and transparency of the standard setting process." We also, secondly, noted that no charter existed for the IAPC.

Interestingly, in its final report, the review task force expressed similar thoughts, saying the terms of reference might more appropriately be referred to as a "charter" if IAPC should become a Board.

The reforms of IAPC were developed in 2001. Since then, the need for measures enhancing public trust of audit has increased significantly. Our main comments strive for enhancing the independence of the IAASB, improving and clarifying the corporate governance arrangements for the IAASB and emphasising the particular importance of audit standards. They are the following.

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[1] 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.

- The Terms of Reference should be replaced by a Charter for IAASB and be significantly expanded, incorporating a number of the areas and issues included in the suggested Preface.
- The public interest dimension should be further emphasised in the Charter/Reference document (IAASB should not be seen as setting the standards on behalf of IFAC).
- The Charter/Reference document should also govern the IAASB's Consultative Advisory Group.
- In the conceptual structure for the standard setting (and for the handbook), audit should be the paramount area and all standards applicable to audit should be easily identifiable. The attempt to use assurance as an umbrella concept comprising audit and other assurance services will introduce ongoing confusion.

2. Terms of Reference

The ED includes a very brief Terms of Reference as the fundamental governing document for the IAASB. If read alone, the document indicates a surprising informality in IFAC's relationship to the IAASB. However, a number of issues are resolved in the suggested Preface to the International Standards. In our understanding, the Preface is a document that will be determined and issued by the IAASB. We recommend that all major governance issues should be addressed in the Terms of Reference, the Preface should only provide an overview of key aspects dealt with in the Terms of Reference, and the Terms of Reference should be included in the handbook.

Considering that the IAPC has been upgraded to "Board", we had expected that a Charter should be developed rather than Terms of Reference. We recommend that IFAC replace the Terms of Reference with a Charter as the governing document for IAASB

Considering the proposed draft Terms of Reference more in detail, we note the following.

Independence

The IAASB is an IFAC body. However, it should nevertheless be an independent standard setting body, acting in the public interest. This should be made clear in the Charter/Reference document.

Considering this, we do not think that the Charter/Reference document should say that the IAASB operates "...on behalf of the IFAC Board..." as this is likely to be perceived either as unclear or as a limitation of the public interest role.

We have also noted that the proposed Preface explains that: "IAASB members are expected to act in the common interest of the public at large <u>and the worldwide accountancy profession" (underlined here)</u>. Does that really make sense if there is a conflict of interest between this profession and the needs of users?

Objective

According to the ED, the IAASB's suggested objective is to "improve auditing and assurance standards and the quality and uniformity of practice" (underlined here), by establishing standards and publishing other papers. Even if "improving" generally is good, it is insufficient as an objective for IAASB. We therefore suggest that the objective of the IAASB should be to develop and issue high quality standards for the audit of financial statements that are acceptable to investors, auditors, governments, banking regulators, securities regulators, and other key stakeholders across the world.

Due process

The suggested Terms of Reference are not very comprehensive on what requirements for due process the IAASB should comply with. This is unsatisfactory and unnecessary. At a minimum, the reference document should make it clear that all draft standards should be published for comment during a period longer than 2 months, and that comment letters are published on the Internet unless the respondent requests confidentiality.

Voting

Dissenting opinions will, according to the proposed Terms of Reference, not be included in the exposure drafts or pronouncements. However, our experience with the IASB is that the inclusion of dissenting opinions in the EDs is very helpful when the proposals are analysed. We suggest that dissenting opinions should be included in the EDs.

The proposal also includes the use of proxy. We do not think that this is consistent with the intended standing of IAASB. Considering the possibilities to use conference calls and telephone hook up, we suggest that the use of proxy should not be allowed.

The Consultative Advisory Group

The Charter is silent on the Consultative Advisory Group (CAG). We believe that this is unsatisfactory and recommend that the existence and the key dimensions of the Consultative Advisory Group's operations should be governed by the Charter. This would include

- participation in the CAG
- functioning and purpose of the CAG
- IAASB's process for evaluating the input from the CAG
- frequency of meetings
- the chairing of the CAG's meetings

3. Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services

As explained above, we recommend that the Preface, a document to be issued by the IAASB itself, should not be used as a governing document. Rather, this should be done in the Terms of Reference or, preferably, a Charter for the IAASB. On the other hand, as you will see below, we believe that the issue of black and grey lettering should be dealt with only in the Preface and not, as suggested in the proposal, in addition be explained in an Operations Policy. Possible differences between gray and black letters are highly relevant for the reading and understanding of the standards and should be fully explained in a Preface.

