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JICPA Comments on the Discussion Paper
The Evolving Nature of Financial Reporting: Disclosures and Its Audit Implications

The Japanese Institute of Certified Public Accountants ("we", "our" and "JICPA") is grateful for the opportunity to comment on the IAASB's Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications (DP).*

Currently, Generally Accepted Accounting Principles in Japan (J-GAAP) has been developed using the approach that is closer to rule-based rather than principle-based, especially if compared to the approach of IFRSs. Also, ISAs are neutral in respect of financial reporting frameworks, and we believe this should remain unchanged.
However, the voluntary implementation of IFRSs has already begun in Japan; and we are also very interested in the discussions resulting from the DP. The discussions raised in the DP are closely linked to those relating to the issues of financial reporting framework, the framework being the criteria for the preparers. As such, we believe it is crucial that the audit issues should be discussed in conjunction with those related to relevant financial reporting framework. In order to maintain and enhance the usefulness of the financial statement audit, as well as eliminate the undue expectations relating to auditors, we believe it is important to establish an understanding between all stakeholders regarding the nature of information required by the financial reporting framework, as well as the related auditor's role. Based on this background, and general views, we provide below our comments on the Consultation Questions for Auditors in Section VI.

Consultation Questions for Auditors

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.

(Comment)

There may have been some cases of general discussions between auditors and entities about disclosures that might be considered immaterial. However, since the approach, to date, that has been used in developing J-GAAP is closer to rule-based, compared to the approach of IFRSs, the entities as well as the auditors tend to think that the required disclosures should be included in the financial statements, except if that is clearly immaterial. Therefore, we believe it is extremely rare that there is big debate between entities and auditors about whether certain disclosure, which is required by financial reporting framework, is immaterial. At the same time, as the financial reporting framework is moving to a principle-based one, in the future, we expect such debates may also increase in Japan.

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

(Comment)

Although the auditor needs to take into account the respective nature of the disclosures, the auditors' general approach to identification and assessment of the risks of material misstatements in disclosures is similar as compared to the approach in class of transactions and account balances. In both cases, through understanding of the entity and its environment, including its internal controls, the auditor identifies and assesses the risks of material misstatement at assertion level.

The note disclosures provide information in conjunction with related financial statement items, or in the context of the financial statement as a whole, and these cannot exist in isolation. Therefore, in practice, the audit procedures to identify and assess the risks of material misstatements in disclosures are performed in connection with procedures for the related line items and/or overall financial statements.

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

(Comment)

Since the clarified ISAs have yet to be implemented in Japan, at this stage, we are not in the position to comment on the related implementation challenges. However, discussions have also taken place in Japan whether it is necessary to provide further audit guidance relating to note disclosures, such as qualitative or forward-looking information.

For example, in 2008, when the Accounting Standard for financial instruments was revised, and certain entities were required to include sensitivity analysis information into note disclosures, such as value at risk, it generated discussion on how to deal with such types of information in an audit. Also, note disclosures which refer to the use of the experts, such as sensitivity analysis, are now increasing, and there are concerns that in some cases the auditor can perform only limited procedures that may exist for such information.
Therefore, we believe there may be room to consider whether there is a necessity for more guidance regarding what audit evidence the auditor needs to obtain on such disclosures.

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.

(Comment)
Even though management believed it had appropriate supporting evidence for the disclosure, if the auditor did not believe so, it would not constitute sufficient appropriate audit evidence for the auditor. In such circumstance, the auditor may encounter difficulty in obtaining sufficient appropriate audit evidence. However, we do not think it is an issue specific to disclosures.

Even if management's consideration of a disclosure required by the financial reporting framework can be appropriately supported by evidence and documentation, due to the nature of the information, there may be an expectation gap between the stakeholders' expectation regarding the auditor's role for such information and the actual role of the auditor on that information. In such a case, it is "unauditable" for the auditor in order to meet such stakeholders' expectation. (Please see our comment on A12 below)

The responsibility for the preparation of the financial statements is on management, and therefore, an audit is conducted on the premise that management provides evidence that support their assertions. Therefore, if management does not provide supporting evidence for the assertions, it is not appropriate for the auditor to conclude that sufficient appropriate audit evidence has been obtained. Such a case should be regarded as to constitute a scope limitation of an audit.

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

(Comment)

Regarding the disclosures on which the auditor can obtain relevant information from a traditional accounting system, such as the breakdowns of the line items, there is no issue specific to the disclosure. On the other hand, regarding the disclosure which is derived from a system that is outside a traditional accounting system, especially disclosures which explain management intent or includes forward-looking information, it leads to discussion as to what constitutes sufficient appropriate audit evidence, as well as about identification of relevant assertions of that disclosure.

However, we believe it would not appropriate to discuss the issue of audit evidence for disclosure in isolation, as if audit evidence for disclosure would be completely separable from others. The disclosures do not exist in isolation. Rather, they exist in the context of the related line item or the financial statements as a whole. The auditor does not perform procedures in a manner that is completely separable for the disclosure and, therefore, the issues of audit evidence for the disclosures should be considered in conjunction with the issues of audit evidence for related line items and/or the financial statements as a whole.

