NEW ZEALAND INSTITUTE OF CHARTERED ACCOUNTANTS

30 May 2011

Technical Director
International Auditing and Assurance Standards Board
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Dear Sir

The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications

The Professional Standards Board (PSB) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on the IAASB Discussion Paper *The Evolving Nature of Financial Reporting: Disclosure and its Implications*.

The PSB strongly supports this project and our comments are our best endeavours to represent the range of views in New Zealand.

Please find attached our responses to the Questions for Auditors in Appendix A and our response to one of the Questions for Regulators in Appendix B.

If you have any queries or require clarification of any matters in this submission, please contact Misha Pieters (misha.pieters@nzica.com) or me. Yours sincerely

Yours faithfully

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APPENDIX A

CONSULTATION QUESTIONS FOR AUDITORS

1. ***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.***

   The PSB understand that entities may take the view that a required disclosure is immaterial to justify its non-inclusion in the financial statements. This can be particularly difficult in situations where auditors regard a disclosure to be material based on its nature rather than size (e.g. related party disclosures), whereas the entity's management considers the disclosure immaterial based on size. The factors considered by auditors to arrive at a professional judgment include:

- whether or not the omission will affect judgment of readers of the financial statements,
- materiality of the financial statement item to which the disclosure represents,
- current economic conditions (where relevant),
- the industry that the preparing entity belongs to and nature of the financial item (for example, during the global financial crisis, the financial sector's financial instruments and their disclosures were given more consideration),
- disclosures of similar entities, and
- history of misstatements or omission of disclosures by the client.

Furthermore, auditors rarely propose removal of a disclosure on the financial statements on the grounds of immateriality provided that the auditor is satisfied that those disclosures are not misstated. Reasons for this include:

- minimising the risk that a regulator might later question the omission of a disclosure; and
- minimising the risk that what appears to be an immaterial disclosure might later be judged to be material, on the basis of hindsight in the light of future adverse events – in other words, "it is better to be safe than sorry".

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

   This is often based on the auditor's previous experience with the entity and consideration of what disclosures are expected to be most significant to users of the entity's financial statements.

   The approach for the identification and assessment of the risks of material misstatement of disclosures may be influenced by the following factors:

Factor	**Impact**
Nature of the business of the reporting entity	The nature of the business of an entity is a determinant of the balance sheet and income statement profile of an entity resulting in significant balances that may drive the volume of disclosures (e.g. financial institutions will normally be subject to disclosure requirements on financial instruments. In this case, the risk of material misstatement on disclosures may be assessed to be higher).
Reporting profile of an entity	An entity that has public accountability will most likely have its disclosures scrutinised by financial statement users. Hence, the risk of material misstatement may be assessed as higher.

Factor	Impact
Financial distress	Entities that experience financial distress may be assessed to have higher risk of material misstatement about going concern disclosure.
Management's attitude towards financial reporting	Entities with management teams that have unstructured processes and practices for financial reporting are assessed to have higher risk of material misstatements of disclosures.
Skill-level of preparers of the financial statements	Financial statements prepared by inexperienced staff with relatively low levels of training are assessed to have a higher risk of material misstatement of disclosures.

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

   The PSB identify two requirements in ISA that pose practical challenges in auditing disclosures as follows:

   a. ISA 540.A119: "Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements."

   We believe that the above explanatory material only provides guidance on what considerations an auditor will need to apply on accounting estimates and related disclosures that are not recognised in the financial statements. However, there is a significant practical challenge in determining the appropriate level of audit effort that an auditor needs to apply on those estimates that are in the disclosure as against those that are recognised in the financial statements. Specifically, while the same considerations apply, the question is whether auditors are expected to exert the same level of audit effort for estimates that are only included in disclosures as opposed to those that are recognised in the financial statements.

   b. ISA 705.18: "If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated."

   For the case of qualitative disclosures such as those that deal with forward-looking information and management's judgment, there is a significant practical difficulty in assessing the combined effect of individual misstatements in disclosures on the overall fairness of the financial statements that will warrant the qualification of an opinion.

   This practical difficulty is not evident in respect of recognised items where individual misstatements are aggregated by the auditor and based on a pre-determined quantitative materiality level, to determine whether the financial statements as a whole are free from material misstatement.

