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June 17, 2011

Mr. James Gunn
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Board
545 Fifth Avenue, 14th Floor
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By E-mail: Edcomments@ifac.org

Dear James,

Re.: Discussion Paper "The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications"

We would like to thank you for the opportunity to provide the International Auditing and Assurance Standards Board (IAASB) with our comments on the Discussion Paper "The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications" (hereinafter referred to as the "paper").

We would like to commend the IAASB for addressing one of the most important and pressing issues that affect audits of financial statements: the evolving nature of financial reporting and its impact on audits. This paper is timely and should be considered by accounting standards setters when deliberating the content of new or revised accounting frameworks and standards, as well as by accounting and audit regulators, when considering the application of accounting standards or their impact on audits. However, we do have fundamental concerns about the scope of the paper that we address in the body of this letter in addition to the matters that we address in the Appendix to this letter in response to the consultation questions and as other relevant comments by section.

In relation to the scope of the paper, we believe that the malaise in current accounting standards setting, the results of which usually end up bedeviling auditors, extends to beyond just disclosures, even though some disclosures are particularly affected. As the IDW had noted in the IDW Concept Paper "Additional Issues in Relation to a Conceptual Framework for Financial Reporting" from

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2007 (hereinafter referred to as the "IDW Concept Paper", a copy of which is attached together with the accompanying letter to the IASB and the related IDW press release), which is referred to in the paper, the IASB and the FASB need to recognize that financial reporting is foremost a practical exercise that takes place with real information based upon evidence, not an exercise based solely on classical economic theory. Our analysis of the IAASB paper indicates that the thrust of the paper can be distilled into two main issues: evidence and materiality, but that the treatment of these issues needs to be broader than just for disclosures.

The Need for an Accounting Evidence Concept

The IDW Concept Paper notes that both the original conceptual framework documents of the IASB (IASB Framework) and the FASB (SFAC No. 2), and in particular chapter 3 of the new IASB Conceptual Framework, did not adequately apply decision and measurement theory. This extended to relegating the objective of decision theory (defining the desired relationship between costs and benefits as a basis for decision-making), and hence of financial reporting, to a cost constraint, which diminishes the consideration of the role of costs and benefits when designing accounting standards, eliminates the importance of certain vital concepts, such as reliability, and demotes an important concept such as verifiability to an "enhancing qualitative characteristic".

Furthermore, the IDW Concept Paper posits that the IASB Conceptual Framework needs to translate the concept "verifiability" into its logical implication: verifiability presupposes the existence of "evidence" to be verified. What matters in relation to verifiability is not (as the IASB Framework asserts) that two different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation, but that they have a reasonable basis for reaching such a consensus: *evidence*. Hence, "accounting evidence" needs to be a fundamental financial reporting concept.

The issue of evidence and the related issue of auditor work effort and auditability permeates the IAASB paper and is therefore one of its two central issues. However, by concentrating only on disclosures (albeit, the issue of evidence is often more critical for some kinds of disclosures than for the recognition and measurement of some kinds of line items, but not always), the paper appears to suggest that evidence to support the recognition or measurement treatment chosen by management for line items in the financial statements is without evidential or auditability problems. However, it is precisely because of the decreasing reliability of evidence associated with line items in the financial statements (due to recognition and measurement requirements that involve more future-oriented information) that additional disclosures are needed. Furthermore, the meaning of an audit opinion depends on the accounting evidence available to support it. This does not mean that matters that are supported by less evidence are not auditable – only that the meaning of the opinion is different because the assurance (i.e., the strength of the evidence) supporting that opinion is less. We believe that, as a matter of principle, the scope of the IAASB paper should have extended to the need for accounting standards setters to deal with the issue of accounting evidence to be obtained by management to support its financial statements as a stewardship responsibility of management and as a prerequisite for an audit.

Our views appear to be supported by a speech by Jay D. Hanson, Board Member of the PCAOB, on May 23, 2011, which noted, among other things, that the quality of an entity's processes, controls, documentation and people have an impact on the quality of the audit, and that the better the evidentiary support for management valuations, the better the work of the auditor in this respect can be.

The Need for More Guidance on Materiality

The second of the two central issues that permeate the IAASB paper is the concept of materiality and its application. Other than two paragraphs in the old IASB Conceptual Framework (reduced to one in the new) and another three in IAS 1, there are no additional requirements or guidance on materiality in IFRS: In comparison, ISA 320 contains no less than 6 paragraphs in the introduction, and another 10 paragraphs in the application material, that provide guidance on materiality. Further audit literature (e.g., the IFAC SMP Guidance) provides additional assistance and tools for the application of the concept of materiality. The requirements and guidance in ISA 320 are at a principles-based level and are useful to auditors when considering materiality – and do not just represent "additional rules".

Yet materiality is, in the first instance, a financial reporting concept, and thus an auditing concept – not the other way around. As ISA 320 intimates, since materiality is entirely user-driven, accounting materiality cannot be different than audit materiality. Preparers of IFRS financial statements need to consider materiality when determining what to present and disclose in the financial statements (see IAS 1.29 - 1.31). However, it is apparent that financial reporting standards provide very little guidance on the application of materiality by preparers.

Furthermore, when designing internal control over financial reporting, management also needs to design internal control such that management obtains reasonable assurance that the financial statements are not materially misstated (see COSO Internal Control Framework). This includes considering the risk of material misstatement resulting from the aggregation of uncorrected misstatements detected by internal control and undetected misstatements. Hence, when designing internal control management also needs to apply a "performance materiality" concept. Financial reporting standards, such as IFRS and US GAAP, and internal control frameworks, such as COSO, need to address this issue in an integrated way.

In this context, it is important to distinguish, on the one hand, between materiality and "performance materiality" as financial reporting concepts in terms of what should be presented and disclosed in the financial statements (and reducing the risk that financial statements are materially misstated), and on the other hand, other thresholds that management needs to apply when meeting its stewardship responsibility to safeguard an entity's assets through internal control over entity assets, liabilities (claims on assets), commitments (future claims on assets) and entity transactions, which would involve much lower thresholds. The latter thresholds deal with the control over the actual assets, liabilities, commitments and transactions, whereas the former deals with their presentation and disclosure in the financial statements.

We are particularly concerned about the length and complexity of disclosures for IFRS, even though IAS 1.31 clearly states that a specific disclosure required by an IFRS need not be provided if not material. In this context it may be helpful for IFRS to clearly distinguish those disclosures that are always deemed to be material (e.g., some related party transactions) from those that need not be disclosed unless material.

