European Federation of Accountants and Auditors for SMEs

International Auditing and Assurance Standards Board (IAASB)
545 Fifth Avenue, 14th Floor
New York, New York
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Attn. IAASB Technical Director

Brussels, 10 June 2011

Dear Sir

Comment on IAASB Discussion Paper, The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications

The European Federation of Accountants and Auditors for SMEs ("EFAA") represents accountants and auditors providing professional services primarily to small and medium-sized entities ("SMEs") both within the European Union and Europe as a whole. Constituents are mainly small practitioners ("SMPs"), including a significant number of sole practitioners. EFAA's members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, and tax and business advice) to SMEs.

General comments

EFAA appreciates the opportunity to comment on the IAASB Discussion Paper, The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications (the paper).

As EFAA's focus is on SMEs our comments reflect that perspective. While we agree with the analysis in paragraph 13 of the paper that auditing issues may arise, SME financial statements do not suffer from the lengthy and complex disclosures on which the paper dwells. Indeed, under European derived law many SMEs are allowed to prepare financial statements for the public record that contain only simplified information (so called 'abbreviated accounts'). We have structured our response as answers to the questions posed in the paper for preparers and auditors. Our comments include the user perspective but do not separately answer the paper's questions for investors, lenders and other creditors; neither do we answer from the perspective of the regulator, as EFAA has no regulatory functions.

Request for Specific Comments

Our comments on the specific questions raised are set out below.

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<u>CONSULTATION QUESTIONS FOR PREPARERS</u>

Members of EFAA member bodies may prepare financial statements as employees of larger SMEs or as practitioners providing compilation services.

Section II–Financial Reporting Disclosure Trends

P1. What have been the most significant challenges you have experienced in preparing disclosures?

In general the major challenges arise where there is a need to establish systems to produce newly required information or to make what are initially unfamiliar valuations (which may require the assistance of an expert in some situations). Other significant challenges can arise in areas where there is considerable uncertainty over a disclosure: such as where the going concern basis is in doubt or significant contingencies exist.

P2. Have you included a disclosure in your financial statements to comply with a specific disclosure requirement, even though you believed the disclosure was immaterial? What factors led you to this decision? What practical difficulties exist when deciding to omit a disclosure that you consider to be immaterial?

EFAA believes that the disclosures required under a particular financial reporting framework are generally necessary in order to give a fair presentation even where a matter may not individually be material. In some circumstances it may assist the reader of the accounts if certain information is available from one year to the next for comparative purposes even if in any particular year the disclosure would not be material.

The degree of aggregation of figures and the level of detail given in disclosures is however something that is ordinarily subject to routine judgement driven by materiality.

Section IV–Audit Issues Regarding Disclosures Required by a Financial Reporting Framework

P3. Have you experienced requests from auditors for evidence to support your disclosures that you find difficult to satisfy? If so, please explain the context.

There are undoubtedly occasions when this occurs albeit EFAA is not in a position to recount specific instances. Some disclosures are not capable of being audited to the same degree of precision as other disclosures, for instance where they require the use of an expert or indeed are driven by management expertise. This is generally accepted.

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P4. Some disclosures are relevant to an understanding of the entity but are not related to any specific line item in the financial statements. Below are two examples of these types of disclosures:

(a) Financial statements may include disclosures of the policies and procedures for managing the risk arising from financial instruments. Such disclosures may, for example, discuss the controls the entity has put in place to mitigate risks. What evidence or support do you believe you need to have as a basis for the assertions you make in the financial statements on such disclosures?

(b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65–66). In preparing financial statements, what, in your view, would be sufficient evidence for you to support your stress test disclosure? What do you believe would constitute a misstatement of a stress test disclosure?

The evidence necessary to support a particular disclosure will naturally depend on the nature of that disclosure and management assertions and judgements may be the subject of representations requested by auditors. In relation to the specific questions raised we would comment as follows:

(a) In practice the entity's policies for managing risk are documented and the related procedures are performed; hence there is little difficulty in using this information to construct a particular disclosure.