4. ***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.***

Some degree of difficulty arises in obtaining audit evidence on disclosures concerning fair values determined using valuation techniques especially those using inputs under level 3 of the fair value hierarchy. Also, in some cases, the disclosures are based on management intent and hence are not verifiable using external data. Instead, management representations are obtained and other internal evidence collected where available. Please refer to further comments below.

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

We believe that the key issue with gathering evidence for the examples in paragraph 60-70 is the sufficiency and appropriateness of the audit evidence obtained for the disclosure.

In dealing with this issue, we comment as follows:

- Relationship of the disclosure to the line item in the financial statements: some argue that disclosures providing direct and supporting information to a line item *recognised* in the financial statements will require a higher threshold for sufficiency and appropriateness of audit evidence than those that are not recognised in the financial statements. For example, a disclosure of a recognised amount for a fair value determined using Level 3 inputs in the hierarchy under IFRS 7 will require significant audit effort whereas some argue that less audit effort is required for a disclosure for a fair value of a financial item that is reported at amortised cost in the financial statements. However, in our view, this is a matter for professional judgement based upon the nature and significance of the information judged in its surrounding circumstances.

- Source of information for the disclosure: the closer the link of the disclosures are to the financial accounting system, the less significant the audit effort will be required in obtaining sufficient and appropriate audit evidence. For example, audit of a property, plant and equipment note will not require additional significant audit effort since the information on the balances have already been tested for existence and accuracy assertions.

- Materiality of the disclosure: the more material the disclosure, the higher is the threshold an auditor will need to meet to ensure that the evidence gathered was sufficient and appropriate for a disclosure.

- The nature of the disclosure: the more forward-looking the nature of the disclosure, the more uncertainty an auditor encounters when considering the sufficiency and appropriateness of the audit evidence obtained. Reliance on information provided by management is expected since there is high degree of difficulty in obtaining external corroborative information. Nevertheless, evidence could be obtained on the reasonableness of the inputs, assumptions and models used to develop forward-looking information.

6. ***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 stated earlier, this is a matter for professional judgement based upon the nature and significance of the information judged in its surrounding circumstances. In some cases, for example, the accounting standard and its accompanying Basis for Conclusions might provide insight into whether the additional fair value disclosure is intended to provide important information, or whether it is intended to be supplementary information that might be useful to some users but is not particularly important to an understanding of the entity's financial position or performance.

7. ***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.***

   We believe that an auditor's 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, should be based on the guidance provided in IAS 1.17(c). This states that the fair presentation of financial statements requires an entity "to provide additional disclosures when compliance with the specific requirements under IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance." The challenge to auditors in applying this guidance is the determination of whether the additional disclosures are relevant to the information needs of all users or some users given that financial statements are general purpose in nature and should be prepared to meet the common needs of most users and not the specific needs of some users. This challenge arises in two different contexts: determining when additional information that the entity does not propose to include should be added to the financial statements, and determining when additional information currently included in the financial statements should be removed.

8. ***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?***

   Overall, we believe that developing prescriptive requirements is both impracticable and inappropriate. The ultimate decision as to whether a disclosure is material is a matter of professional judgement by the auditor in the context of the nature of the disclosure and the objective and requirements of the relevant financial reporting framework.

   Having said that, considering the evolving nature of financial reporting and increasing emphasis on disclosures, we believe that some additional guidance could be developed to assist with the application of materiality in the audit of disclosures. While we note that ISA 320, "Materiality in Planning and Performing an Audit" provides guidance in the application of materiality in the audit, it is fair to say that most of the guidance has more direct application in the audit of line items in the financial statements than for disclosures. We encourage the IAASB to consider expanding the guidelines to include a broader framework in assessing materiality of misstatements in the disclosures.

   We have considered views on materiality of disclosures of some regulatory bodies such as The Danish Securities Council (Fondsradet)[i] and the Irish Auditing and Accounting Supervisory Authority (IAASA).[ii]

   The Fondsradet have stated its views of materiality on disclosures by dividing disclosures into broad categories and assigning "determinants" of materiality for each category:

Type of Disclosure	Views on materiality
Accounting policies	Users of financial statements have to know which specific measurement alternatives the reporting undertaking has chosen, which significant assumptions it has made in relation to specific measurements and what particular uncertainties apply to the recognition and measurement of material items.
Notes relating to financial statement items	The materiality level used for the recognition and measurement of the financial statement item will be used to assess whether the related note contains a misstatement.