When the IASB creates requirements for the categories of disclosures listed, it is not enough to simply apply the definition of materiality. While we agree that what is material depends upon the relevant facts and circumstances, additional criteria that preparers need to apply and factors that preparers need to consider when evaluating the material completeness and accuracy of the disclosures ought to be included along with the requirements for such disclosures. Furthermore, accounting standards ought to be clear on the evidence that preparers must have and retain to support those disclosures.

One issue related to the concept of materiality is the meaning of the term "fair presentation", which is also addressed in the IAASB paper. IFRS give an explanation of the meaning of fair presentation in paragraphs 15 to 17 of IAS 1. However, in addition to the description of its meaning in relation to faithful representation in paragraph 15 and the three high level criteria in paragraph 17, it may be useful for the IASB to provide further criteria or guidance on fair presentation. In particular, additional further guidance may be useful on when or how the requirement in paragraph 17 (a) for additional disclosures is to be applied. Additional criteria for determining when disclosures that are not specifically required by IFRS need to be disclosed to achieve fair presentation should also be considered. It is very difficult for prepares and auditors to make a judgment as to what users might need as economic circumstances change and it is very easy for users and regulators to claim with hindsight that certain disclosures would have been material to fair presentation. Unless the IASB develops some clearer criteria for additional disclosures to achieve fair presentation, the requirement for fair presentation will remain ineffective and there will be an expectations gap on the meaning of fair presentation between users, and preparers and auditors.

On the whole, financial reporting standards, such as IFRS, need adequate requirements and guidance (such as criteria or factors that may be considered) for preparers of financial statements in relation to materiality, and "performance materiality" and fair presentation because these concepts are central to financial reporting under IFRS. While the IAASB paper addresses the issue of the application of materiality to disclosures, the scope of the paper falls short in that it does not indicate that financial reporting standards need to provide the necessary guidance on disclosures for preparers in the first place and that such guidance is also required for financial statement items that are not disclosures.

Overall, we believe that the IAASB, in conjunction with other stakeholders, needs to convey to the IASB and other affected financial reporting standards setters some of the issues identified in the paper and our letter to further the interests of good financial reporting.

We hope that our views will be helpful to the IAASB. If you have any questions relating to our comments in this letter, we would be pleased to be of further assistance.

Yours truly,

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Executive Director

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Director, International Affairs

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APPENDIX

Responses to Consultation Questions and Other Relevant Comments by Section

Section I - Introduction

Paragraph 1

The ***last sentence*** of this paragraph states that "this shift reflects an underlying trend toward the provision of information that is relevant to users, even if such information may be more subjective and less reliable". The question in this respect is what is meant by "relevance" and "reliable". On a number of occasions, we note that the IAASB paper lacks precision in its use of terms ("reliability", "credibility", etc.). We suggest that the IAASB consider drawing on measurement theory, etc., so that it uses terms in a consistent fashion, rather than drawing on the unfortunate usage of the IASB, which serves to confuse rather than enlighten.

Measurement theory does not recognize the concept of relevance – only of validity, which comprises, in particular, construct, criterion-related and content validity, and of reliability. In this sense, it is improper to speak of relevance and reliability as separate issues, because validity depends on a number of factors, which may include reliability and therefore there may not always be a trade-off between reliability and the other components of validity. For this reason, the thought that one can provide information of greater relevance even though it is less reliable is a fallacy, because if information were completely unreliable, it cannot be valid and therefore not be relevant in any sense.

There seems to be some confusion in the paper about the difference between reliability and risk: reliability needs to be distinguished from the *risk* of a certain degree of unreliability. For example, it can be stated with 0 % risk that the cash flows of an entity in the following year are between positive and minus infinity; conversely, the risk that the cash flow of an entity in the following year is not precisely one number to the penny is generally close to 100 %. One can increase precision (a possible aspect of reliability, depending on the circumstances) by narrowing the range, but this increases the risk. In other cases, a statement about a range may be of a certain degree of reliability with a certain risk of being incorrect. In any case, when *evidence* about the reliability of information is weak (i.e., the degree of reliability is less verifiable), the risk of unreliability (that is, the obverse of the level of assurance as to the degree of reliability) rises. Hence, the shift referred to in the sentence in the paper actually refers to the underlying trend toward the provision of information that bears greater risk that the information is unreliable. One source of such risk and unreliability is subjectivity due to a weaker evidence that undermines the ability to make a definitive (both in terms of reliability and risk), as opposed to subjective, assertion.

Paragraph 2

The last sentence of paragraph 2 states that “disclosures have become the balancing item in the calculus of how to provide credible, decision-useful information.” It is unclear what the term “balancing item” means – that is, what are disclosures supposed to “balance”? We surmise that what is meant that disclosures are supposed to “balance” less reliable and more subjective information, but this is not clear. However, based on our comments to paragraph 1, such disclosures cannot “mitigate” information subject to greater risk of unreliability: such disclosures can only clarify the nature and extent of unreliability and risk. While helping users understand the limitations of information is important so that they are aware of these limitations, the less reliable and more risky information is, the less valid it is, regardless of disclosures of that fact. Furthermore, disclosure of the limitations of the information may not add to its credibility (i.e., the perceived risk from a user’s point of view), such disclosures may detract from credibility – and rightfully so.

Paragraph 11

This paragraph makes the preliminary assumption that “all disclosures required by a financial reporting framework are capable of being covered by the auditor’s report on the financial statements” (i.e., all such disclosures are auditable). However, the issue is often not only a binary condition of auditable vs. unauditable. Rather, the strength of the evidence obtainable by practitioners, and hence the level of assurance that can be obtained in relation to particular information, varies.

In this context, a distinction needs to be made between scope limitations (not being able to obtain the evidence that can reasonably be expected to be obtainable, which precludes the ability to form an opinion on a matter in a particular instance) and inherent limitations (evidence that is inherently not available or obtainable (and is not reasonably expected to be so), that therefore has an impact on the general auditability of certain information or the level of assurance obtainable) and therefore always precludes the ability to form an opinion. It is important to restrict the discussion on auditability in the paper to the latter.

SECTION II – Financial Reporting Disclosure Trends

I1) In general, do you believe that the reliability of disclosures is at the same level as that of the line items on the face of the financial statements? Do you believe that different types of disclosures in audited financial statements can or should have different levels of reliability? Please explain your answer.