(b) We have little experience of stress tests and disclosures in an SME context.

However, as a general point we should state that EFAA believes that SMEs should be exempted from the disclosure of non-financial information and we thus make no comment on non-financial information in the context of large companies.

P5. What do you believe represents a material misstatement of a disclosure? Please give an example of what, in your view, would constitute a material misstatement for the following categories of disclosures:

- Judgments and reasons;
- Assumptions/models/inputs;
- Sources of estimation uncertainty/sensitivity analysis disclosures;
- Descriptions of internal processes;
- Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis; and
- Objective-based disclosure requirements.

We believe that a material misstatement would be one that individually or when combined with others significantly affects the view of users of the financial statements. This assessment is made on a company by company basis and any example we give may not be material in all cases. Nevertheless we suggest the following examples:

- Judgments and reasons - disclosures intended to deceive by presenting incorrect narrative
- Assumptions/models/inputs - omission of factors that would have produced a different outcome
- Sources of estimation uncertainty/sensitivity analysis disclosures - while materiality depends on the materiality of the subject matter, a financially significant error could arise if users believe a matter is overly or less certain than in reality
- Descriptions of internal processes - divergence from a fact that would change user perceptions such as describing a company's environmental systems when none exist
- Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis – we would regard a level of misstatement to be material if it would be material to the line item
- Objective-based disclosure requirements – given their nature, such matters would have to be assessed individually and we do not cite any particular matter

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CONSULTATION QUESTIONS FOR AUDITORS

Section II–Financial Reporting Disclosure Trends

A1. Have you had discussions with entities about whether some of their required disclosures might be considered immaterial? What factors did you take into account? Please explain what difficulties (if any) you have experienced.

SME clients often defer to their auditor's judgements on specific accounting issues. These tend to be routine conversations and are often related to ensuring that line items are adequately but not excessively analysed in the notes to the financial statements or that trivial matters are not included. Therefore we generally note few difficulties in this area.

Section III–How Do ISAs Currently Deal with Disclosures?

A2. How do you approach the identification and assessment of the risks of material misstatement in disclosures?

Auditors vary in their approach to this. Typically they will test with a materiality level for the financial statements as a whole and that provides a baseline. For example, auditors may find information whilst performing their procedures on the purchases, creditors and cash cycle relevant to related party transactions but minor transactions may not be discovered. Given the sensitivity of related party transactions separate procedures may be put in place to obtain evidence on this disclosure but this evidence is naturally limited due to the impact of the above. It would be impossible to carry out all general tests in an audit at the lowest materiality level that could be set in relation to important disclosure items. This is recognised in ISAs.

A3. Are there ISA requirements that, in your experience, pose practical challenges in respect of disclosures? Please explain your answer.

In general, it is possible to apply the ISAs to disclosures in the financial statements of SMEs but we are concerned about the difficulties that may be introduced if further disclosure of non-financial information were to be required. EFAA believes that SMEs should be exempted from the disclosure of non-financial information.

Section IV– Audit Issues Regarding Disclosures Required by a Financial Reporting Framework

A4. Have you encountered situations where you experienced difficulty in obtaining sufficient appropriate audit evidence for a disclosure, even though management believed it had appropriate supporting evidence for the disclosure? If management's consideration of a disclosure can be appropriately supported by evidence and documentation, are there factors that could nevertheless make a disclosure unauditable? If management has not provided evidence and documentation in support of a disclosure, do you believe you are able nevertheless to obtain SAAE on the disclosure? Please explain your answer.

There are undoubtedly occasions when this occurs albeit EFAA is not in a position to recount specific instances. It is accepted that some disclosures are not capable of being audited to the same degree of precision as other disclosures, for instance where they require the use of an expert or indeed are driven by management expertise. This is generally accepted.

