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Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
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31 May 2011

Dear Sir/Madam,

Re The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications

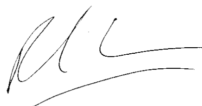
By way of background, Hermes is one of the largest asset managers in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including the BT Pension Scheme, The BBC Pension Trust, The National Pension Reserve Fund of Ireland, Highland Good Steward (USA), PNO Media (Netherlands), Canada's Public Sector Pension Investment Board, and VicSuper of Australia (only those clients which have expressly given their support to this response are listed here).

We welcome the IAASB's attention to this issue, which we believe is of vital importance. We also note that this area is a key one on which the IAASB must liaise with the IASB; we have previously noted to the IAASB the central importance of building closer ties between the two organisations.

As a brief aside, we strongly welcome the statement (in paragraph 10) that ISAs do not impose requirements on management. We firmly agree that they should not, but note that in some cases they do in fact do so – and that seem to do so for reasons which are protective of the interests of auditors rather than to ensure that audits are carried out effectively. We would welcome the IAASB mounting a review to ensure that any aspects of ISAs that in effect impose requirements on management are removed. In this respect, we would draw the IAASB's particular attention to ISA 580 on written representations.

Our comments in response to the detailed questions to investors are below.

Yours sincerely,



Paul Lee
Director

Hermes Equity Ownership Services Response to IAASB Consultation:

"The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications"

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?

The nature of the disclosures required under IFRS (and indeed other reporting standards) varies dramatically. Given this, it is clearly true that the level of reliability attaching to them will differ one from another, and also differ from that of the actual line items. Notwithstanding this, there will undoubtedly be disclosures which should have the same degree of reliability – and so the same degree of audit assessment – as line items.

I2) In the particular circumstance when a financial statement line item is measured on one basis, such as amortized cost, but the disclosure includes the fair value of the line item, should the auditors effort on the fair value disclosure be the same as if the fair value was on the face of the financial statements?

Yes we believe that the auditor must apply the same degree of rigour in its assessment of numbers which appear in the disclosures as those same numbers appearing on the face of the financial statements themselves. In the specific case given, at different times investor analysis will favour using the fair value numbers or favour using amortised cost; the choice of which number is more relevant will depend on the analysis the investor is doing and on the prevailing market circumstances (or those of the specific company in question). The investor will naturally expect the same level of reliability in those numbers whichever is disclosed on the face of the accounts and which in the disclosures.

I3) 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 and your reasoning for why you believed they were immaterial in the context.

There are undoubtedly immaterial disclosures. Many of these are immaterial to the individual company and included simply because peers in the sector in question make the disclosures or for other extraneous reasons. We would strongly support companies being brave enough to be much more idiosyncratic about the disclosures they make such that they are genuinely relevant to the company in question and so genuinely assist investor understanding of the company. We believe auditors should be less active in pressing for uniformity of disclosure.

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?

As indicated above, we believe that a lack of consistency is appropriate and acceptable – indeed, it is the only way to deliver corporate reporting which adequately captures the circumstances of individual organisations. Each company is unique and professional judgement must be applied to it by management and auditors to ensure reporting is appropriate to its unique circumstances. We believe that there is a stronger argument for consistency of disclosures by an individual entity over time – particularly as it would be unfortunate for a disclosure to be made one year, not the next but then for it to return in a third year, as such would tend to generate cynicism about the company's approach to reporting. So a lower threshold for materiality needs to apply to disclosures which have been made historically by a company; having said this, that materiality would decline rapidly over subsequent years so that disclosures are not made for purely historic reasons.

I5) Does the shift in the IASB Conceptual Framework away from reliability and towards faithful representation change what you expect of preparers and auditors? Please explain your answer.

No. Unlike many commentators we do not see a significant difference between reliability and faithful representation. Our understanding of the difference is just that it is a semantic reflection of the reality of modern business life that there is less absolute certainty in valuations of assets, arising not least from the increased use of financial instruments. If anything, this inherent uncertainty adds to the burdens on preparers and auditors to consider the assumptions which underlie the particular valuations they have applied – but we would hope that this is not a substantive difference from what went before.

I6) 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:

(6a) 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 a misstatement of such a disclosure?

We are clear that disclosures must be accurate to the extent that they fully and clearly describe the risk management framework and approach. Whether those disclosures describe an approach which effectively mitigates the risk is a separate matter – one which would not amount to misstatement (perhaps it might be mismanagement), and one that should not be made the subject of audit attention.