No general assertion can be made as to the comparative reliability (using the definition of reliability in measurement theory) of disclosures and line items on the face of the financial statements. Some disclosures (e.g., a listing of commitments with their due dates, or a description of an accounting policy) can be almost perfectly reliable. Other disclosures, such as the prediction of future interest rates within a valuation calculation may be much less reliable. On the other hand, when recognition criteria are applied to a complex sales contract, the decision of whether or not to recognize revenue may require considerable judgment and therefore the figures in the financial statements may be considerably less reliable. The same applies to some measurement (as defined in IFRS) decisions. Consequently, the mere fact that numerical values are involved often leads to the illusion of reliability, when in fact the basis for the decisions leading to the numerical values are rather soft.

Hence, not only different types of disclosures in audited financial statements may be of varying reliability, but also the numerical values in the line items of the financial statements may also be of varying reliability. Furthermore, due to varying strength of the evidence supporting the reliability of assertions in line items and disclosures in the financial statements, the risk of these line items and disclosures being less reliable increases.

I4) Do you believe that consistency in disclosures is important (either over time for the same entity, or between entities in the same industry), even if achieving this aim may result in extensive disclosures that may not, in the context of a particular entity, be material to that entity in the current period?

We believe that consistency in disclosures is important over time for the same entity, but disclosures that are not material should not be required to be included. Furthermore, we also agree that consistencies of disclosures are important between entities in the same industry, but that disclosures that are not material should not be required to be included. Users of financial statements would recognize that the lack of disclosure in a particular period for an entity or for a particular entity signifies that the matter is not material in that period or for that entity.

R1) Have you encountered a disclosure which you believe was immaterial, and could have been removed to enhance the understandability of the financial statements? Please provide examples, your reasoning for why you believed they were immaterial in the context and why you believed they were not omitted.

Without getting into specific disclosures, we note that preparers tend to use disclosure checklists in developing disclosures and that auditors tend to use disclosure checklists to test the completeness of those disclosures. Often the content of the checklists is applied without consideration of whether particular disclosures are material in a particular instance. Furthermore, to save time when preparing disclosures close to preparation deadlines, often disclosures are, in whole or in part, "copied and pasted" from the financial statements of previous years or from the financial statements of components in the case of group financial statements, even though the disclosures may not be material in the current year or to the consolidated financial statements, respectively.

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.

Based on our discussions with our practitioners, discussions with entities about whether required disclosures are material are common occurrences. When the disclosure is required by IFRS, the primary factor that is taken into account is whether users perceptions about the financial condition, financial performance or cash flows would be affected by the disclosure. The main difficulty is differences in perception by management and the auditor as to whether user perceptions would be affected.

Please provide any other relevant comments that you wish to make on Section II.

Paragraph 16

It seems to us that the fifth and sixth bullet points actually deal with the same underlying issue and could be merged.

Paragraph 22

This paragraph describes the developments in the IASB Conceptual Framework. The statement is made in the second last sentence that "Verifiability, which might have been considered as similar to reliability…". However, the IASB does not make this statement in its Framework. Furthermore, based on the analysis in our response to Part I above, verifiability is an evidence-driven concept, whereas reliability is an intrinsic characteristic of information. The IAASB should take greater care when making assertions about such concepts.

Paragraph 23

The first sentence states that "disclosures about the line items may become at least as important, *if not more useful*, [italics added] to users as the number on the face of the financial statements." However, unless a disclosure of a line item includes a breakdown of the contents of a line item, the disclosure can never be more useful than the line item itself, because such a disclosure explains how the line item was calculated and is therefore only supplementary to the line item itself.

The second sentence states that "disclosures … are being used to achieve balance between the principles of relevance and faithful representation". First, relevance and faithful representation are qualitative characteristics, and not principles. Second, and more importantly, if one were to apply the concepts under measurement theory as described in our response to Part I, it is clear that the disclosures noted in the previous sentence serve the validity (i.e., the relevance) of the information – not just its faithful representation. There is therefore no need to "balance" relevance and faithful representation, but rather a need to balance reliability, and content, criterion-related, and construct validity.

Paragraph 24

The quote from the IASB Conceptual Framework states that "Free from error means there are no errors or omissions in the description of the phenomenon…". However, whether errors or omissions exist in a description depends upon having criteria that identify the phenomenon to be described and that stipulate the aspects of the phenomenon (i.e., its properties) to be described and how that description should be made. If there are no such criteria, errors and omissions cannot exist. This issue becomes particularly critical when dealing with objectives-based disclosures (e.g. fair presentation), for which there are inadequate criteria set forth in financial reporting standards, such as IFRS.

The quote goes on to clarify that free from error also means "…and the process used to produce the reported information has been selected and applied with no errors in the process". This is a strange assertion, because reported information may be accurate even though the process was faulty: the use of the word "and" in this case implies that information is in error even if the information is accurate but the process was faulty. Furthermore, just because an appropriate process was applied without error does not mean that the information is accurate, since internal control over financial reporting can only provide management with reasonable assurance that information is free of material misstatement. As the IDW Concept Paper notes, neither the Framework nor IFRS deal with the quality control or internal control over financial reporting processes, which we consider to be a fundamental flaw.

The concentration on process rather than results in this context is puzzling, because the appropriateness of a process can only be determined by reference to the appropriateness of the outcome of that process. Therefore, the assertion thereafter in the quote that an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate leads to the conclusion that it is not possible to determine the appropriateness of a process for developing an estimate.

Overall it is apparent that the Framework contains a number of conceptual problems and inconsistencies and that it does not address important issues in relation to quality or internal control over financial reporting as noted in the IDW Concept Paper. The IAASB needs to consider how to convey these issues to the IASB.

Paragraph 25

We note our comments in the letter, which clarify that the concept of verifiability is predicated on having an accounting evidence concept.

Paragraph 26

This paragraph of the paper refers to the IDW Concept Paper, which we find commendable. However, the paper does not address the basis for the need for the IDW Concept Paper's recommendation that accounting evidence needs to be a fundamental concept in conceptual frameworks for financial reporting. In particular, the IDW Concept Paper explains that whether information is beneficial depends on the costs of obtaining that information vs. the benefits of that information for the user, and that the costs and benefits of that information depends on the availability of that information, and in particular, on evidence. Consequently, the assertion in the paper that the IDW Concept Paper focuses on the need for management requiring "accounting evidence to support their judgments" falls considerably short of the thrust of the Concept Paper, which demonstrates that there is a need for an accounting evidence concept for all assertions in the financial statements, not just for those involving judgment.

