BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via Email: EDComments@ifac.org

Mr Jim Sylph
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11 April 2003

Exposure Drafts on Audit Risk

Dear Mr Sylph,

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

- Amendments to ISA 200 "*Objectives and Principles Governing an Audit of Financial Statements";*
- *ISA XX1 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements";*
- *ISA XX2 "The Auditor's Procedures in Response to Assessed Risks"; and*
- *ISA XX3 "Audit Evidence"*

The Committee has a strong interest in promoting independent high quality international standard setting for audits, and believes that the exposure drafts include 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

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Appendix

Basel Committee Comments on IFAC and IAASB Exposure Drafts Amendments to ISA 200 "*Objective and Principles Governing an Audit of Financial Statements*", *ISA XX1 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement"*, *ISA XX2 "The Auditor's Procedures in Response to Assessed Risks"* and *ISA XX3 "Audit Evidence"*

1. General comments

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.

The Committee is pleased to note the efforts to require an enhanced understanding of the entity and appreciates that this should be a continuous, dynamic process throughout the audit. We support the proposals to require an assessment of the risks of material misstatement. This is consistent with modern supervisory approaches. The proposed requirement for the auditor to perform a more rigorous risk assessment with the linkage of identified risks of material misstatement to audit procedures should improve the quality of audits where such assessments are not already common practice. We are also pleased to see that the IAASB's proposed standards are similar to the COSO[2] framework for internal control, a framework that the Basel Committee built upon in its 1998 paper *"Framework for internal control systems in banking organisations".*

In the remainder of the note, we identify areas where we have concerns or recommendations. Our main comments include the following:

- ISA 200 and other standards should give prominent recognition to the fact that a statutory audit may necessitate additional considerations and audit work in many countries.

- The concept of assertions needs an improved explanation and a better location and we offer some suggestions as to how this might be achieved (The amendments to ISA 200).

[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.

[2] COSO - Committee of Sponsoring Organisations of the Treadway Commission.

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- It should be made clear that the understanding of the entity's internal controls is not limited to controls that the auditor intends to rely on for the audit of financial statements and is not limited to controls over financial reporting. (The ED "Understanding the Entity...").

- The standard need to be clarified concerning its mandatory provisions (The ED "Understanding the Entity...").

- Documentation should be required for identified risks that require special audit consideration and risks for which the reduction of the risks of material misstatement is not possible (The ED "Understanding the Entity...").

- More fully developed guidance on how substantive procedures and testing of controls should interact is needed. (The ED "The Auditor's Procedures...").

2. Amendments to ISA 200 "Objective and Principles Governing an Audit of Financial Statements

Broadening the scope of ISA 200

ISA 200 - "*Objective and Principles Governing an Audit of Financial Statements"* is an important component in the framework of international audit standards but its sole focus is the audit of financial statements. At the same time, the statutory scope of the audit of public or other commercial enterprises also may impose other important audit and reporting requirements on the auditor. Important examples may be the assessment of the Board's and Management's compliance with the company statutes and company law, and mandatory requirements to assess internal control even outside the area of internal controls needed for financial reporting.

We understand that international audit standards are not intended to address individual countries' specific situations. We nevertheless believe that ISA 200 and other standards should give prominent recognition to the fact that a statutory audit may well necessitate additional considerations and audit work in many countries. This could be done by adding as a new paragraph the following explanation:

"This standard deals with the objective and principles governing an audit of financial statements. In many countries, however, the mandatory scope of statutory audits goes further and may include, for example, an assessment of compliance with specified laws and regulations."

Audit risk

The standard elaborates on audit risk and defines it to comprise inherent risk, control risk and detection risk, detection risk being the risk that the auditor will not detect a material misstatement that exists in an assertion. This definition is certainly understandable from the auditor's perspective. However, for the user of the audit report, the audit risk also includes the risk that the auditor detects but fails to appropriately report a material misstatement. We believe it would be useful to explicitly include this risk.

