



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA E-MAIL : EDComments@ifac.org

Mr Jim Sylph
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Exposure Drafts on Clarity and Documentation

Dear Mr Sylph,

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

- Proposed Policy Statement *"Clarifying Professional Requirements in International Standards Issued by the IAASB"* and IAASB Consultation Paper *"Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements"* and
- Proposed Revised ISA 230 *"Audit Documentation"*.

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

Please find our detailed comments in the two 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.

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

Basel Committee Comments on IAASB Exposure Draft:

“Proposed Policy Statement, Clarifying Professional Requirements in International Standards Issued by the IAASB” and IAASB Consultation Paper “Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements”

1. Introduction

The Basel Committee on Banking Supervision ¹ has a strong interest in high quality and independent audits of banks. Adequate arrangements for the drafting of international standards for auditing ensuring that they are understandable, clear and capable of consistent application are therefore important for banking supervisors.

Our comments refer to the questions contained in the explanatory memorandum to the exposure draft and in the consultation paper.

2. The Exposure Draft (ED)

Equal authority

1. Do respondents agree with the view of the IAASB, or would a statement of “equal authority” assist in clarifying the responsibilities of the professional accountant?

We agree that a statement of ‘equal authority’ on its own does not clarify the responsibilities of the professional accountant. Furthermore, it would be difficult to have a statement of ‘equal authority’ when the standards use ‘shall’ and ‘should’, which may be seen as a hierarchy of requirements. The arguments in the ED are not fully explored and could be better exposed. We believe that some wording is needed which states unequivocally that all aspects of a standard need to be considered in performing an audit. The Board may wish to consider whether the proposed wording in paragraphs 2, 4 and 8 is sufficiently clear and imperative.

Categories of professional requirements

2. Do respondents agree with the proposed categories of professional requirements and the related obligations they would impose on professional accountants? Please state the reasons in support for your response.

Each auditing standard should provide sufficient detail and structure to be applied on a consistent basis. Clear and consistent use of language is therefore very important. We are aware that the proposed categorisations are also used in standards of the US PCAOB and

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.

we understand that convergence may be an issue. However we do have some concerns as follows.

It is not absolutely clear what will be the basis for deciding whether a requirement is a “shall” or a “should”. It is stated in paragraph 4 that these verbs relate to professional requirements. However, it is not clear how these professional requirements are identified and what criteria are used to establish what is a “shall” and what is a “should”. It could be presumed that “shall” refers to the “principles” of the standard and “should” to an essential procedure following from the principle. However, we see some indications in the ED that the “shall” is considered to be a general procedure for all circumstances and “should” as a more specific procedure which may not be applicable in all circumstances. Given this ambiguity, we urge the Board to define the two verbs in the glossary detailing not only what they mean in terms of requirements but also what they represent (i.e. principles or rules).

Non-native English speakers argue that the sole difference between both types of requirements is that a departure from a “presumptive requirement” is acceptable in rare circumstances. They wonder whether this difference justifies the use of two words (see also question 6). In this respect, it may be good to recall that international financial reporting standards consistently use “shall”.

We have an additional concern. In the standards there is extensive use of the phrase, “the auditor should consider”. The status of “should consider” with regard to documentation is unclear. In paragraph 4, it is stated that a “should consider” means that consideration is presumptively mandatory, but the action or procedure is not. It is important that these points be clarified with respect to documentation requirements.

3. Do respondents believe that the proposals will improve the quality and consistency of audits? Please state the reasons in support for your response.

See comments in response to question 2 above.

4. Do respondents agree with the proposed requirement for the professional accountant, when departing from a presumptive requirement, to document why the professional accountant decided to depart, and how the alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the presumptive requirement? Please state the reasons in support for your response.

Documenting why an auditor has not followed a presumptive requirement is a good discipline for the professional accountant. This element ensures that the auditor has covered the procedural requirement involved and, if not, provides explicit reasons why not. It also presents a clear record for others in the audit firm and public oversight boards of the audit work done. We therefore support the proposed approach of documenting any departures, but, we also refer to our comment about the documentation requirements of “should consider” above (question2).

