Chairman

Via email: edcomments@ifac.org

Mr Arnold Schilder
Chairman
International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
New York, New York 10017
United States

11 September 2014

Exposure Draft: Proposed Changes to the International Standards on Auditing (ISAs) – Addressing Disclosures in the Audit of Financial Statements

Dear Mr Schilder

The Basel Committee on Banking Supervision ("the Committee") welcomes the opportunity to comment on the IAASB's May 2014 Exposure Draft: *Proposed Changes to the International Standards on Auditing ("ISAs") – Addressing Disclosures in the Audit of Financial Statements* (the "ED"). As noted in our June 2011 comment letter to the IAASB on its Discussion Paper: *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications* (the "DP"),[1] we continue to have a strong interest in high quality financial reporting by banking organisations that includes relevant and meaningful disclosures.

Since the financial crisis, there has been an increased focus on the quality of disclosures by banks. The external auditor has an important role to play in evaluating whether the bank's disclosures are consistent and meaningful and, when taken with the financial statements as a whole, present the bank's financial condition and performance in a way that is informative and understandable to users.

Therefore, as noted in our previous comment letter on the DP, we believe that disclosures required by a financial reporting framework should, in principle, be audited with the same rigour as that which applies to auditing the primary financial statements. We are encouraged by the proposed changes in the ED which place more emphasis in the ISAs on auditing disclosures and further clarifying the expectations of auditors when auditing financial statement disclosures.

However, we believe that certain parts of the ED could be further developed and enhanced to promote the effectiveness of auditing disclosures. Our comments on the respective matters requested by the IAASB are set forth in the Annex to this letter.

[1] http://www.bis.org/bcbs/commentletters/ifac41.pdf.

The Committee supports the International Accounting Standards Board's ("IASB") Disclosure Initiative project to improve transparency and understandability in financial reporting, and the IAASB's contributions to and coordination with this IASB initiative.

This letter and its Annex have been prepared by the Committee's Accounting Experts Group, which is chaired by Mr René van Wyk, Registrar of Banks, South African Reserve Bank. If you have any questions regarding the above comments, please feel free to contact Mr van Wyk (+27 12 313 3601) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely

Stefan Ingves

Annex

1. Whether, in your view, the proposed changes to the ISAs are appropriate and sufficient for purposes of enhancing the focus of the auditor on disclosures and, thereby, will further support the proper application of current requirements in the ISAs?

The Committee welcomes the various proposed changes to the ISAs, and in particular the following:

- clarifying the definition of 'financial statements' in ISA 200,[2] and the specific references made to disclosures in various ISAs;
- emphasising the importance of auditing financial reporting disclosures early and throughout all stages of the audit. Amongst other points, this should enable the auditor to consider the possible implications for disclosures due to changes in the entity's environment;
- including considerations of any implications for the audit of disclosures derived from systems and processes that are not part of the entity's general ledger system and models;
- enhancing application guidance in ISA 260 (Revised)[3] to include disclosures as part of the reportable matters when communicating to those charged with governance;
- providing more emphasis on identifying risks of material misstatements in disclosures in ISA 315 (Revised);[4] and
- providing additional guidance on what constitutes a misstatement in ISA 450,[5] including consideration of omission of disclosures beyond what is specifically required, but which may be necessary for a fair presentation.

In our view, these proposed changes should support the auditor in taking a more robust approach to auditing disclosures and facilitate a more consistent application of the ISA requirements. These are also in line with the Committee's recommendation that the external auditor evaluate whether the disclosures included in the financial statements, both quantitative and qualitative, are sufficient and are consistent with his/her understanding of the bank's risk profile, activities and strategy (see paragraph 182, Basel Committee (March 2014), *External audits of banks*).

In addition, the Committee is comfortable with the IAASB's approach of amending each of the ISAs to incorporate requirements for and consideration of auditing disclosures as we believe it is integral to the audit of assertions about classes of transactions and events and account balances.

---

2 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

3 ISA 260 (Revised), *Communication with Those Charged with Governance*

4 ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

5 ISA 450, *Evaluation of Misstatements Identified during the Audit*

However, as noted in the cover letter, we believe that certain parts of the ED could be further developed and enhanced to promote the effectiveness of the audit of disclosures. See our comments to Question 2 below for details.

2. Are there any specific areas where, in your view, additional enhancements to either the requirements or guidance of the ISAs would be necessary for purposes of effective auditing of disclosures as part of a financial statement audit?

Elevation of certain application material to ISA requirements

In our view, some of the changes to the application material, and indeed some of the application material, should be elevated to ISA requirements as they reflect audit procedures that would be carried out in all audits of disclosures. Including them in application material implies that this would not be the case. For example, we would expect an auditor to evaluate the adequacy of presentation and disclosure as described in paragraph A59 in ISA 330[6] at all times. The same expectation applies to evaluating misstatements in non-quantitative (ie note disclosures as discussed in paragraph A13a in ISA 450 and evaluating the appropriateness of the disclosure of significant accounting policies and the understandability and relevance of the information presented in the financial statements as described in paragraphs A3a and A3b, respectively, in ISA 700.[7]

We would therefore encourage the IAASB to elevate the relevant application material text to ISA requirements to enhance the quality of audits of disclosures.

