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

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Introduction

These comments are submitted by the Association of International Accountants and written by John Dunn, AIA technical adviser and Lecturer at the University of Strathclyde, United Kingdom. AIA welcomes the opportunity to participate in this discussion. AIA is a Recognised Qualifying Body in the UK for statutory auditors, so the following comments are based upon the consultation questions for regulators, including audit oversight bodies.

About AIA

The Association of International Accountants (AIA) was founded in the UK in 1928 as a professional accountancy body and from conception has promoted the concept of 'international accounting' to create a global network of accountants in over 85 countries worldwide.

AIA is recognised by the UK Government as a Recognised Qualifying Body for statutory auditors under the Companies Act 2006, across the European Union under the Mutual Recognition of Professional Qualifications directive and as a Prescribed Body under the Companies (Auditing and Accounting) Act 2003 in the Republic of Ireland. AIA also has supervisory status for its members in the UK under the Money Laundering Regulations 2007.

AIA promotes and supports the advancement of the accountancy profession both in the UK and internationally. The AIA exams are based on International Financial Reporting and International Auditing Standards and are complimented by a range of variant papers applicable to local tax and company law in key jurisdictions together with an optional paper in Islamic Accounting.

AIA members are fully professionally qualified to undertake accountancy employment in the public and private sectors.

Comments on IAASB Discussion Paper – The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications

Section II–Financial Reporting Disclosure Trends

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.

AIA agrees with the underlying concern that published financial statements are becoming longer and more difficult to interpret. Having said that, much of the additional disclosure and complexity is due to the increasing complexity of the underlying business and financial transactions and relationships that must be accounted for.

AIA does not believe that financial statements will be more understandable if mandatory disclosures are scaled back. It is, however, recognised that the behaviours listed in the discussion paper, such as providing immaterial disclosures rather than appearing to leave gaps in the financial statements, may be a common practice.

It could be argued that professionals should be capable of reading the financial statements intelligently and filtering out the key facts and figures that are required for any particular purpose.

Lay readers will undoubtedly be overwhelmed by the level of detail even if the statements are reduced considerably. It may be that any move towards making the statements appear to be more accessible will be counter-productive if lay investors are tempted to make their own decisions without seeking expert advice.

Section III–How Do ISAs Currently Deal with Disclosures?

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

ISAs generally provide a sound basis for dealing with disclosures. Clearly, there may be scope for misunderstandings on the part of users if they do not fully appreciate the limits of the work undertaken by auditors. For example, the guidance in ISA 501 concerning segmental disclosures is sound, but readers may not fully understand that the audit opinion relates to the financial statements as a whole and not to individual segments.

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

R3) What do you believe are the key issues with gathering audit evidence for the examples given in paragraphs 60–70?

These are all matters of judgement, both in terms of reporting and in terms of gathering sufficient evidence. The most important issue is for the auditor to obtain an understanding of the business and the risks that it faces. Once that has been done the auditor is far better equipped to understand the importance of, say, a fair value disclosure in the context of the financial statements.

AIA believes that auditors should be equipping themselves to make these evaluations through the planning and risk evaluation processes that they should be undertaking as a matter of course.

R4) 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 expect an auditor to apply on the fair value disclosure? Should the auditor's effort be the same as if the fair value was on the face of the financial statements?

AIA believes that readers will expect any formal disclosures in the financial statements to have been subject to audit and so the information in the notes should potentially be subject to the same degree of audit as information appearing in the primary statements.

That principle is dependent upon the disclosures themselves. If, for example, the note disclosing a fair value makes it clear that the figure is an estimate and is subject to too much uncertainty to permit it to be reflected in the financial statements then the auditor need not do more than establish that the estimate is reasonable.

R5) 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.

AIA believes that the shift from reliability to faithful representation means that preparers must be held to a higher standard of care because they are effectively taking greater responsibility for informing users. Auditors have to ensure that the basis of such disclosures is adequately disclosed so that users are aware of the possibility that judgements and estimates may be subject to a degree of uncertainty.

Auditors should be subject to the same standard of care as before, although it may have to be accepted that certain disclosures will be more likely to be subject to challenge with hindsight and that auditors' opinions are based upon the facts as they were known and understood as at the time of publication.

R6) 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.

AIA believes that it would be difficult, if not impossible, for the regulatory regime to accommodate every potential user's needs for information. There may be occasions when users will have to ask for specific disclosures, either directly from the entity or as a voluntary disclosure.

It is difficult to imagine how equity holders could be disadvantaged by a failure to disclose such matters unless there are consequential implications. For example, the breach of a critical law may have going-concern implications and so the auditor should be aware of that possibility and should gather evidence accordingly.

R7) 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.

AIA believes that the present overarching definition of materiality in terms of user behaviour is the only acceptable basis for defining the concept. It is not necessarily helpful to have different benchmarks for different categories of disclosure. Broadly, prepares and auditors must consider how the disclosures will be used by users and that may require clarity on matters such as the degree of uncertainty.

The shift towards faithful representation has the potential to require increasing amounts of disclosure of such information as the basis upon which an estimate has been arrived at.

R8) 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?

AIA believes that this is not, in principle, different to any other test of compliance. Auditors will almost certainly have to form an opinion on such procedures as a normal part of planning the audit and so there should be no particular requirement to gather additional information. Reviewing documents and reports and seeking management assurances through the letter of representation should suffice. This is based upon the assumption that the broader discourses on corporate governance will mean that entities will be far more likely to document their procedures and the resulting outcomes and so there will be evidence available.

(b) 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?

AIA believes that the auditor's responsibility should be restricted to ensuring that the work undertaken by the entity is adequately described and reported upon. It is debatable whether the application of stress testing will ever be sufficient to guarantee that there are no unforeseen events or that the results of the tests undertaken will be adequately understood.

AIA believes that the only realistic definition of a misstatement in these circumstances would be an outright fabrication of the results or the application of the process in an unrealistic manner that makes recklessly optimistic assumptions about the likelihood of the scenarios under consideration or their effects.

Section V–Questions about Auditability

R9) Are there disclosures which, in your view, are not capable of being audited? Please explain your reasoning.

AIA believes that the fundamental purpose of an audit is to provide assurance. AIA does not believe that there are any disclosures that are not capable of being audited. There are, clearly, disclosures that could be distorted by dishonest managers or that are based upon assumptions and forecasts that may prove to be incorrect.

At the very least, the auditor can express a view on whether the work undertaken by the preparer is reasonable and whether the results are internally consistent. Users of financial statements will have to accept that there are limits to the extent to which the auditor can guarantee that the statements are free form misstatement.

R10) 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?

AIA believes that this is a complex question that cannot necessarily be answered without seeking legal advice (and that is likely to vary between jurisdictions).

A very broad measure of the quality of an audit could be whether an informed and impartial observer would support the auditor's decision to express that particular opinion on the financial statements.

R11) Some believe that the manner in which a financial reporting regulator enforces financial reporting requirements may influence how auditors approach the audit of financial statements, including disclosures. What is your view?

AIA believes that there is a cultural dimension that affects the nature and extent of the reliance that is placed on financial statements. There is undoubtedly some basis for the argument that auditors have to tailor their approach to reflect that "accounting culture". For example, the tension between relevance and reliability may be settled in different ways depending upon the attitude of government or other regulators and that may be influenced in turn by the prevailing attitudes of users within that jurisdiction.