



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA e-mail: EDComments@ifac.org

Mr Jim Sylph
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5 May 2005

Exposure Drafts on Materiality and Auditing Estimates

Dear Mr Sylph

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

- Proposed Revised ISA 320 *"Materiality in the Identification and Evaluation of Misstatements"* and
- Proposed Revised ISA 540 *"Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosure)"*.

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 One

Basel Committee Comments on IAASB Exposure Draft ISA 320 (Revised) “Materiality in the Identification and Evaluation of Misstatements”

1. Introduction

The Basel Committee on Banking Supervision¹ has a strong interest in high quality and independent audits of banks and has carefully analysed the above proposal.

The Committee is pleased to note that the Board intends to expand guidance on materiality in the identification and evaluation of misstatements and welcomes the Board’s initiative to provide updated and expanded guidance on this important subject.

We have one general question about any conforming amendments required for other standards. As the focus on materiality has moved away from a large emphasis on audit risk, we would have expected to see various conforming amendments related to planning, the objectives of the audit and communication with those charged with governance. We believe that the Board should examine the need for such amendments.

In the remainder of the note, we identify those areas where we have specific concerns or recommendations.

2. General observations

As banking supervisors, we appreciate the efforts of the Board to converge definitions used in ISAs with definitions in IASs in areas where this is practical. However, while we believe that the proposal to adopt the IAS 1 definition of materiality is helpful, it is not necessarily complete. In our view, materiality is equally important for items that are or should be disclosed in addition to “omissions or misstatements of items”. Furthermore, we believe the new Standard should also emphasise the importance of materiality for disclosures as these are increasingly important for understanding financial statements.

At the same time, we note that paragraph 7 on using local definitions of materiality could raise separate issues and challenges for auditors. We are aware that there are differences of view on this matter but would encourage further discussion and research in the interest of identifying an approach that can be more broadly supported.

Paragraphs 8 and 9 of the Standard are also problematic.

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.

Paragraph 8b addresses the need for users of financial statements to understand the relationship between the level of materiality and the cost and timing of the audit. We are not sure that this statement, which implies the costs of audit place a limit on materiality, necessarily conveys exactly what is intended. We believe that the point of paragraph 8b is to emphasise that the audit can provide only reasonable, not absolute, assurance as the latter is not economically feasible.

Also, as currently drafted, paragraph 8c asks users to recognise the uncertainties inherent in the measurement of certain items. This appears to be inconsistent with paragraph 16 which notes that materiality is determined without regard to the degree of uncertainty associated with the measurement of particular items. Paragraph 16, however, is a helpful addition to the Standard and should remain.

Furthermore, we are not convinced of the reasoning set out paragraph 9, in particular that the collective needs of investors as a group form an appropriate frame of reference for determining materiality.

Taken together, we wonder whether paragraphs 8 and 9 are really essential to the Standard. Our preference would be to delete these paragraphs in their entirety. However, if they must remain, we would strongly recommend amending these paragraphs in line with the comments made above.

We have previously noted the need for the IAASB to revise IAPS 1006 “Audits of the Financial Statement of Banks” so as to bring this Practice Statement into line with new developments in internal control. In this regard, paragraphs 13 to 16 of the Standard state that the auditor often applies a percentage to a chosen benchmark to determine what is material and, as explained at the end of paragraph 13, the auditor has regard to the industry in which the entity operates when identifying an appropriate benchmark. In this context, we suggest that the illustrative quantitative examples set out in paragraph 14 should be adapted, as appropriate, for incorporation into practice statements such as IAPS 1006. In this regard, IAPS 1006 would specially emphasise the importance of equity for benchmarking purposes.

Finally, bold lettered paragraph 39 very usefully brings in the principle of requiring the auditor to consider uncorrected misstatements together with the 'qualitative aspects of the entity's accounting practices'. However, given the importance of the 'qualitative aspects of the entity's accounting practices', we would have expected it to be given more prominence in the standard, for example by placing it at the beginning of the Standard as well. We would therefore recommend that the Board consider this amendment. We would also appreciate more information about how this consideration of the qualitative aspects of the entity's accounting practices relates to ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement”, in particular paragraphs 109 and 112.

3. Other comments

Paragraph 16 indicates that materiality should not be determined with respect to the extent of uncertainty attached to given estimates. However, the paragraph would benefit from additional language to deal with special considerations for auditors where the financial statements contain a number of estimates.

Paragraph 31 relates to misstatements and, within the category of “known misstatements”, makes a distinction between “misstatements of facts” and “misstatements involving subjective decisions”. We do not question this difference. However, we would suggest dropping the words “*misinterpretation of facts*” within the first subcategory because, by definition, an interpretation involves the use of judgement and is therefore subjective. For this

reason, we believe that interpretations should be part of the second subcategory. We would further suggest that the discussion set out in Footnote 4 is closely related to paragraph 31 and might add greater value if incorporated directly into the text.