Concept of assertions

Paragraph 23 emphasises that the responsibility for preparing and presenting the financial statements rests with the management of the entity. Paragraph 7 of the ED *"Audit Evidence"* reiterates this management responsibility and further explains this responsibility by introducing the concept of assertions. References to assertions and assertion level also appear in paragraphs 16-22 of the amendment to ISA 200, in several paragraphs of the ED *"The Auditor's Procedures in Response to Assessed Risks"* (e.g., paragraphs 40, 44, and 58), and in other existing ISAs and International Auditing Practice Statements.

We believe that the concept of assertions is fundamental to an understanding of the objective and general principles governing a financial statement audit, particularly in relation to audit risk. Accordingly, the discussion of the concept of assertions should be moved from its proposed location in paragraph 7 of the ISA on audit evidence to the amendment to ISA 200.

This could be accomplished by revising the first sentence of paragraph 23 of the amendment to read "While the auditor is responsible for forming and expressing an opinion on the financial statements, management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity in accordance with the applicable financial reporting framework." This could be followed by a new paragraph 24 (and the caption "Concept of Assertions") that draws from the text of paragraph 7 of the ISA on audit evidence, but starts with the definition of "assertions" from the Glossary of Terms in the ISAs. However, certain modifications should be made to the text of paragraph 7 for consistency with the audit risk discussion in the amendment to ISA 200. We would suggest that the introductory portion of this new paragraph 24 read as follows:

"Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements. In representing that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework, management implicitly makes the assertions identified below. The auditor assesses the risk of material misstatement at the assertion level by considering the different types of potential misstatements that may occur, and thereby designs audit procedures that are appropriate.[1]"

In addition, the footnote to this paragraph (now found in paragraph 7 of the ISA on audit evidence) describes assertions as essentially dealing with recognition and measurement. However, classification and presentation of the elements of financial statements are also critical to giving a true and fair view. We therefore recommend that the footnote be expanded to include "classification and presentation."

Other drafting suggestions

The wording of paragraph 16 should be amended to make it clear that the auditor is also concerned about misstatements that individually are not material, but which aggregate to material misstatements. We suggest that the first sentence should be replaced with the following “The auditor is concerned with material misstatements as well as misstatements that individually are not material, but which aggregate to a material misstatement. The auditor is not responsible for the detection of misstatements that are not otherwise material to the financial statements take as a whole.”

3. Exposure Draft "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" (ISA XX1)

The auditor and the entity's internal controls

The ED is in an important regard not clear, or is at least not explicit. This concerns the issue of internal controls. According to paragraph 4 of the ED, "the auditor should obtain an understanding of the entity and its environment, including its internal control". Paragraph 51 explains that internal control is designed to provide reasonable assurance about the achievements of the entity's objectives with regard to reliability of financial reporting, operations and compliance with applicable laws and regulations. However, the standard then introduces the concept of "controls relevant to the audit". Paragraph 56 emphasises that although the entity's objectives and therefore controls relate to financial reporting, operations and compliance, not all of these objectives and controls are relevant to the audit of the financial statements.

Paragraph 57 states that the controls relevant to the audit are those that are likely to prevent, or detect and correct, material misstatements of the financial statements.

Although paragraph 58 indicates that "controls relating to operations and compliance objectives" may be relevant to the audit, the ED does not satisfactorily emphasise the potential importance and relevance of these controls to the financial statement audit.

We recommend that the standard should make it clear that the understanding of the entity's internal controls required is not limited to controls that the auditor intends to rely on for the audit of financial statements and is not limited to controls over financial reporting data. Furthermore, concerning compliance controls, we recommend that the standard should express the spirit and the wording of the key paragraph of ISA 250 *Consideration of laws and regulations in audit of financial statements*. Paragraph 2 of ISA 250 makes it clear that "when planning and performing audit procedures and reporting the results.... the auditor should recognize that non compliance with laws and regulations may materially affect the financial statements."