Paragraph 30

We agree that objective-based disclosure requirements create particular challenges for prepares in standing back form the financial statements. We also agree that this is a judgmental process. However, we disagree that it would be difficult for management to generate evidence of its stand back process to support its judgments. Critical in this respect is that management have a process, for such a stand back, the operation of which should be documented. Again the IDW Concept Paper notes that the IASB Conceptual Framework (whether old or new) and the IFRS do not address the issue of financial reporting processes and their documentation, which is a fundamental flaw.

<u>SECTION III – How Do ISAs Currently Deal with Disclosures?</u>

R2) Do you believe the ISAs provide sufficient requirements and guidance in respect of disclosures? Please explain your answer.

We believe that the ISAs provide sufficient requirements with respect to disclosures because the requirements in the ISAs do not distinguish between the audit effort in relation to financial statement items that are line items and financial statement items that are disclosures. This is exemplified by the application material in ISA 315.A111 (c), which guides auditors in the identification of risks of material misstatement for disclosures. For this reason, as a matter of principle, the audit of disclosures should be performed with the same intensity as an audit of line items. However, there may be a case to clarify this further by means of additional application material.

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

The disclosures required in a set of financial statements are driven by the requirements of the financial reporting framework in relation to disclosures and the circumstances of, and events relating to, the entity whose financial statements are being audited. Consequently, the identification of the existence of risks of material misstatement due to the omission of disclosures that ought to be in the financial statements involves considering the requirements of the financial reporting framework in light of an entity's events and conditions. Basis for the identification of these risks is management's draft financial statements, the auditor's understanding of the entity and its environment, including an understanding of internal control over the identified disclosures, and the application of useful tools, such as disclosure checklists (which aid the auditor's understanding of the financial reporting framework). The nature and extent of the particular disclosures identified then forms the basis for an assessment of risk of material misstatement of disclosures at a financial statement and assertion level, including the assessment of whether risks of material misstatement in relation to particular disclosures are significant risks or risks for which sufficient appropriate audit evidence cannot be obtained by substantive procedures alone.

The assessment of risk of material misstatement for disclosures (for completeness or otherwise) is revised, as needed, as the audit progresses.

Towards the end of the audit, the auditor is required by the ISAs to "stand back" and consider the fair presentation of the financial statements as a whole when the financial reporting framework is a fair presentation framework. This involves considering the presentation of the financial statements as a whole, including the interaction among the line items of the financial statements and the disclosures and the impact of this interaction on overall fair presentation. ISA 700 provides further details of the issues considered in this context.

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

There are no ISA requirements that, in our experience, pose practical challenges with respect to disclosures. However, this does mean that the way requirements are applied (e.g., materiality) may need to be different than for line items on the face of the financial statements. Additional guidance on such issues might, however, be considered if necessary.

Please provide any other relevant comments that you wish to make on Section III.

Paragraphs 47, 48 and 49

Paragraph 47 states that ISA 540 "contains specific requirements for the auditor to *obtain* sufficient appropriate audit *evidence* about the reasonableness of accounting estimates and related disclosures including *evaluating* the adequacy of the disclosure of estimation uncertainty. [*italics added*]" In addition, paragraphs 48 and 49 deal with additional matters that an auditor is required to evaluate under the ISAs, including the overall presentation of the financial statements, including related disclosures, the adequacy of disclosures, and whether the financial statements achieve fair presentation.

IFRS do not require management to obtain accounting evidence to adequately support the reasonableness of their accounting estimates and related disclosures, including the evaluation of the adequacy of the disclosure of estimation uncertainty. Furthermore, the IFRS do not require management to undertake an evaluation of the overall presentation of the financial statements, including related disclosures and the adequacy of disclosures. While IFRS do require the financial statements prepared by management to achieve fair presentation, there does not appear to be a requirement in IFRS that management perform an evaluation of the fair presentation of the financial statements, nor a requirement to document this. In consequence, the IFRS do not require that management gather any evidence of such evaluations and to document this evidence.

On this basis, the IFRS fall short of the requirements needed for management to support the estimates and disclosures in the financial statements, including their fair presentation. The IAASB needs to convey these deficiencies to the IASB.

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

I8) If there were certain disclosures that were determined to be incapable of being audited, would you want them to be included in the financial statements and labeled —unaudited or would you prefer that they be placed outside of the audited financial statements?

If disclosures are determined to be incapable of being audited, it means that sufficient appropriate audit evidence is not obtainable. In this case, management would also not have evidence to justify making such disclosures and would have neither a basis for making those disclosures nor for including them in the financial statements, which, as the IDW Concept Paper noted, should be based on "accounting evidence" so that management meetings its stewardship responsibilities. The question even arises whether assertions made without evidence to support them really qualify as "disclosures", rather than just as statements or assertions. For this reason, such assertions or statements have no place within the financial statements because they are not just unaudited, but are also incapable of being adequately supported by management.

Consequently, we would not support the inclusion of such statements or assertions within the financial statements, even if they are marked "unaudited". However, if such statements or assertions are, unfortunately, required by the applicable financial reporting framework, then management should be required to state that they do not have adequate support for them in addition to being marked "unaudited".

R5) Does the shift in the IASB Conceptual Framework away from reliability towards faithful representation change what you expect of preparers and auditors? Please explain your answer.

There is a clear difference between faithful representation and reliability that affects how preparers and hence auditors deal with the information in financial statements. More importantly, the change in concept and terminology affects how the IASB deals with the requirements it sets for the information to be provided in the financial statements.

The concept of reliability, as well as the concept of validity, come from measurement theory ("measurement" in measurement theory refers to a systematic mapping process of empirical objects to representations thereof, not "measurement" as defined by IFRS or US GAAP). In measurement theory, validity refers to the degree to which a measurement measures what it purports to measure, whereas reliability refers to the precision and accuracy of a measurement. Validity is a conceptual issue, whereas the ascribed degree of reliability is ultimately an verification (evidential) issue. On this basis, the concept of faithful representation is closer to validity, whereas reliability is closer to the concept of verifiability as noted in the Framework, but the IASB concepts are poor substitutes for the broader concepts used in measurement theory. It is the IASB's characterization of "faithful representation" as a fundamental characteristic, but verifiability as only an "enhancing characteristic", that causes the real shift in how the IASB deals with the nature of the information it requires to be reported and hence how preparers and auditors deal with the information in financial statements.