Type of Disclosure	Views on materiality
Notes providing supplementary measurement information	The omission of required notes providing users with material supplementary measurement information is considered a misstatement unless the recognised amount as well as the amount disclosed in the note is immaterial. The materiality level used for the recognition and measurement of the financial statement item will be used to assess whether the related note contains a misstatement.
Risk notes	The type or nature and particular circumstances of the information will be given greater weight in the determination of the materiality of the note.
Control notes	A qualitative assessment is used on the materiality level of this note and will be based on the type/nature and particular circumstances of the disclosure. As the assessment is qualitative, any departure in terms of amounts in such notes should be assessed relative to the importance of the note to the users of the financial statements. It follows that materiality level in terms of amounts of these notes will be considerably lower than the general materiality level.

For IAASA, its views on materiality broadly covered all aspects of financial reporting and did not exclusively deal with disclosures. However, IAASA states that that the purpose of a disclosure can have an impact on the materiality threshold.

We neither support nor reject the views as summarised above but refer to them as they may be useful to the IAASB in its standards development efforts. Specifically, we believe that the Fondsradet categorisation of disclosures by type when considering materiality is one of the approaches that the Board may consider in forming its views.

9. ***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:***

   - ***Judgements 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.***

   The following could potentially be material, depending on the facts and circumstances:

Category	Potential material missstatement
Judgments and reasons	• Judgments that contradict facts and are unrealistic, • Judgments that are biased, and • Judgments that are unclear and unreasonable.
Assumptions/models/inputs	• Unreasonable assumptions, • Use of incomplete and/or incompatible assumptions, • Use of models lacking general acceptance, • Use of models with no theoretical support, • Misapplication of models,

Category	Potential material missstatement
	• Unreasonable inputs, • Use of incomplete and or incompatible inputs, • Use of inaccurate inputs.
Sources of estimation uncertainty/sensitivity analysis disclosures	• Incomplete disclosures of the sources of uncertainty and sensitivity, • Downplaying the impact of a significant source of uncertainty and sensitivity. • Use of unreasonable level of changes in variables for sensitivity analysis.
Descriptions of internal processes	• Descriptions of an internal process that does not in fact exist, • An inaccurate and/or incomplete description of internal processes, • Unsupported assertions of the current and future efficacy of the internal process.
Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis	• Fair value using an inappropriate valuation model, • Fair value determined through misapplication of a valuation model, • Fair value using incomplete and/or unreasonable assumptions.
Objective-based disclosure requirements	• Incomplete disclosures such that the objective of the disclosure is not met, • Inappropriate level of detail of the disclosures such the objective of the disclosure is not met, • Excessive disclosures that obscure critical information.

10. 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?

a. An example of this type of disclosure requirement is found in IFRS 7.33(b): For each type of risk arising from financial instruments, an entity shall disclose its objectives, policies and processes for managing the risk and the methods used to measure the risk. Given the requirement under IFRS 7, we believe that for this type of disclosure, sufficient and appropriate evidence will constitute the following:

- Whether the disclosure properly describes the entity's objectives, policies and processes for managing the risk and the methods used to measure the risk, for example, as documented in the entity's policies' and procedures' manuals and meeting minutes.
- The evidence will be obtained from the appropriate level of management that is in charge of managing such risk.

Note that the auditor's work does not include an assessment as to whether the entity's policies and procedures will actually manage the risk arising, in this instance, from financial instruments.

An example of misstatement for this disclosure will be an incorrect and/or incomplete description.

b. The proposed disclosure is: ***If*** an entity prepares stress testing information for internal risk management purposes it shall disclose that fact and information that enables users of financial statements to understand the (i) the implications for the financial position and performance of the entity; and (ii) the entity's ability to withstand the stress scenario or scenarios. [Emphasis added]

Therefore, stress testing is not mandatory for all entities and therefore the resulting disclosures are also not mandatory for all entities.

In our view, the appropriate audit approach falls between the two views expressed in paragraph 66. If stress testing has been performed, evidence should be obtained on whether the disclosure is an accurate description of the stress testing that was performed. However, the auditor should also consider the reasonableness of the information disclosed in the entity's circumstances. Any concerns should be discussed with management.