Some consideration needs to be given to how these documentation requirements will fit with those set out in ISA 230 on audit documentation. In particular, if there is not a requirement to document performance of a procedure, but a requirement to document why the procedure has not been followed, this would lead to lack of consistency within the standards.

5. Do respondents agree with the applicability of the proposed documentation requirement to departures from existing International Standards before they are revised? Please state the reasons in support for your response.

This would seem reasonable.

However we have a concern as in some of the current standards, “should” is used in footnotes and grey type lettered paragraphs, and in some of the older standards it is unlikely that “should” would have been drafted with the view that it is to be considered “presumptively

mandatory”². It is more likely that they would be mandatory. Therefore, we reiterate our concern about the need to define the two verbs in the glossary detailing not only what they mean in terms of requirements but also what they represent (question 2).

6. Will the proposed terms “shall” and “should” result in translation difficulties? The IAASB had considered the word “must” as an alternative to “shall” – would this alternative resolve any identified translation difficulties?

Non-native English speaking members fear an additional complexity in the translation process and are not convinced that the additional translation burden will be outweighed by the additional benefits. They also believe that non-native English speakers do not understand “should” as a “presumptive requirement”³. Some argue that “must” as an alternative to “shall” may be clearer but will not resolve the translation difficulty, as the more difficult term to translate is “should”, not “shall”.

7. Does the anticipated increase in the number of bold type requirements that may arise by adopting the proposals raise concern over the specificity and level at which professional requirements are set? Please state the reasons in support for your response.

As the bold and grey lettered paragraphs are implicitly of equal status, there should not be such a change in the specificity and level at which professional requirements are set. However, the latest standards do have more current tense requirements (e.g. ISA 315) and therefore, under the clarity project, these will now explicitly become more specific requirements in the standards. However, the increase in number of requirements arises from the more complex situations which the standards are covering (e.g. audit risk) and the way these standards have been drafted.

On balance, we believe that more bold type requirements would not raise concern over the specificity and level at which professional requirements are set.

Bold type

8. Do respondents agree with the decision of the IAASB to retain the bold type convention?

Yes, as it aids readability of the standards by providing a structure where the key requirements of the standard are in bold and the more descriptive material is in grey. Furthermore, the same drafting convention applies to international financial reporting standards.

Implementation

9. Do respondents agree that the IAASB should apply the proposals on a prospective basis? Please state the reasons in support for your response.

As regulators we are keen to have clear and consistent audit standards to aid the quality of the audit. We would therefore favour exposing a complete package of revised standards at a single point in time. However, we understand that redrafting all standards would not be practicable as it would consume a significant amount of time and effort and would require existing projects to be put on hold.

² A good example may be ISA 520 on analytical procedures, paragraph 2.

³ See for example Longman English Grammar where on a scale which reflects a degree of choice, “should” is at the lowest level of advisability and “must” at the highest level of necessity with different modal verbs in between, including “ought to”, “had better”, “is to”, “need to”, “have to” and “have got to”.

The prospective approach will undeniably increase confusion during a transitional period when standards would exist in both the existing and new style of drafting. We strongly encourage the Board to launch a new and identifiable project that would ensure a redrafting of all existing standards under the proposed drafting convention, within a reasonable period of time and starting with key standards like “Audit Risk” and “Fraud”.

The Consultation Paper

1. Has the length and style of these standards aided or impaired their understandability and clarity? Please explain the reasons that are persuasive in reaching your view and provide examples that help illustrate your view.

In general, regulators are supportive of longer and more detailed standards as they provide for a tighter regulatory environment and consistent application. Regulators also favor requirements with overarching principles.

2. If there is concern over the length of the standards, please also explain what is viewed as being problematic – the amount of explanatory guidance provided, scope of matters addressed or other aspects of the standards. How do respondents consider such matters might be resolved?

See comments in response to question 1 above.