By using the narrower concept of verifiability, rather than reliability, and relegating it to secondary status, the IASB is really conveying that having evidence to support the information in the financial statements does not really matter as long as the information faithfully represents what little evidence (if any) there is. For this reason, some of the expectations of regulators with respect to preparers and auditors that this shift in the Framework will not cause any fundamental change are misplaced: preparers, and hence auditors, will apply IFRS as they are, and if IFRS do not require evidence so that information is reliable, then such evidence would not be forthcoming because it is not required. The IFRS need to specify the evidence needed by preparers to justify the use of particular accounting treatments.

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.

If management's consideration of a disclosure (or any other item in the financial statements) can be appropriately supported by evidence and documentation thereof, then a disclosure (or other item) is, by definition, auditable. The key is that the evidence be adequate to support management's disclosures (or other items) and consequently be adequate for audit purposes. In some circumstances, even when management has not provided evidence and documentation thereof in support of a disclosure, there may be other sources of evidence (e.g. from outside the entity in some circumstances) that an auditor may draw upon and that may be adequate in the circumstances. However, as a matter of principle, it is management's responsibility to support its disclosures and other items in the financial statements, and indeed, if management fails to do so management has not met its stewardship responsibilities. As we noted in the IDW Concept Paper, the lack of recognition in the IASB Conceptual Framework and the IFRS that it is management's responsibility to gather adequate evidence and document that evidence appropriately to support its assertions in the financial statements is a fatal flaw in the IFRS and the IASB Conceptual Framework.

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

Paragraph 61

It is true that note disclosure for property, plant and equipment is derived largely from the accounting system, which means that evidence regarding such disclosures (whether to support management's assertions or to support the audit) would be derived from the work on the line items. However, there are, for example, considerations of "recoverable amount" and estimated useful life that involve matters not directly related to matters derived from the accounting system that may be relevant to a consideration of the carrying amounts of property, plant and equipment. Consequently, it is important not to generalize too much about these matters.

Paragraph 62

We agree that an auditor is not required to obtain the audit evidence needed to express an opinion on the segment information individually. However, we would like to point out that this is because materiality relates to the financial statements as a whole, rather than to individual items in the financial statements. Nevertheless, there may be situations where users of the financial statements are particularly sensitive to changes in segment information. In those circumstances, the ISA 320 recognizes that materiality that is less than the materiality for the financial statements as a whole may be appropriate. In this case, the audit evidence needed in relation to segment information would increase, theoretically even to the point to which an opinion could be given on the segment information.

Paragraph 63

We agree with the assertions made in this paragraph, but would like to point out that *management* would need to obtain adequate evidence to evaluate the reasonableness of assumptions and methods it uses regarding the recognition and measurement of the financial statement amount.

Paragraph 64

As noted previously, both management and an auditor need to seek the same amount of evidence about a fair value amount, regardless of whether it is a line item on the face of the financial statements or a disclosure.

Paragraphs 65 and 66

With respect to the audit evidence needed for stress tests, we note that the IFRS requirement relates to disclosing the fact that one was done, and to disclosure enabling users to understand the implications for the entity and its ability to withstand the scenario(s). No disclosure is needed on information in relation to the appropriateness of the tests. On this basis alone, (a) appears to reflect the evidence required. However, IAS 1.18 states “An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material”, which implies that an inappropriate stress test or one that was inappropriately carried out, even if properly disclosed, represents an inappropriate accounting policy. Furthermore, there is a presumption by users that management applies only stress tests that it considers appropriate (or that are required by regulation) and that they are applied appropriately. For these reasons, management would need to obtain evidence to support the appropriateness of a particular stress test, and whether it was appropriately performed to justify disclosing such a stress test in the financial statements (i.e., there would be no justification for including the disclosure of a stress test in the financial statements when the stress test is not appropriate or not appropriately performed, and doing so would be a violation of IAS 1.18). Hence, an auditor would need to obtain the evidence needed as described in (b).

Paragraph 67

This paragraph addresses three separate issues: 1. whether an auditor is expected to test that an internal control described in the notes is also operating effectively; 2. what evidence auditors are expected to obtain about management intent when evidence of intentions is subjective and may not be verifiable using external data; and 3. the evidence for forward-looking disclosures when there is limited external evidence corroborating or undermining management's process for determining the disclosure. Each of the three require separate treatment because the auditing issues are different.

In relation to the need to audit the operating effectiveness of internal control when that control is described in the notes, we would like to point out that the issue here is similar to the one identified in relation to stress tests in paragraphs 65 and 66. When management has made no assertion with respect to the operating effectiveness of internal control, it is understandable that an auditor take the position that the operating effectiveness of internal control need not be tested. However, IAS 1.18 states "An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material," which means that an inappropriate internal control or one that is not operating effectively would represent an inappropriate accounting policy, even if adequately disclosed. Furthermore, there is a presumption by users that management would describe only internal controls that it considers are appropriately designed, implemented and operating effectively – otherwise, there would be little point to making the disclosure. For this reason, management would need to obtain evidence to support the appropriate design, implementation and operating effectiveness of the internal control described to justify describing that internal control in the financial statements (i.e., there would be no justification for including the description of that internal control in the financial statements when the control does not operate effectively and it would be a violation of IAS 1.18 to do so). Management generally obtains such evidence by means of its monitoring process. In any case, since management ought to describe such an internal control only when management believes the control is adequately designed, implemented and operating effectively, an auditor would need to obtain evidence needed to justify that disclosure. This may not extend to testing the design, implementation and operating effectiveness of internal control, but must at least include gathering evidence that the monitoring process yielded adequate evidence for management in this respect, which was the basis for the inclusion of management's description in the financial statements.

With respect to what evidence auditors are expected to obtain about management intent when evidence of intentions is subjective and may not be verifiable using external data, we would like to point out that there usually is evidence within the entity whose financial statements are being audited that either supports or undermines management's assertion of intention and an auditor is generally in a position to consider the reasonableness of intentions within a certain context. It is true that such evidence is generally indicative rather than persuasive on its own, but such evidence can generally be corroborated by means of written representations to the auditor to make the aggregate evidence persuasive (see ISA 580).