It will often be important that the outcome of the auditor's analysis and tests of internal controls is timely reported to the management, audit committee or board as appropriate. We recommend that this aspect should be incorporated in the standard, together with a reference to paragraph 49 in ISA 400 *"Risk Assessments and Internal Control".*

Clarification of the standard's mandatory provisions

As you know, we have previously expressed our concerns about the lack of clarity as to what provisions of ISAs are actually mandatory requirements for an auditor. The ED *"Understanding the Entity..."* also has problems in this regard. In this ED, we in particular believe that the substance of paragraphs 11, 12, 13, 14 and 22 should be clearly identified as mandatory requirements by the use of "black-lettering" and/or more explicit language.

In addition, paragraph 53 explains that "obtaining an understanding *involves* evaluating the design of a control and determining whether it has been implemented." We instead recommend that the standard should explain that "obtaining an understanding *necessitates* evaluating the design…". If only black letter wording is mandatory, such a reworded sentence would also need to be in bold type.

Paragraph 54 explains that "Obtaining an understanding of an entity's controls is not *likely to be* sufficient to serve as testing the operating effectiveness of controls." We instead

recommend that the standard should explain that “Obtaining an understanding of an entity’s controls is not sufficient to serve...."

Paragraph 6 - depth of understanding

The final sentence of paragraph 6 somewhat surprisingly states that “The depth of understanding (of the entity and its environment, including its internal control) that is required by the auditor in performing the audit is ordinarily less than that possessed by management in managing the entity.” For two reasons, we do not regard this sentence as appropriate. First, the auditor should clearly have the necessary understanding of the entity for performing the audit, regardless of whether this understanding in some areas is deeper than “management's” understanding or not. Secondly, within the audit team as a whole, the specific knowledge of an entity's internal control should often be much deeper than the understanding that the entity’s top management possesses. We therefore suggest that this last sentence of paragraph 6 should be deleted.

Paragraph 8 - risk assessment procedures

The conceptual structure of the ED is to some extent circular. The required understanding of the entity and its internal control is in paragraph 4 described as a prerequisite for assessing the risks of material misstatement. Yet, in paragraph 8, risk assessment procedures are to be performed to obtain the same understanding that in paragraph 4 is required for the risk assessment. We suggest that the terminology used/explanations given are reviewed to avoid scope for confusion.

Paragraph 51 - components of internal control

The standard enumerates in paragraph 51 the five components of internal control. Four of those components are elaborated further in the standard itself, but the entity’s risk assessment process is dealt with in Appendix 2. To increase the consistency of the standard we suggest including a discussion of this internal control component in the standard itself.

Paragraphs 95 and 117 - documentation of identified risks

Paragraph 95 says “the auditor should assess the risks of material misstatement.” Paragraph 104 then states that “as part of the risk assessment as described in paragraph 95, the auditor should determine which of the risks identified are, in the auditor’s judgment, significant risks that require special audit consideration.” Paragraph 110 addresses the evaluation of controls “over those risks for which, in the auditor’s judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level.” Paragraph 117 discusses what the auditor should document, including “the controls evaluated as a result of the requirements in paragraphs 104 and 110.”

However, it does not appear from paragraph 117 that the auditor is expected to document (a) which of the risks identified are, in the auditor’s judgment, significant risks that require special audit consideration (paragraph 104) and (b) those risks for which, in the auditor’s judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level (paragraph 110). Merely documenting “the controls evaluated as a result of the requirements in paragraphs 104 and 110,” as required by paragraph 117(c), is in our view not sufficient and we recommend that the standard should require documentation as identified in (a) and (b) above.

Paragraph 107 - non-routine transactions

Paragraph 107 discusses significant non-routine transactions. The second sentence states "Non-routine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently." Paragraph 108 gives some examples of non-routine transactions. Non-routine transactions that are often of concern include those initiated by senior management at the end of a period. The first bullet point in paragraph 108 refers to management intervention. It would be useful to add a separate bullet that refers to "Accounting entries initiated by management and recorded at or around the end of an interim or annual reporting period."