3. Has the degree of detail provided in the standards aided or hindered their adoption or implementation? Please provide specific details of the circumstances that have arisen as a result of the style in which ISAs are written.

We cannot provide examples where the detail provided in the standards has hindered their application. We consider the explanatory guidance as helpful in clarifying the scope and application of the Standards. We believe that the arguments in support for the present style are more convincing (paragraph 15) than the concerns (paragraph 14).

4. Are there other options for improvement in standards that should be considered by the IAASB?

The Board could consider following the approach of the IASB in their latest IFRSs: presenting an introduction to the standard, application guidance and the basis for conclusions. This could aid readability, clarity and application of the standards. The key principles, the explanatory guidance and the framing of the issues could be separately explored.

5. Do respondents believe that the IAASB should continue with its present style of ISAs, or is there a need for ISAs to be restructured? What are the reasons that are persuasive in reaching your view?

In general, the Committee has no strong feelings about restructuring the standards.

6. If ISAs are to be restructured, which option should be pursued and why? Are there other options that the IAASB should consider, particularly in helping with the ability for auditors of both large and small and medium-sized entities to implement ISAs?

If the Board prefers to restructure the standards, the Committee sees some merit in option B, because this option may facilitate the incorporation of the standards into legislation in some countries. However, the Committee is not sure that the benefits of restructuring will compensate for the additional burden incurred in restructuring all standards.

See also our response to question 4.

7. Notwithstanding the decisions of the IAASB regarding the proposed Policy Statement (see accompanying Exposure Draft), in the event there is strong support for restructuring of ISAs, do respondents agree that any such restructuring should be applied on a prospective basis ? Or should restructuring be applied prospectively, but on a priority basis first for a limited number of ISAs that have attracted concerns about their length and complexity, namely the IAASB's recently issued audit risk and fraud ISAs? If so, what are the reasons that are persuasive in reaching your view?

Please refer to our earlier response to question 9 on the Exposure Draft.

Fundamental Principles

8. Do respondents believe that identifying “fundamental principles underlying an ISA audit” would aid in communicating the principles that underlie the professional requirements in ISAs and ultimately help drive the auditor's professional judgement? Please give reasons for your answer

We would welcome such an approach as:

- a) It would highlight such principles and emphasise the key role of professional judgement in an audit.
- b) It would provide a hierarchy and framework for international auditing which would further aid clarity and consistency in the following way:
 - i) There would be a hierarchy of auditing statements with the principles as the key overarching objectives of an audit, followed by standards at a lower level and practice statements at the next level. Therefore it would be clear that the principles are key and that the standards should serve the principles.
 - ii) The provision of a framework would ensure that any areas that are not currently covered by ISAs are covered by the principles laid out in the statement of principles.

However, we believe that there needs to be some clarity about how these principles should be derived: they should start from “what is the purpose of the audit” – at a public interest level – and then progress to what the principles of such an audit might be and then what standards are necessary to follow these principles.

9. Should the establishment of such principles be considered a high, medium, or low priority of the IAASB for the immediate future?

Given our response to question 8 above, we would regard this as a high to medium priority, although we would not want it to slow down the major thrust of the clarity project.

10. Do respondents consider the proposed fundamental principles to be complete and appropriate, and do respondents believe the method by which they have been derived to be appropriate? If not, what matters do respondents believe should be considered in development of the fundamental principles?

Though the proposed fundamental principles are appropriate to some extent, they are a mix of operating procedures and principles of professional behaviour which makes it unclear whether they are all of the same equivalent status. Fundamentally, they also do not address the objective of an audit, which should drive the principles that follow. There needs to be a clearer linkage back to the objectives of an audit such that the hierarchy of principles is clear. An analogy could be made with the IASB Framework where there are objectives of financial statements, qualities of such which follow from the objectives and then elements of the financial statements which follow from the qualities of financial statements.

11. Do respondents believe that the fundamental principles should be expanded to serve as a basis for all assurance engagements?

It would seem more appropriate to focus on audit for the moment where there is much more concern given recent events.