Consistent use of the terms 'financial statements', 'notes' and 'disclosures'

The proposed changes to ISA 200 clarify the definition of 'financial statements' to include disclosures, and provide a description of disclosures. However, we noted the following in the proposed changes to the other affected ISAs:

- In some instances, references are made to 'financial statements' only, while in others, references are made to 'financial statements, including disclosures'. Given the proposed definition of 'financial statements', we question the purpose and the need to make specific references to 'disclosures' when 'financial statements' are mentioned.
- In some instances, references are made to 'disclosures' only, while in others, references are made to 'notes to the financial statements' or 'the related notes'. Because 'disclosures' are broader than just the 'notes', it is unclear to us if 'disclosures' and 'notes' would be subject to different ISA requirements.

Therefore, we encourage the IAASB to ensure the consistent use of the terms throughout the ISAs to enhance consistent application of the ISAs. However, if the IAASB determines that specific references to 'disclosures' are necessary and appropriate in certain ISAs when 'financial statements' are mentioned, we recommend that a reference to 'disclosures' be added to the objective of proposed ISA 720 (Revised)[8] that refers to 'financial statements'.

---

6 ISA 330, *The Auditor's Responses to Assessed Risks*

7 ISA 700, *Forming an Opinion and Reporting on Financial Statements*

8 Proposed ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

Quality control

Given the importance of disclosures, we believe the audit of disclosures should be an area of focus for the engagement quality control reviewer. The reviewer should confirm that financial statements comply with the applicable financial reporting framework and any statutory disclosure requirements. Furthermore, working paper files should adequately document the work performed on disclosures.

Materiality

The Committee supports further deliberations and considerations by the IAASB (and other relevant bodies) on how to apply the concept of materiality to note disclosures in an audit. To assist the auditor in focusing on this area at all stages of the audit, we believe that ISA 320[9] should include a specific requirement for the auditor to undertake an initial determination of what is material for note disclosures.

In this context, we note that certain financial statement items are used in the calculation of key metrics used by a wide range of users of the financial statements. For example, for banks, regulatory ratios such as the leverage ratio, liquidity ratio and capital adequacy ratio are calculated based on account balances reported in the financial statements or are derived from the financial statements. The Committee expects the auditor to consider these ratios as an input to the determination of materiality thresholds for the audit (see paragraph 157, Basel Committee (March 2014), *External audits of banks*).

Enhancements to the discussion of an entity's internal control in relation to disclosures

With the proposed changes in the various ISAs to enhance the focus of the auditor on disclosures, the discussion of an entity's internal controls in ISA 315 (Revised) could be enhanced to include specific considerations of the controls around the production of financial statement disclosures as these are likely to be different from the controls that relate to other assertions about classes of transactions and events and account balances. It is important for an auditor to understand how an entity determines the appropriateness and adequacy of its financial reporting disclosures, especially for disclosures derived from systems and processes that are not part of the entity's general ledger system and models. This should enable the auditor to assess whether and to what extent further audit procedures will be needed with respect to those disclosures.

ISA 700 Forming an Opinion and Reporting on Financial Statements

ISA 700 requires the auditor to evaluate whether the 'information presented in the financial statements is relevant, reliable, comparable and understandable'.

We have already noted above that paragraph A3a, part of the application material supporting this requirement, should be elevated to a requirement. We believe that it is important for the auditor to rigorously challenge whether the financial statement disclosures are adequate and really useful; it is not enough simply to confirm that the disclosures comply with the specific disclosure requirements on the subject. Therefore, we believe that more guidance should be provided

---

[9] ISA 320, *Materiality in Planning and Performing an Audit*

regarding the procedures that should be performed to meet this requirement. Such guidance could cover the auditor's approach to whether:

- the disclosures meet the disclosure objectives of the relevant accounting standards;
- given the environment in which the entity is operating, there are additional disclosures that should be included in the financial statements; and
- the disclosures are, in fact, informative and meaningful; for example, whether the information in the disclosures has been sufficiently disaggregated and is comparable.

Obtaining sufficient appropriate audit evidence for disclosures

The Committee appreciates the challenges and difficulties in setting requirements and providing guidance to auditors for obtaining sufficient appropriate audit evidence for certain disclosures. However, we believe that it is important for the IAASB to incorporate more robust ISA requirements for auditors in this area to enhance the consistency and quality of audits of disclosures, particularly in relation to the following disclosures:

- Information derived through processes other than accounting processes;
- Management judgments and assumptions;
- Qualitative disclosures including descriptions of internal processes;
- Risk management disclosures ; and
- The extent to which it is appropriate to rely on management representations for disclosures which are highly subjective.

3. Whether, in your view, the proposed change to the assertions will help appropriately integrate the work on disclosures with the audit work on the underlying amounts, thereby promoting an earlier and more effective audit of disclosures?

The Committee supports the IAASB's proposal to integrate the relevant assertions relating to disclosures into the relevant assertions about classes of transactions and events and account balances. We believe this approach is in line with our expectation that the audit of disclosures is integral to the audit of the respective assertions and hence promotes a more effective audit of disclosures.