In banking organisations, important risks may also be associated with routine transactions, due to the big volumes and large aggregate amounts that may be involved. Although the potential existence of these risks is suggested in a later section of the ED (see paragraph 112), we suggest that the standard should also draw auditors' attention to the possibility that risks associated with routine transactions may necessitate special audit consideration.

Appendix 1: Understanding the Entity and Its Environment

In Appendix 1 and 3 on Understanding the Entity and Its Environment, the lists of financial reporting examples (on pages 33 and 43) do not explicitly include "critical accounting estimates."

Given the importance of understanding the entity's corporate governance and its functioning, it may also be useful to include in the final sentence of the preamble of Appendix 1 a reference to the corporate governance element of the control environment that is included in Appendix 2.

Appendix 2: Internal Control Components

Paragraph 6 - risks relevant to financial reporting

The list of circumstances in paragraph 6 does not list the risk of business combinations where the integration of the information systems and accounting policies used by the acquired entity has not been completed. The acquired business may have separate and different information systems that are not compatible with those of the acquiring entity, which may adversely affect the consolidated entity's ability to report financial data. In addition, the accounting policies (including valuation methods) of the acquired business may differ from those of the acquiring company and may lead to inconsistencies in the recognition and measurement of revenues, expenses, assets, and liabilities.

Paragraph 7 - risk assessment in small entities

The first sentence of paragraph 7 states that the "risk assessment process is likely to be less formal and less structured in small entities than in larger ones." It might be appropriate to add a new sentence after the first sentence that states that "Furthermore, the risk assessment process in small entities may not fully identify and consider all of the risks to which the entity is exposed."

Paragraph 21 - monitoring in small entities

An example of how these monitoring activities are conducted as part of the overall management at small entities may be useful to auditors and other readers of the standard. A new second sentence could be added that states "These activities may consist of a

comprehensive set of independent reviews of significant internal controls where the persons performing the reviews are not also responsible for managing or operating the controls."

Appendix 3: Conditions and events that may indicate risks of material misstatements

Appendix 3 would benefit from adding two additional items: the market's or analysts' expectations, and performance or share price related compensation for management (cf. paragraph 47).

Other drafting suggestions

The document is organised so that the issue of understanding the entity is dealt with after the issue of risk assessment. This obfuscates the logical relationship and flow between those two steps. Certainly the risk assessment cannot be done before a certain understanding has been obtained. We therefore suggest that the order of appearance should be changed between the section "Understanding the entity and its environment" and the section "Risk assessment procedures".

The bold type sentence in paragraph 82 is unclear. A possible alternative could be that "The auditor should understand how the entity defines and co-ordinates financial reporting roles and responsibilities and how significant matters relating to financial reporting are communicated within the entity."

The term "environment" is not defined in the ED, but appears to be used to partly cover "soft" aspects of the entity and partly to cover factors external to the entity. You may wish to consider using the term only with this latter meaning.

4. Exposure Draft "The Auditor's Procedures in Response to Assessed Risks" (ISA XX2)

Tests of controls versus substantive procedures

We believe that more fully developed guidance on how substantive procedures and testing of controls should interact is needed. (See, for example, paragraph 23.) "Substantive procedures" as defined by IAASB do not only comprise tests of details of transactions and balances, but also analytical procedures. The very nature of analytical procedures (analysis of significant ratios and trends including investigation of fluctuations and relationships that are inconsistent with other relevant information) is worthwhile to keep in mind. In some cases the logical relationships, for example, between an asset and its income, will provide valuable audit evidence. In other cases, however, analytical procedures will only be able to provide limited support, if any.

In this context, we also wish to encourage the IAASB to consider adding a project to enhance ISA 520 "Analytical Procedures" to its work programme. Such a project could provide guidance on how to design substantive analytical procedures for different types of accounts and assertions and to clearly articulate how relevant auditing concepts influence the design and performance of analytical procedures.