Should the IAASB issue standards on behalf of IFAC?

The proposal explains that IFAC has established the IAASB to issue standards on its behalf. We believe that the meaning of this is unclear and that it may even counter the ambition that the IAASB should be - and be seen to be - an independent standard setting body.

Should the IAASB act in the interest of the profession?

As noted above (Terms of Reference), we question the statement in paragraph 5 that "IAASB members are expected to act in the common interest of the public at large <u>and the worldwide accountancy profession" (underlined here)</u>.

The override

Paragraph 14 includes an override for the auditor. "In extremely rare circumstances, a professional accountant may judge it necessary to depart from a requirement of an Engagement Standard to achieve more <u>effectively</u> the objective of the engagement" (underlined here).

An override may be necessary. We hesitate however for the suggested prerequisite, namely "effectively"? This could unnecessarily open up for deviations from the standards. We suggest that the IAASB consider a more restrictive approach, such as the use of reliable or faithful as the prerequisite. Furthermore, it may be necessary to consider a disclosure requirement when the override has been used.

Various drafting comments

In paragraph 4, the International Auditing and Assurance Standards <u>Board</u> is defined to be a standing <u>committee</u> of IFAC. We find the terminology inconsistent and suggest that the IAASB should be described as a Board established by IFAC.

In paragraph 7, IAASB meetings to <u>discuss</u> the development of standards etc are open to the public. As this can be understood to mean that meetings taking decisions are not open to the public, a minor redrafting should be done.

The content of paragraph 9 should preferably appear before the content of paragraph 8.

4. The Structure of the handbook

As explained in the Invitation to comment, the IAASB intends to restructure the Auditing and Assurance Handbook. Four different sections would be used:

- Quality control
- Audits and reviews of historic financial information
- Assurance engagements on other subject matters
- Related services

The underlying conceptual structure is however that the concept **assurance** is intended to comprise **"audit"** and **"other assurance**". This is also made clear in the diagram included in the draft Preface, where an "Assurance Framework" is intended to cover both "audit" and "other assurance engagements". IAASB's audit standards are of particular importance. They aim at global use and have to be understood easily by readers in a great number of countries, not only by the individuals that closely follows the IASB's work. We believe that the intended structure does not support this objective, as it is impractical and unclear. Already the name IAASB ("...auditing and assurance standards...") makes it clear that audit and assurance are supposed to be different approaches. Even the drafting of the ED itself shows that the term "assurance" is frequently used meaning "other assurance". In contrast, we believe that it should always be entirely clear what standards covers auditing.

The IAASB further explains that quality control should be a joint section for all services covered by the IAASB standards (audit, assurance, related services). However, there may be cases or issues where a higher ambition is needed for audit than for other services. We therefore note that having joint quality control standards for audit and other services may introduce a risk of not paying sufficient attention to those cases in the development of the standards.

Concerning drafting, we note that the word "historic" is sometimes used in association with audit, such as audit of historic financial statements or historic financial information. We believe that financial statements is a defined term and that adding the term "historic" introduces lack of clarity and not precision. Also the use of the term "historic" in "historic financial information" appears to be unwarranted. We suggest that audit should be defined in relationship to financial statements and other statutory assessments (such as the exercise of directors' duties).

5. Operations Policy No 1

The operations policy seems intended to be the IAASB's instruction to itself on how to write standards. The main purpose nevertheless seems to be to explain to readers of the standards how the standards are to be understood. Therefore, if the IAASB decides to maintain its view that so called black and grey letter paragraphs have different authority, it appears advisable to incorporate the substance of the suggested operations policy No 1 in the Preface.

We prefer, however, that international audit standards should not give different authority to black and grey letter paragraphs. Equal authority for black and grey letter paragraphs in standards is already used in international accounting standards. It would be unfortunate if the IAASB took a different view for international audit standards. A closely related aspect is that the international audit standards do not always make it evident what is a mandatory requirement in all audits, and what is required only in specific cases. We encourage the IAASB to undertake the necessary efforts to ensure that mandatory requirements are always evident.