(6b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65–66). What work would you expect an auditor to do in relation to the proposed stress test disclosures? What do you believe would constitute a misstatement of a stress test disclosure?

Again we believe that the disclosures must describe the stress tests accurately and the auditor's role must be to see that they do. It is not the auditor's role to assess the effectiveness of those stress tests. In each case, our firm view is that the auditor's role is to assess the accuracy and fullness of the disclosures in describing the procedures, not to assess the effectiveness of the underlying procedures in such cases. We are tempted to suggest that those arguing for a different interpretation (and perhaps arguing that there is a so-called expectations gap in this area) have a clear interest in expanding the role of the audit and so the fees payable for the service.

I7) What do you believe represents a material misstatement of a disclosure? Please give an example of what, in your view, would constitute a material misstatement for the following categories of disclosures:

Judgements and reasons – misstatement would be were the stated judgements and reasons are not an accurate reflection of the current reasoning of management. This is clearly difficult to audit, and perhaps it can be done only in two ways:

(1) in a form of negative assurance, if through its work on the audit the auditor becomes aware that the stated judgements and reasons are not an accurate reflection of management thinking; and

(2) by the auditor compiling a list of the relevant judgements and reasons and highlighting these both to management and those charged with governance, inviting them to confirm their ongoing validity or identify any which are not or are no longer accurate.

Assumptions/models/inputs – there is an aspect of this area which is simply a reflection of the above. In a sense, assumptions are just another form of judgement. But there is a further area where we believe misstatement can occur and therefore audit work is necessary; we do not believe that an audit can be carried out appropriately in this area without a testing of the models through some form of sensitivity analysis as part of the audit process. In particular, the sensitivity analysis should reveal how dependent the results of models are on the inputs and assumptions applied. Where the model valuations alter dramatically as a result of a relatively small change in assumptions, the auditor will need to carry out further tests to understand whether the headline numbers disclosed are the appropriate ones, and is also likely to need to expect greater disclosures associated with the relevant line items. Where the valuations change little depending on the assumptions and inputs then the auditor can have more confidence in the line items and is likely to expect fewer disclosures associated with them.

Sources of estimation uncertainty/sensitivity analysis disclosures – there is some read-across from the above discussion. But generally the focus here should be on whether the descriptions are fair and accurate.

Descriptions of internal processes – as covered under Question I6, any misstatement would revolve around misleading descriptions of the processes rather than any consideration of the effectiveness of those processes.

Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis – the issues here are as discussed in our response to Question I2.

Objective-based disclosure requirements – this is perhaps the hardest area that the discussion paper identifies, at least in terms of auditability. Such disclosures require highly judgemental decisions by management about what is appropriate. It seems to us that the only way in which an auditor can audit these disclosures is to arrive separately at its conclusion of what in its judgement is an appropriate level of disclosure – and be aware in doing so of the need to avoid seeking additional disclosure for the sake of it – and to compare that with the level of disclosure arrived at by management. Only by debating any difference between the levels concluded on by each party can a decision be reached as to whether management have indeed delivered appropriate corporate reporting – and the debate and discussion may be as important in arriving at that conclusion as the absolute substance of any disagreement.

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 labelled unaudited ‖ or would you prefer that they be placed outside of the audited financial statements?

We believe that unaudited items should never be included in audited financial statements. Further, we believe that if there are questions about the auditability of an item there must also be questions about whether it is appropriate to be included in the accounts because it raises the issue of whether the company, and in particular its board, has an appropriate basis for making such a disclosure. If an item is incapable of being audited, it is likely that the board will struggle to have a sufficient basis for confidence that it should be disclosed. As indicated above, we believe that there are a range of activities open to auditors in relation to softer disclosures, which we believe are expected by investors as minimum activities in relation to audited accounts.

Other comments on Section IV: Materiality

The discussion paper expresses concern about the scale of disclosures regarding share-based payments even if their value is small. We will note that there needs to be a different materiality threshold applied where information provides insight into the approach of the management of the company and their effective stewardship of its assets. A disclosure of payments to agents in the form of senior management will always be of crucial importance to their principals – the shareholders – in assessing whether they are acting with appropriate awareness of their fiduciary obligations. We would note that this concern extends to senior management and not to the bulk of employees, about whom disclosures can be much more circumspect (provided they do not collectively exceed the standard financial materiality thresholds).