12. Do respondents agree with the proposed authority to be afforded the fundamental principles?

No. The framework or set of fundamental principles should be positioned within a separate document with sufficient authority, e.g. a document of a higher authority than a standard.

Practice Statements

13. Do respondents believe the present description of the authority of Practice Statements to be clear and understandable? If so, do respondents agree with the authority that is afforded them? If not, what should be the authority of Practice Statements?

We have some doubts as to maintaining Practice Statements which deal with particular issues such as derivatives. It has already been argued that the derivatives Practice Statement should be incorporated in the standard that deals with auditing of fair values. The Practice Statements that provide detailed guidance on IT and those that seek to interpret the application of standards across groups of auditors are useful. However, there is a difference between providing guidance and interpreting the application of standards. The Board should explore this difference further.

Approval of a Practice Statement by simple majority could be sufficient.

14. Given the existing authority of Practice Statements and their use in providing additional guidance to International Standards, should the IAASB change the style in which Practice Statements are written? To the extent they are derived from professional requirements contained in an international Standard, should Practice Statements enunciate requirements?

It would seem most coherent to have the Practice Statements follow the same approach as the standards in their use of "shall" and "should" if that is the route taken.

15. Taking account of the options identified above, what future role should the IAASB consider for Practice Statements? Are there other options that the IAASB should consider? Please explain why a particular option is being suggested and how it might be of benefit.

See the response to question 13 above. Although this does not relate explicitly to the current question, we believe that more emphasis should be put on clarifying the IFAC Code of Ethics as ethical issues have a significant impact on the quality of the audit.

Appendix

Basel Committee Comments on IAASB Exposure Draft

ISA 230 (Revised) “Audit Documentation”

1. Introduction

The Basel Committee on Banking Supervision⁴ has a strong interest in high quality and independent audits of banks and has carefully analysed the proposals. Rigorous and consistent arrangements for the documentation of an audit contribute to audit quality and are therefore important for banking supervisors.

Our comments in section 2 refer to the questions contained in the explanatory memorandum to the exposure draft. Additional general comments are grouped in section 3 of this note and additional specific comments are presented in section 4.

2. The Exposure Draft (ED)

Question 1: What are respondents’ views on the appropriateness of specifying a time period in the ISA for the auditor to complete the assembling of the final audit file?

There are two possible alternatives. ISA 230 could specify a time period for the auditor to complete the assembling of the final audit file, the approach chosen in the Exposure Draft, or ISA 230 could introduce the principle of a time period and allow the exact duration of the time period to be defined by the appropriate body in each national jurisdiction. The second alternative may cause problems on international audits, though it would be in line with a principles based standard. On balance, as long as it is emphasised that the specification of the time period is guidance, rather than a rule, and the principle of completing the assembly of the file in a timely manner is also emphasised, the Committee prefers the approach taken by the IAASB.

Question 2: Do respondents agree that 60 days from the date of the auditor’s report represents a reasonable time limit for such a period? If not, please indicate what time period would be considered more appropriate and why.

In the Committee’s opinion a period shorter than 60 days (e.g. between 30 and 45 days) from the date of the auditor’s report seems appropriate as it should be used primarily for “assembling and completing” the audit files and for organising these files in a manner that facilitates understanding of the audit opinion. Neither the exposure draft nor the Explanatory Memorandum clearly explains why 60 days is the necessary period. The proposed wording of the Exposure Draft would be clearer if the process of “assembling and completing” could be emphasised in the Standard as suggested under Section 4 of this note. Furthermore, there may be some ambiguity if the “date of the auditor’s report” is identified as the starting point for the assembly and completion period. The Committee suggests that the date at which the auditor’s report is released would be more suitable for this purpose.

⁴ 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.

3. Additional general comments

Explanatory Memorandum

As indicated in the Explanatory Memorandum, the IAASB also considered Auditing Standard No. 3, "Audit Documentation," issued in June 2004 by the U.S. Public Company Accounting Oversight Board ("PCAOB"). In order to understand the IAASB's proposals for the revised Standard, it would be useful to explain the choices made by the IAASB in an Explanatory Memorandum. (This possibility was also mentioned during the IAASB's September 2004 meeting.)