Finally, we believe that the language of paragraph 36 needs to be strengthened to convey a more sceptical view about offsetting. Specifically, we would suggest that the second sentence of paragraph 36(b) assert that offsetting is “usually” or “generally” inappropriate.

Appendix Two

Basel Committee Comments on IAASB Exposure Draft ISA 540 (Revised) “Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosure)”

1. Introduction

The Basel Committee on Banking Supervision² has a strong interest in high quality and independent audits of banks and has carefully analysed the above proposal.

The Committee is pleased to note that the Board intends to expand guidance on auditing accounting estimates and welcomes the Board's initiative to provide updated and expanded guidance on this important subject.

How this new Standard is expected to relate to ISA 545, “Auditing Fair Value Measurements and Disclosures” and IAPS 1012, “Auditing Derivative Financial Instruments” is of particular importance to the Committee. As noted in the Committee's comments on IAASB priorities for the current year, we view these three documents as treating related topics and believe that it would be useful to consider them together. While we recognise that ED ISA 540 includes more current approaches for audits of estimates measured at other than fair value, we believe these may be equally useful in a fair value context and even for derivatives. Therefore we would suggest that the Board gives a high priority to aligning the principles in ISA 545 and IAPS 1012 with this new Standard on accounting estimates.

2. General observations

We would appreciate the inclusion of specific wording emphasising the importance of auditing estimates in disclosures as these are increasingly important for understanding financial statements.

The sections about management's identification of accounting estimates (paragraphs 15 to 17) and about management's process for making accounting estimates (paragraphs 18 and 19) are somewhat imbalanced in that they tend to emphasise the role of management over that of the auditor. We suggest starting the relevant sections with the paragraphs that identify the role of the auditor (paragraphs 17 and 19) and then subsequently explaining the role of management.

Paragraph 30 offers three possible responses to the risk of material misstatement. However, the meaning of “one or more of the following procedures” is open to some interpretation. If these responses are meant to be cumulative, for example starting with (a) and then progressing to (b) and (c) where substantive testing and testing of controls do not provide sufficient comfort, this needs to be made clearer. Some confusion occurs, however, because

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the text also suggests that going straight to (c) can be the right response when the estimates being tested are more unique in character. Therefore, what remains unclear is whether (b) is a supplementary procedure to be applied when (a) is inconclusive, or whether (b) can also be applied independently. We believe the first is what is intended, but the text needs to make the connection between (a) and (b) more explicit.

Paragraphs 41 to 44 suggest that a possible response to the risks of material misstatement is to make an independent estimate and we support this approach, including the auditor's option under paragraph 43 to use the work of an expert. We suggest that the standard provide criteria for determining the types of estimates for which the auditor may wish to use the work of an expert and what kind of expert would be used for certain categories of estimates.

The relationship between paragraphs 54 through 57 and 58 to 59 is not entirely clear. If management has not conducted a sensitivity analysis or considered alternative outcomes, paragraph 54 requires the auditor to consider whether it is practical to develop a reasonable range of outcomes with which to evaluate the reasonableness of management's point estimate. Paragraphs 55-57 then provide guidance on how that might be done. However, we would have also expected to find guidance on what the auditor should do when he cannot develop a reasonable range of outcomes. Paragraph 59 states that when the auditor does not agree with management's estimate, management must perform further work to provide additional support for the point estimate. The remaining possibility – that the auditor cannot determine whether to agree or disagree with management's estimate and what management is required to do in that case – is not addressed.

Paragraph 73 explains that what constitutes good reason for changing the location of an accounting estimate (within a range of reasonable estimates) from one period to another is a matter of judgment. The example provided deals with circumstances involving a change in management and proposes that new management could have different intentions and therefore evaluate business risks differently. This is offered as a plausible reason to justify a change in location, although the auditor is nevertheless encouraged to look for audit evidence backing the assertion and to consider the potential for management bias using guidance in paragraphs 75 through 78. While this overall approach identifies the need to exercise professional scepticism, the section dealing with indicators of possible management bias is of particular importance. We would suggest making paragraphs 75 to 78 more robust by cross referencing the section to other ISAs, like ISA 220, "Quality Control for Audit Work", ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", ISA 320, "Audit Materiality" and ISA 260, "Communications of Audit Matters with Those Charged with Governance". This would also make this section more practical and useful in guiding the auditor's overall approach to obtaining sufficient and appropriate audit evidence to conclude whether management bias is an issue.

We would also suggest that the approach taken in paragraph 77 may be too specific. It might be more helpful to deal with more than one scenario, for example, assessment of an estimate that has not changed location followed by the more challenging situation of one that has, to demonstrate how, and the extent to which, professional scepticism should be applied.