In relation to the evidence for forward-looking disclosures (other than management intent) when there is limited external evidence corroborating or undermining management's process for determining the disclosure, we would like to point out that there usually is evidence external to the entity or internal to the entity (or both, as the case may be) that supports or undermines management's assertions in such forward-looking disclosures. Again, such evidence is generally indicative rather than persuasive, but, as noted in paragraph 68, such evidence can be corroborated by testing the process of how management made the disclosure and the data on which it is based, including evaluating whether the assumptions used by management are reasonable. Further corroborating evidence can be obtained by obtaining a written representation from management in relation to those assumptions, as well as on the forward-looking disclosure itself.

Paragraph 69

We completely agree that users do not understand that the evidence obtained in relation to disclosures involving inherently uncertain financial statement amounts cannot make that information more reliable (i.e., reduce inherent measurement uncertainty) because of the lack of strength of the evidence available. We noted previously in our response to Part I that the degree of reliability cannot be separated from the risk that such information does not exhibit that degree of reliability. Users, however, do not understand this relationship and often presume that such risks for different items in the financial statements are the same. However, in this case, the IAASB is at fault by not recognizing and having audit reports clearly convey to users that the level of assurance (i.e., the risk of a certain degree of unreliability – in this case, a material misstatement) is just an expression of the strength (i.e., the combination of sufficiency and appropriateness) of the evidence obtained. Therefore, since the strength of the evidence varies by assertion in the financial statements, the level of assurance obtained for different items, including disclosures, in the financial statements varies. Instead, for political reasons, the IAASB chose to equate reasonable assurance with “high” assurance, which conveys to users the notion that such assurance is always uniformly high among financial statements and within financial statements. Since this can never be a reflection of reality, this notion is ludicrous, as we had previously pointed out in our comment letters on the revision of ISA 200 as part of the clarity project.

Paragraph 70

As we pointed out in our other relevant comments to paragraph 30 that we wished to make on Section II above, objective-based disclosure requirements create particular challenges for prepares in standing back form the financial statements. We also agree that this is a judgmental process. However, we disagree that it would be difficult for management to generate evidence of its stand back process to support its judgments. Critical in this respect is that management have a process, for such a stand back, the operation of which should be documented. The IDW Concept Paper notes that the IASB Conceptual Framework (whether old or new) and the IFRS do not address the issue of financial reporting processes and their documentation, which is a fundamental flaw. Furthermore, it is critical that financial reporting standards have some criteria that management, and hence auditors, can apply, when considering the need, nature and extent of objective-based disclosures (including fair presentation – see response to A7 below).

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?

As a matter of principle, there is no difference in effort (whether from management or the auditor) in obtaining supporting evidence that should be required depending upon whether an item or disclosure is on the face of the financial statements. For this reason, such effort required related to the disclosure of fair value of a line item should not be different from that required for that item measured on another basis, such as historical cost. This implies that the effort should be the same as if fair value were on the face of the financial statements.

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.

Objective-based disclosures, such as the fair presentation requirement, do provide a useful safety valve such that general purpose financial reporting frameworks do not degrade into pure rules-based compliance exercises that are of less value to users of financial statements. The potential cases given in the question are excellent examples of matters that may be material to users. However, the fundamental issue in this respect is, other than the definition of materiality (which is rather general and therefore not helpful in practice), there are no criteria for determining when disclosures that are not specifically required by IFRS need to be disclosed to achieve fair presentation. It is very difficult for prepares and auditors to make a judgment as to what users might need as economic circumstances change and it is very easy for users and regulators to claim that certain disclosures would have been material under the fair presentation requirement with hindsight. The IASB needs to consider some clearer criteria for additional disclosures to achieve fair presentation. Otherwise, the fair presentation requirement will remain ineffective and would result in an expectations gap in relation to what users expect from "fair presentation", and what management and auditors believe they can deliver in this respect. Hence, in line with our other relevant comments to paragraph 30 on Section II above and our response to paragraph 70 in question A5 above, it is critical that management be required to have a process, for such a stand back, the operation of which should be documented.

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?

First, we do not share the notion held by some that all disclosures specifically required by financial reporting standards are per se material. Rather, whether a disclosure is required depends upon whether it is material. However, some disclosures are deemed always to be material. The problem in this respect is the fact that financial reporting standards do not always clearly distinguish which specifically-required disclosures need not be made if not material, and which disclosures are always deemed to be material. The consequence is the inclusion of many immaterial disclosures by preparers (and the support of this by auditors) to be "on the safe side" with regulators.

It is difficult to apply the concept of materiality to qualitative disclosures because the consideration of whether and how a qualitative disclosure is material is primarily a qualitative consideration.

We question some of the assertions in paragraph 84. If entities engage in transactions with financial instruments that involve high nominal contract amounts that exceed the gross assets of a bank, then the same materiality and performance materiality considerations apply as for other financial statement items. However, the question in this respect is what is the potential impact of the instruments, rather than the nominal amounts. Hence materiality and performance materiality needs to be applied to the potential impacts on the entity and its financial statements, rather than on the nominal amount. Consequently, applying materiality and performance materiality in the normal way would not reduce the risk of a material misstatement to lower than an acceptably low level.

Overall we believe that the ISAs, as auditing, rather than financial reporting, standards, have adequate guidance on the materiality of financial statement items, including disclosures: it would be inappropriate for auditing standards to provide further guidance that usurps the role of financial reporting standards. Hence, we believe that financial reporting standards need to be clearer on which disclosures need only be made if material and which are always deemed material. Furthermore, additional criteria for the determination of qualitative materiality would also be helpful.

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.

As a matter of principle, a material misstatement of a disclosure is one that, in light of the surrounding circumstances, would reasonably be expected to influence the economic decisions of users of financial statements. This principle draws on the commonly used description or definition of materiality and would apply to each of the following types of disclosures.

Judgments and reasons

The description of a judgment is materially misstated, when the judgment made is not described accurately or the judgment was inappropriate, such that it would reasonably be expected to influence the economic decision of users. The description of reasons would be materially misstated when the reasons given were not the reasons applied in a decision or judgment, the reasons actually applied are not described accurately, or the reasons were clearly inappropriate, such that it would reasonably be expected to influence the economic decision of users.

Assumptions/models/inputs

The description of an assumption, model, or input is materially misstated when the assumption, model or input described is not the one used, or their description of the ones used are inaccurate, or the assumptions, models or inputs are clearly unreasonable or inappropriate, such that it would reasonably be expected to influence the economic decision of users.