The documentation requirements of ISA 230 and references to what is included in the documentation sections of other ISAs.

To ensure a coherent approach in the ISAs, there should be a clearer link between the requirements of the documentation ISA and the specific documentation requirements in the individual ISAs.

4. Additional specific comments

Nature and Purposes of Audit Documentation (paragraphs 4 to 6)

Paragraph 4 of the ISA appears to be missing "planning" although it is included in paragraph 5(a) and it is indirectly included in paragraph 7(a) in the nature, timing and extent of audit procedures. It would be preferable to explicitly include documentation of audit planning in paragraph 4 to emphasise its importance.

The proposed standard would be stronger and clearer if paragraph 5 (c) were revised to state that the purpose of audit documentation includes "Clearly demonstrating that the work was in fact performed". The new ISA would further benefit from an additional sentence indicating that the documentation requirement applies to the work of all those who participate in the engagement as well as to the work of experts that the auditor uses.

Form, Content and Extent of Audit Documentation (paragraphs 7-16)

Paragraph 11 would be clearer if the second sentence were separated and put in a new paragraph and would include the word 'retain'. The new sentence would read: "The documentation of such audit evidence, however, does not imply that the auditor needs to retain information that is incorrect or superseded".

The Committee suggests adding a new paragraph following paragraph 10 that should require that the auditor identify all significant matters or findings in an engagement completion document. The discipline of preparing a completion document can ensure that no significant matters or findings are overlooked and can improve the quality of the audit by ensuring these matters are fully articulated. It would also assist in the engagement quality control review under ISA 220.

Changes Resulting from the Process of Assembling and Completing the Audit File (paragraphs 18 and 19)

Paragraph 17 deals with events after the date of the auditor's report that may lead to the need for the auditor to reach new conclusions, and the resulting changes to the audit documentation. Paragraph 18 then describes how changes resulting from the process of assembling and completing the audit file should be dealt with. The juxtaposition of the two paragraphs is confusing as it could be read that assembling and completing the file (in

paragraph 18) is covered by the principles relating to changes to audit documentation after the date of the auditor's report (in paragraph 17).

The Committee suggests two modifications to remedy the situation.

First, it would be better to put the issue dealt with in paragraphs 18 and 19 after paragraph 16 as the last section under the heading 'Form, Content and Extent of Audit Documentation', as it is the logical last step in preparing and finalizing the audit documentation.

Second, adding a principle would make the issue clearer. This principle could be along the lines of paragraph 19.

Also, the use of the word 'changes' in the context of assembling and completing the audit file in paragraph 18 is not considered appropriate. Users of financial statements may question the quality of an audit if they believe that the auditors are allowed to change the audit file that supports the audit opinion during the process of assembling and completing the file. This may give rise to a potential reputation problem and would cause concern to the regulators. The use of the term 'changes' should be limited to the two remaining cases dealt with in paragraph 17: the performance of new audit procedures or new conclusions reached.

The same concern exists with respect to the use of the word 'deleting' in paragraph 18.

Therefore, the Committee suggests that the following new heading and new paragraphs 17 and 18, which would replace paragraphs 18 and 19 of the Exposure Draft, be placed at the end of the section on 'Form, Content and Extent of Audit Documentation', and that paragraph 17 of the Exposure Draft be renumbered as paragraph 19:

"The Process of Assembling and Completing the Audit File

17. The auditor assembles a complete and final audit file without undue delay after the date of the auditor's report. The date on which the assembling of the audit file is finally completed is ordinarily not more than XX days after the date of the auditor's report.

18. Assembling a complete and final audit file includes, for example:

- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the audit team prior to the date of the auditor's report.
- Performing routine file-assembling procedures such as discarding superseded documentation, and sorting, collating and cross-referencing final working papers.
- Signing off on file completion checklists prior to completing and archiving the audit file."