5. Exposure Draft "Audit Evidence" (ISA XX3)

The concept of assertions

As discussed above in our comments on the amendment to ISA 200, we believe that paragraph 7 on the concept of assertions should be moved from this ISA to ISA 200 because the concept of assertions is fundamental to an understanding of the objective and general principles governing a financial statement audit. Once paragraph 7 has been moved, the first reference to the term "assertions" in this ISA would appear in paragraph 8. It would therefore be useful to add a sentence to paragraph 8 that references ISA 200 for guidance on the concept of assertions. Alternatively, such a sentence could be added to the Introduction to this ISA.

Types of audit procedures

Paragraphs 22-36 describe various types of audit procedures an auditor may use. This listing should be expanded to include re-estimation, i.e., the process by which the auditor uses its own approach (e.g., model) to compute a value, compares this to the value calculated by the entity, tries to understand the reason(s) for the difference, if any, and decides whether additional audit procedures are necessary.

Other drafting suggestions

"Audit evidence" is defined in paragraph 3 as all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based. We recommend that the definition should include a formal requirement for documentation and say “all of the documented information”.

6. Conforming changes

The IAASB’s explanatory memorandum to the exposure drafts identifies various ISAs that may need significant conforming changes. We note that International Auditing Practice Statement 1006 Audits of Financial Statements of Banks also needs to be reviewed for changes necessitated by the various proposals included in this consultation.

7. Answers to IAASB’s questions

Question: Are there special audit considerations [for the audit of small entities] in applying the standards and guidance contained in proposed ISA XX1 “ Understanding the Entity...”, and proposed ISA XX2 “The Auditor’s Procedures...”?

Answer: We believe that the standards are equally applicable for the audit of small entities, even if the application of the standards needs to be tailored by the auditor to the individual circumstances. See also our comments above relating to paragraphs 7 and 21 of the ED “Understanding the Entity...”.

Question: ISA XX1 “Understanding the Entity...” contains additional guidance that deals with internal control including the requirement to obtain an understanding of the components of internal control: is this additional guidance helpful?

Answer: Yes. Please see our discussion above.

Question: Where the auditor plans to rely on controls that have not changed since they were last tested, paragraph 38 of ISA XX2 “Auditor’s Procedures...” requires the auditor to test the

operating effectiveness of such controls at least every third audit. Is it appropriate for the ISA to specify a time period, and if so, is every third audit an appropriate limit? If not, please indicate what time period, if any, is considered more appropriate.

Answer: Both an entity and its auditor will wish to ensure that audit resources are used in the most cost effective way possible. Therefore - under certain conditions - it may be appropriate to draw upon work done during the audit of the previous year.

The wording of paragraph 38 is however ambiguous and could lead to the auditor applying 'cycle testing' inappropriately. For example, paragraphs 38 and 39 could be interpreted as requiring the auditor to only have to test the operating effectiveness of one third of the controls, other than significant controls, each year.

We believe that in most cases (i.e. except for the fully automated controls example described in paragraph 36) the auditor should be required to test the operating effectiveness of a control each year in which he or she intends to rely on that control. In our view, where reliance is to be placed on a control, this reliance should not be supported by audit procedures performed in prior audits unless there is reliable evidence (e.g. an automated change control process) that the control has not changed. Where the control is identified as a key control and substantive audit procedures will be reduced as a result, we believe that the testing of the operating effectiveness of the control should be performed each year.

In the very limited circumstances where there are fully automated controls and there are also computer generated logs confirming that the software has not been changed since the prior year, it would be acceptable in our view for the auditor to test routine programs at least every third year. We agree that where a control is not required to be tested each year it is important that a time frame is provided such that the auditor's reliance is not indefinite. A time frame of at least every third year appears suitable to us, subject to consideration by the auditor of the factors identified in paragraph 38 each year.

Question: Is it appropriate for the IAASB to establish detailed documentation requirements as set out in ISA XX1 and ISA XX2? Are the proposals practical?

Answer: Yes. See our recommendations above for further enhancing the documentation-requirements in the draft standards.