11. 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?

Qualitative and quantitative misstatements are both evaluated with reference to the pre-determined materiality level and professional judgment. We believe that misstatements of disclosures that are qualitative and judgmental in nature can be qualitatively accumulated. However, their evaluation with reference to the overall fairness of the financial statements will be made not against a numeric materiality level but a threshold that an auditor sets using professional judgment. This threshold will need to be set by considering such factors as to whether the misstatement or omission is critical to the reader's assessment of an entity's risk of financial failure or breaches of significant legal and other regulatory requirements or inadequate disclosure of related party transactions and unusual or suspicious transactions.

We believe that a prior year's disclosure misstatements can influence the evaluation of the current year's financial statements, for example, by indicating a trend or attitude by management towards financial statement disclosures.

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

In our view, despite difficulties identified above, disclosures are auditable. In some cases, it is necessary to provide clarification as to whether the process or outcome is what is being audited.

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

We believe that the criteria to be used are whether the financial statements do not contain a material misstatement or have an omission that could influence the economic decisions of a user. With regard to any misstated or omitted material information, the auditor in exercising professional judgment must have considered whether the information is critical to a reader's assessment of an entity's risk of financial failure or breaches of significant legal and other regulatory requirements or inadequate disclosure of related party transactions and unusual or suspicious transactions.

14. ***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?***

General Comment:

We believe that the manner in which a financial regulator enforces financial reporting requirements influences how auditors approach their audits including how they may approach disclosures.

Firstly, regulatory enforcement creates additional pressures for compliance on the audit client's management because they are primarily responsible for the preparation of the financial statements. This can assist in ensuring compliance. For example, the threat of enforcement provides additional persuasive support for auditors in cases of debate about the need for disclosure where clients can sometimes argue that the disclosures are not important and that "nobody reads them anyway." In the same manner, high-risk disclosures are also identified based on prior enforcements and these will likely be given more audit effort.

However, a regulator that appears to apply a very low level of materiality or raises numerous issues on immaterial or very insignificant items encourages a "tick box' mentality. As a result, preparers focus on compliance with the specific disclosure requirements in the standards, irrespective of materiality, to avoid any risk of enforcement action by the regulator. This can result in voluminous disclosures of immaterial information, which reduces rather than enhances the usefulness of the financial statements to users.

The New Zealand Experience

The main regulator of the New Zealand securities market is the Securities Commission. It established the Financial Reporting Surveillance Programme (FRSP) in 2004 as part of carrying out its function. The FRSP involves reviewing selected issuers' financial statements. At the end of each cycle the Commission publicly reports on this surveillance work to provide market participants with a summary of its findings. The aim of the Commission's FRSP is to encourage New Zealand issuers to improve the quality of their financial reporting.[iii]

Its first Cycle review took place in 2005 and it is still an ongoing surveillance programme. The following Table below provides summarised date on the number of issuers reviewed and matters raised on the reviewed financial statements for the last 12 cycles the FRSP.[iv]

Cycle #	Old NZ GAAP	Number of issuers reviewed	Number of issuers written to	Issuers written to %	Matters raised	Matters per issuer written to
1	Old NZ GAAP	40	15	38%	22	1.5
2	Old NZ GAAP	46	19	41%	24	1.3

Cycle #	Old NZ GAAP	Number of issuers reviewed	Number of issuers written to	Issuers written to %	Matters raised	Matters per issuer written to
3	Old NZ GAAP	45	19	42%	27	1.4
4	Old NZ GAAP	40	17	43%	27	1.6
5	Old NZ GAAP	40	16	40%	19	1.2
6	Old NZ GAAP	30	20	67%	37	1.9
7	Old NZ GAAP/NZ IFRS	44	17	39%	29	1.7
8	NZ IFRS	40	35	88%	97	2.8
9	NZ IFRS	24	17	71%	31	1.8
10	NZ IFRS	20	17	85%	50	2.5
11	NZ IFRS	24	20	83%	34	1.7
12	NZ IFRS	21	17	81%	39	2.3

It is apparent that under New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), the Commission has written to more issuers and raised, on average, more issues per issuer than under Old NZ GAAP. This would be a reflection of the fact that NZ IFRS has more complex, comprehensive and detailed requirements than Old NZ GAAP.