A5. What do you believe are the key issues with gathering audit evidence for the examples given in paragraphs 60–70?

The discussion paper analyses the examples it provides and in general we agree with the analysis of key issues thereby provided. Paragraph 62 of the analysis refers to the requirements in ISA 501, "Audit Evidence—Specific Considerations for Selected Items" concerning segment disclosure. The application material (paragraph A26) recognizes the difficulty of doing more audit work on segments because they are smaller than the turnover disclosed and similar thinking, albeit not embodied in application material elsewhere, is undertaken by auditors in relation to many disclosures.

A6. Some disclosures include the fair value of a financial statement line item measured on another basis, such as historical cost. In this circumstance, what level of effort do you believe should be applied to the fair value disclosure? Should your effort be the same as if the fair value was on the face of the financial statements?

The audit effort will not generally be the same as if the fair value was on the face of the financial statements although the materiality will be similar. For non-listed companies, line items primarily serve the stewardship function of the financial statements, whereas disclosures primarily have an information function. Moreover, consequences of misstatement are more limited for disclosures than for line items, as changes do not directly affect the results or financial position. In some circumstances that can be different, e.g. it is known that third parties like banks use disclosures to recalculate solvency and profitability and therefore the auditor should inquire for the intended use of disclosures.

A7. What is your expectation regarding the need for disclosures not specifically required by the financial reporting framework, but which some users may believe are relevant to the fair presentation of the financial statements? Examples may include non-compliance with a critical law, even though there is no quantitatively material effect, or the fact that the entity does not have a material holding of a particular asset class, such as sovereign debt, which may be of particular interest in the current economic environment.

A fair view framework requires that general purpose financial statements contain additional disclosures where necessary to reach a fair presentation. Clearly, compliance with relevant financial reporting standards will generally indicate that a fair view is given and what is a fair presentation will change over time.

The question seems to be about either the different powers of the various stakeholders to demand information or, more generally, the trigger points that signal a significant change in what constitutes a fair presentation. Unless there is some mechanism for drawing such events to the attention of preparers, even if factors influencing change are highly significant, they will not be taken up by all preparers immediately. This is to be expected and those exercising hindsight must be careful of making undue criticisms.

Disclosures in financial statements by definition have to be relevant and material otherwise there is always a threat that important disclosures are "buried" in a tsunami of irrelevant details. Having said that, it is for management to decide what is material and relevant and the auditor has only limited possibilities to require restriction to what is important or material. Moreover, in several instances law and accounting standards require disclosures without regard to whether they are material or relevant. Therefore, the accounting principles should include a paragraph as to what sort of disclosures are included. Other disclosures, not relevant for the fair presentation of the financial statements, should appear only as accompanying information.

A8. In light of the discussion in paragraphs 79–87, what do you believe is the appropriate way of applying materiality to disclosures? Do you believe there is sufficient guidance in the ISAs?

We repeat our point about the way in which overall materiality is generally used in an audit and there is an expectation that, in the absence of special factors, a lesser materiality for sub-disclosures is not appropriate. Where there are special factors, then it may be necessary to carry out audit work in relation to the particular disclosure to a higher degree of precision. That work is nevertheless limited by the considerations mentioned above.

We do not hold the view that all disclosures are material. We believe the correct approach is promulgated by the IASB. Having said that, disclosures required by a standard are highly indicative of matters being necessary to achieve a fair presentation and it is reasonable that they be included ordinarily even if, in one year, they are not at a level that might otherwise be considered to be material.

A9. What do you believe represents a material misstatement of a disclosure? Please give an example of what, in your view, would constitute a material misstatement for the following categories of disclosure:

- Judgments and reasons;
- Assumptions/models/inputs;
- Sources of estimation uncertainty/sensitivity analysis disclosures;
- Descriptions of internal processes;
- Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis; and
- Objective-based disclosure requirements.

Please refer to our answer to question P5.