Sources of estimation uncertainty/sensitivity analysis disclosures

The description of an estimation uncertainty is materially misstated when the description is inaccurate (e.g., the described range of uncertainty does not reflect the actual range) such that it would reasonably be expected to influence the economic decision of users. The disclosure of a sensitivity analysis is materially misstated when the sensitivity analysis described does not reflect the kind of analysis actually carried out, the sensitivity analysis actually carried out is inaccurately described, or, if the sensitivity analysis was accurately described, the nature of the sensitivity analysis is inappropriate in the circumstances or the sensitivity analysis was inappropriately performed, such that it would reasonably be expected to influence the economic decision of users.

Descriptions of internal processes

The description of an internal process is materially misstated when the description is of a process of a different kind than that actually carried out, the description is inaccurate, or, if the description of the process actually carried out is accurate, the process was inappropriate or was inappropriately performed, such that it would reasonably be expected to influence the economic decision of users.

Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis

Fair value information (whether recorded in a line item on the face of the balance sheet or disclosed in the notes) is materially misstated when the value shown departs materially from the fair value. When there is an active, normally functioning market, this departure would normally be reckoned from the market price (however defined by the financial reporting standards). However, in the absence of such a market, preparers must use models, such as those based on future cash flows, to determine fair value. In those circumstances, the disclosures in relation to judgments and reasons, assumptions models and inputs, sources of estimation uncertainty, sensitivity analysis, and internal processes become necessary. Nevertheless, disclosure of these matters does not rectify the use of inappropriate values (IAS1.18 states “An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material”).

Objective-based disclosure requirements.

Using the fair presentation example of an objective-based disclosure requirement, financial statements are materially misstated because they are not fairly presented when the overall presentation of, for example, the financial position, financial performance, and cash flows, does not appropriately reflect these such that it would reasonably be expected to influence the economic decision of users. This means that users would believe, on the basis of the misstated financial statements, that the financial position, financial performance or cash flow are other than they actually are.

However, as we noted above in our response to question A7, there are no criteria for determining when disclosures that are not specifically required by IFRS need to be disclosed to achieve fair presentation, and when such disclosures are materially misstated. The IASB needs to consider some clearer criteria for how additional disclosures achieve fair presentation, and for objective-based disclosures generally.

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?

Before addressing the audit work in relation to the disclosures in (a) and (b) above, we believe it is important to address management's responsibilities in relation to these disclosures.

In relation to (a), management would describe in the notes to the financial statements the controls management has established to mitigate risks. By disclosing these controls to help manage risks that have an impact on the financial statements, these controls become a part of management's accounting policies. IAS 1.18 states: "An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material." Consequently, before including such a disclosure, management must have adequate evidence that the control is 1. appropriately designed to mitigate the disclosed risk, 2. implemented and 3. operating effectively, because if the control were inadequately designed, not implemented or not operating effectively, then management would be disclosing an inappropriate accounting policy. Furthermore, users would presume that management would only disclose a control that management has adequate evidence for believing is appropriately designed, implemented and operating effectively. Management would generally be able to obtain adequate evidence of design, implementation and operating effectiveness through its monitoring process. In this context, it is the auditor's responsibility to evaluate whether management has appropriately disclosed this information. This would involve examining whether 1. the description of the control matches the actual control and 2. whether management has adequate evidence that the control is appropriately designed, implemented and operating effectively based on its monitoring controls. This would not extend to tests of design, implementation and operating effectiveness beyond gathering evidence that the monitoring process yielded adequate evidence for management.

In relation to (b), we refer to our response to question A5.

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?

Forming an opinion on the financial statements as a whole involves consideration of the integrated impact of qualitative and quantitative misstatements – that is, considering if the qualitative misstatement or the quantitative misstatement, or both together, can be reasonably expected to influence the economic decisions of users. This can be achieved by considering what the impact of the qualitative misstatement would be without the quantitative misstatement and vice-versa and then comparing if neither or both existed. Judgmental qualitative misstatements of disclosures cannot be "accumulated", but can be treated like other qualitative misstatements as noted in an integrated manner with other quantitative and qualitative misstatements. Judgmental quantitative misstatements of disclosures can be aggregated together with other quantitative misstatements because the determination of a judgmental misstatement involves a point estimate of that misstatement.

Misstatements in the disclosures of prior years affect the evaluation of the current year's financial statements only to the extent that the matter disclosed is of continuing relevance to the current year, which may include the fact that such a disclosure is no longer necessary in the current year. Misstatements in quantitative disclosures of prior years would need to be treated like misstatements in quantitative disclosure in line items: the impact on any amounts carried forward to the current year's figures needs to be determined, particularly if the misstatements of the prior year were not material and therefore not adjusted. The impact of misstatements in qualitative disclosures of prior years on the disclosures of the current year also requires consideration.

Please provide any other relevant comments that you wish to make on Section IV.

Paragraph 53

As we noted previously in this letter, the notion that all disclosures (and even all other items in the financial statements) currently required by financial reporting standards are not without auditability problems is not a supportable premise. Furthermore, the depiction of two perspectives on what is meant by auditability in this paragraph is based upon a fallacy. We noted in our comment letter that auditability relates solely to the obtainable evidence. Hence the first perspective is correct: auditability depends upon whether the auditor can apply procedures to obtain the evidence necessary to reduce the risk of material misstatement to an acceptably low level. The fact that information is imprecise does not make it unauditable if evidence about the nature and extent of that imprecision is obtainable. This is why imprecise information that is reduced to a point estimate in the line items on the face of the financial statements needs to be supplemented by disclosure about the nature and extent of the imprecision. The auditor can increase the assurance obtained in relation to such disclosures (as opposed to their credibility, which is the assurance *taken* by users from the auditor's report based upon the opinion in the report – credibility is to be distinguished from the assurance obtained by the auditor: see the FEE Paper "Principles of Assurance" from 2003) by obtaining further evidence. The question is the nature and extent of the obtainability of such evidence. Furthermore, inherent limitations on the obtainability of evidence needs to be distinguished from scope limitations as noted previously in this letter.

Paragraph 58

The fact that disclosures are prepared late in the financial reporting process and may be produced using less formal procedures leads to timing and documentation problems for management, but in itself, should not lead to additional issues of whether or not the available evidence for management is adequate to support its disclosures. It is also true that the risk assessment procedures of the auditor may be performed closer to the end of the financial reporting process and that the risk assessment process may be less formalized, but again this leads to timing problems and documentation problems for the auditor, but does not change the evidence that an auditor ought to be able to obtain. Consequently, the assertions in this paragraph ought not to have an impact on audit evidence and materiality issues addressed in the IAASB paper.