For the Cycle 12 results, the Securities Commission wrote to 17 of 21 issuers, mainly about:

(a) financial instruments - in particular, inadequate or incorrect disclosure of concentrations of credit risk by security type and fair-value assumptions;

(b) financial instruments measurement - in particular, the incorrect classification of financial assets and accounting policies for impairment that were inconsistent with NZ IFRS;

(c) cash flow statements - inadequate explanations for certain transactions; and

(d) property, plant and equipment - in particular, inadequate disclosure of significant assumptions underlying valuations.

A recent Securities Commission workshop with issuers identified the increasing volume of disclosure requirements as reducing the usefulness of financial statements. In order to assist in resolving this problem, the Securities Commission is encouraging issuers to remove immaterial information from their financial statements. The Commission considers that that issuers should:

"(a) Develop and apply materiality guidelines for their business.

(b) Document key judgments, and have them approved by the directors and/or the audit committee. These can then be provided to auditors and/or regulators on request.

(c) Remove accounting policies that have no underlying or significant economic activity.

(d) Customise accounting policies and cross-reference the policies to the entity's underlying economic activity. Entities should not regurgitate the whole standard but should explain NZ IFRS in plain English.

(e) Prioritise notes in financial statements and emphasise key areas of judgement and disclosures that reflect how the entity is actually managed (e.g. it is useful to link qualitative and quantitative disclosures).

(f) Align information in any entity news releases to better reflect the information in financial statements and vice versa."

<u>Other impacts on auditing</u>

In addition to the comments above , from an audit perspective, the view of the NZ Securities Commission that issuers should document key judgments, and have them approved by the directors and/or the audit committee is an example of a potential positive impact of regulatory enforcement particularly in the area of audit evidence gathering. If the Securities Commission recommendations on documentation by the regulator are applied, greater audit evidence would be available and audit evidence on disclosures about management's key judgments and estimates will be made available during the early phase of an audit rather than during the finalisation stage.

Secondly, the regulatory stance on customising and cross-referencing accounting policies to the entity and the prioritisation of key areas of judgment will potentially result in a reduction of required audit effort as far as audit of disclosures are concerned. This is predicated on the notion that a more systematic preparation of disclosures will improve its auditability. Nevertheless, challenges remain for both entities and their auditors in applying this approach – preparers often prefer to retain accounting policy disclosures, even if immaterial in a particular reporting period, to avoid the risk of omission in later years in which changed circumstances warrant the inclusion of the accounting policy.

Finally, there is anecdotal evidence that New Zealand auditors cite the findings of the FRSP to convince clients of the necessity and propriety of providing certain disclosures as identified in the FRSP reports.

APPENDIX B

CONSULTATION QUESTIONS FOR REGULATORS

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

We believe that ISAs provide sufficient requirements and guidance in respect of disclosures. Taken as a whole, the ISAs enable auditors to form professional judgments during the audit of disclosures. However, we believe that the ISAs can be further enhanced to address certain practical issues that auditors encounter in the audit of disclosures. Specifically, the provision of guidance in the following areas is encouraged:

- Applying materiality in the audit of disclosures,
- Assessing sufficiency and appropriateness of audit evidence with regard to disclosures,
- Determining the appropriate level of audit work required on accounting estimates that are included in disclosures but not recognised in the financial statements (e.g. fair value estimate disclosures of financial instruments that are measured at amortised cost).

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[i] The Danish Securities Council's general considerations and deliberations on the assessment of materiality in relation to its financial reporting enforcement activities, The Danish Securities Council. http://www.finanstilsynet.dk/en/sitecore/content/Fondsraadet/Regelgrundlag/Vejledninger/Notat-vurdering-vaesentlighed.aspx. Accessed on 10 March 2011.

[ii] Observations on materiality in financial reporting. Irish Auditing & Accounting Supervisory Authority. http://www.iaasa.ie/publications/Obs_materiality2010.pdf. Accessed on 10 March 2011.

iii Financial Reporting Surveillance Programme. Cycle 11 Review of Financial Reporting by Issuers For periods ended 31 March 2009 to 30 June 2009

iv Financial Reporting Surveillance Programme. Cycle 12 Review of Financial Reporting by Issuers For periods ended 30 June 2009 to January 2010