A10. Some disclosures are relevant to an understanding of the entity but are not related to any specific line item in the financial statements. Below are two examples of these types of disclosures:

a) Financial statements may include disclosures of the policies and procedures for managing the risk arising from financial instruments. Such disclosures may, for example, discuss the controls the entity has put in place to mitigate risks. What do you believe would constitute sufficient appropriate audit evidence for such a disclosure? What do you believe would constitute a misstatement of such a disclosure?

b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65–66). What work would you expect to do in relation to the proposed stress test disclosures? What do you believe would constitute a misstatement of a stress test disclosure?

Please refer to our answer to question P4.

A11. How do you evaluate both qualitative and quantitative misstatements in forming an opinion on the financial statements as a whole? Is it possible to accumulate misstatements of disclosures, particularly when they relate to qualitative or judgmental disclosures? How do prior year‘s disclosure misstatements affect the evaluation of the current year‘s financial statements?

Methodology for evaluating and accumulating quantitative misstatements is well-established. In many instances, judgemental disclosures resolve into the acceptability of a range of possible outcomes, and these matters may also be quantified and aggregated using appropriate techniques.

Where a disclosure is qualitative, misstatement can be a matter of absolute disagreement between management and auditor or a matter of degree. Unless there is an obvious trend to misstatements, such as might be observed if management wishes to present an overly favourable picture of the results of a particular year, we do not believe in general that aggregation of qualitative misstatements is sensible. Instead, as well as considering the individual impact on the whole financial statements of each misstatement, the auditor will necessarily consider the financial statements overall in the light of the qualitative misstatements identified collectively. In practice, auditors of SMEs discuss the issues with management and generally individual items will be resolved, making the final judgement relatively simple. It must also be recognized that in the overall context of the financial statements, misstatements in qualitative disclosures may have less impact on users than at first appears when they are identified.

Section V–Questions about Auditability

A12. What are the characteristics of disclosures that, in your view, would not be auditable?

A disclosure is not auditable if there is insufficient evidence to support it. Assuming that a disclosure is valid, rather than a simple error, it is likely to be essentially narrative in nature and relate to nonfactual matters: either a value judgement or a prediction of management.

A13. What criteria do you believe should be used to assess an auditor's judgment in respect of the fair presentation of the financial statements as a whole?

Users rely on the judgement of the auditor regarding the fair presentation of the financial statements because they themselves do not have access to the evidence that the auditor possesses. It is only when another party has access, either to the evidence that the auditors have or the information possessed by the preparers, that the auditor's view may be challenged. This would occur following litigation or perhaps a change of management or auditor. The only valid criteria for assessing the auditor's judgement would be whether the judgement would be supported by other audit professionals.

We believe it is very difficult to document the reasoning behind an overall auditor assessment of fair presentation as it is generally made up of the auditor's conclusions on testing (that no material misstatements have been found), the auditor's consideration as to whether the financial statements disclose all matters required by the financial reporting framework (that work perhaps utilising a checklist), and the auditor's "stand back" to reflect on whether, overall, the picture given by the financial statements is consistent with the knowledge developed by the auditor during the course the audit (that may not relate directly to specific testing at the assertion level).

A14. Some believe that the manner in which a financial reporting regulator enforces financial reporting requirements may influence how auditors approach their audits, including how they may approach disclosures. What is your view?

We believe that regulators exert considerable influence and clearly if this were not the case there would be little value to regulation. In relation to the issue of judgements on disclosures; EFAA believes that there are two principal ways in which the regulator exerts influence. Firstly, there is a fear that the regulator will take a more rigorous view of omitted disclosures and hence the auditor is more likely to insist on their inclusion. Secondly, where the regulator takes a strong line interpreting a relevant financial reporting standard the auditor will acknowledge this in forming their own view of interpretation.

I trust that the above is comprehensive but should you have any questions on our comments, please do not hesitate to contact me.

Yours faithfully,

Federico Diomeda
Chief Executive Officer