Paragraph 71

We ask ourselves why the FRC believes that auditors need to be more skeptical about differences between what management has done and the auditor have accepted *that are not material*. If such differences are not material (individually or in aggregate), then greater skepticism in these areas would cause auditors to need to do more work in areas that are not material, which would be inefficient because it would not serve the purpose of the audit.

SECTION V – Questions About Auditability

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

Disclosures for which sufficient appropriate evidence is not obtainable is not capable of being audited. However, as previously noted in this letter, a distinction needs to be made between scope limitations (not being able to obtain the evidence that can reasonable be expected to be obtainable, which precludes the ability to form an opinion on a matter in a particular instance) and inherent limitations (evidence that is inherently not available or obtainable (and is not reasonably expected to be so), that therefore has an impact on the general auditability of certain information or the level of assurance obtainable) and therefore always precludes the ability to form an opinion. It is important to restrict the discussion on auditability in the paper to the latter.

Appropriate evidence is not generally available when the criteria (the requirements of the financial reporting standards) are unsuitable (as described in ISAE 3000).

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?

The criteria used to assess judgment with respect to the fair presentation of the financial statements as a whole should not be auditing criteria based in auditing standards, but criteria embodied in financial reporting standards, because management needs to make judgments with respect to the fair presentation of the financial statements when completing the preparation of the financial statements. Auditors would gather evidence to determine whether management has applied the criteria appropriately.

Currently, ISA 700.14 (a) and (b) represent high level criteria that auditors apply when considering the fair presentation of financial statements. Some additional criteria are included in PCAOB interim auditing standards (AU 411.04 - .06. IAS 1.15 states an additional criterion that fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework). However IFRS do not provide any further requirements or guidance (criteria) for the determination of fair presentation. As previously noted in our letter, without further criteria and guidance, the fair presentation requirement will remain ineffective. In our view, the development by financial reporting standards setters of such criteria is of critical importance if the fair presentation requirement is to have real meaning. However, we are not in a position to provide suggestions in this respect without further research.

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 do believe that the manner in which financial reporting regulators and audit regulators enforce financial reporting requirements influence how preparers prepare the financial statements and how auditors approach their audits. When regulators take a "tick the box" approach to disclosures, it leads to preparers and auditors not applying materiality when considering whether disclosure need to be included in the financial statements.

This leads to a proliferation of immaterial disclosures that clutter the financial statements and reduce their understandability.

Regulators also appear to often have a tendency to believe that auditors should mitigate the failure of financial reporting standards to provide adequate requirements and guidance for certain issues, and some even seem to believe that auditors can increase inherently imprecise information simply by opining on it, both of which are fallacies. Regulators also sometimes seem to believe that auditors must obtain sufficient appropriate audit evidence even when management is not in a position to provide adequate evidence to support its assertions in the financial statements. Yet in many cases auditors can only obtain evidence that is made available by management (the primary exception being external confirmations and drawing on other external parties for corroborating evidence).

On the whole, the approach regulators take has a major impact on how preparers prepare, and auditors audit, financial statements.

Please provide any other relevant comments that you wish to make on Section V.

Paragraphs 102 and 103

As noted in our other relevant comments made on Section IV in relation to paragraph 53, the depiction of two perspectives on what is meant by auditability in this paragraph is based upon a fallacy because auditability relates solely to the obtainable evidence. The first perspective described in this pargraph is correct: auditability depends upon whether the auditor can apply procedures to obtain the evidence necessary to reduce the risk of material misstatement to an acceptably low level. The fact that information is imprecise does not make it unauditable if evidence about the nature and extent of that imprecision is obtainable. This is why imprecise information that is reduced to a point estimate in the line items on the face of the financial statements needs to be supplemented by disclosure about the nature and extent of the imprecision. The auditor can increase the assurance obtained in relation to such disclosures (as opposed to their credibility, which is the assurance *taken* by users from the auditor's report based upon the opinion in the report – credibility is to be distinguished from the assurance obtained by the auditor: see the FEE Paper "Principles of Assurance" from 2003) by obtaining further evidence. The question is the nature and extent of the obtainability of such evidence. Furthermore, inherent limitations on the obtainability of evidence needs to be distinguished from scope limitations as noted previously in this letter.

Paragraphs 104 and 105

The IAASB is correct in stating that the IASB concept of verifiability appears to be different than the concept of auditabiality. However, as we noted in our letter, the concept of verifiability is predicated on the existence of evidence, a concept which the IASB fails to address in its standards or framework. Hence, properly understood, verifiability and auditability should be equivalent.

Paragraph 106

We completely agree with the assertion that central to the question of auditability (but not just of disclosures) is the question of management's supporting evidence for their assertions in the financial statements. It is unfortunate that this assertion is placed at the end of the paper, when this, together with materiality, is the paper's central theme.

Paragraph 110

Reference is made to "unobservable inputs". We would like to point out that the choice of assumptions and models needs to be based on observable inputs too or their reasonableness cannot be considered. Hence, all fair value information needs to be based on observable inputs, even if these are indirect rather than direct.

Paragraph 111

It is interesting that the IASB considered the difficulties of auditors in auditing risk disclosures required by IFRS 7. Shouldn't the IASB have first considered the difficulties of management of applying IFRS 7 without the ability to obtain the evidence needed to support their accounting treatments under IFRS 7?

Paragraphs 112 and 113

We refer to our letter above that asserts that "accounting evidence" needs to be a fundamental financial reporting concept.

While we agree that a complete understanding of a line item involving assumptions and models requires considering the value presented in the line item together with the accompanying disclosures. However, we would like to point out that the paragraph 4.37 of the current IASB Conceptual Framework points out that the failure to recognize items that satisfy the criteria for recognition under 4.38 is not rectified by disclosure of the accounting policies used nor by notes or explanatory material. Analogously, improper measurement of an item on the face of the financial statements cannot be rectified by disclosure of the process used to perform the measurement nor by notes or explanatory material on inherent uncertainties. For this reason, by auditing the disclosure, the auditor is auditing the recognition and measurement treatment of that line item – not just the disclosures of the process. We note in paragraph 113 the unusual application of the term “verifiability” by the IASB and that the concept needs to be amended to reflect an accounting evidence concept.