Regarding the objective-based disclosure requirements, we believe there is particular difficulty in obtaining audit evidence for completeness assertion. It is not an issue only for auditors; prepares may also face challenges in obtaining supporting evidence. If such types of disclosure are required by the financial reporting framework, we believe it is important to establish an understanding between stakeholders as to what is appropriate supporting evidence for management, as well as what audit evidence the auditor needs to obtain, depending on the nature of the required disclosures.

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

(Comment)

We believe that auditor’s approach to fair value is the same, regardless whether it was included in note disclosures or on the face of the financial statements. Based on the assessed risks of material misstatement, the auditor performs procedures responsive to the assessed risks of material misstatements, for example, testing of how management made the fair value and the data on which it is based, and/or developing a point estimate or range to evaluate management’s point estimate.

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.

(Comment)

In general, we believe the expectation regarding the need for disclosures not specifically required by the financial reporting framework depends on an entity's environment, including the applicable financial reporting framework and its regulatory environment. For example, in an environment where stakeholders tend to stress the comparability between the entities, and the appropriate financial reporting framework and relevant law and regulations take a rule-based approach, as compared to other environments, there would be less cases where the entities would include disclosures not specifically required by the financial reporting framework. Also, if the entity operates on a global basis, as compared to an entity operating in a specific jurisdiction, there may be more cases of entities including such disclosures, since the entity may interact with needs of a more diverse group of stakeholders.

As stated above, J-GAAP has been developed using the approach that is closer to rule-based, especially if compared to the approach of IFRSs, and the formats of the disclosures are usually stipulated in the financial reporting framework, including relevant laws and regulations. Therefore, currently, in Japan, although the auditor does not object if the entity wants to include certain disclosure not specifically required by the financial reporting framework, it is extremely rare that the auditor requests the entity to include certain disclosure that is not specifically required by the financial reporting framework.

On the other hand, we recognize the importance of mechanism for the entity to include the disclosures that are beyond the requirements in the financial reporting framework, especially considering the fact that the financial reporting framework is now moving to focus on a principle-based approach. At the same time, we believe it is not necessarily desirable that many entities need to include disclosures not specifically required by the financial reporting framework for the fair presentation of the financial statements. In such situation, comparability between entities and throughout reporting periods becomes difficult. In addition, regarding the disclosure that the entity includes for the fair presentation of the financial statements which is not specifically required by the financial reporting framework, there is no specific criteria for the entity to prepare such information, and the auditor may not have appropriate basis to evaluate such types of information. As a result, we believe this may result in situations where such types of disclosure would result in being misleading.

If many entities need to include certain type of disclosure, that should be dealt within the financial reporting framework. Therefore, we believe the role of additional disclosures for fair presentation should be limited as complementary: in order to reflect in financial reporting framework advanced practice, or to meet, in certain entities, the needs of general purpose financial statements.

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?

(Comment)

The auditor needs to apply materiality to disclosure through consideration in the context of general principle that “misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of uses taken on the basis of financial statements”, taking account of the nature of information and relevant circumstance. For example, the disclosure of the nominal contract amounts of derivatives or maximum credit risk for a bank may have different influence on the economic decisions of users as compared to the line items. Therefore, considering the above principle, the same performance materiality for account balances may not applicable to such disclosures. Also, regarding qualitative disclosures, when evaluating the effect of the misstatements on the financial statements, the auditor evaluates, considering the above principle, whether such misstatement constitutes material misstatement.

Since there is not much specific guidance regarding application of materiality on the disclosures in ISAs, we agree that it is beneficial to consider whether to develop further guidance. At the same time, we expect the development of further guidance in practice to be challenging, since the application of materiality to disclosures should be considered on a case by case basis, in response to the nature of the respective disclosures as well as relevant circumstances. In addition, the necessary considerations may be different by financial reporting frameworks. Also, for application of materiality to disclosures, guidance is limited not only for the auditors, but also for the preparers. Therefore, in considering development of further guidance in ISAs, as for the basis for such consideration, we believe it would also be necessary to consider whether to develop guidance for the preparers.

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.

(Comment)

Misstatements would constitutes material misstatements if the auditor concludes these, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of financial statements. The same consideration applies regardless of whether or not it is a note disclosure or a line item.

As indicated above, the auditor usually evaluates whether the disclosures constitute material misstatements, in conjunction with the evaluation of relevant line items or in the context of the financial statements as a whole. Therefore, we believe that considering misstatement of the disclosure in isolation, and discussing whether these constitute material misstatements, does not appear to be beneficial. For example, for the note disclosure of judgments and reasons, even if the description of management's judgment is factually correct, if the judgment is not reasonable, and it results in the misstatement on the relevant line items or the financial statements as a whole, the auditor may conclude these constitute material misstatements in conjunction with the note disclosures.

Regarding the objective-based disclosure requirements, the evaluation of the material misstatements is very subjective in nature. In addition, while the evaluation of necessary disclosures, to meet the objective of the requirement, is based on information that was available for the auditor when conducting the audit, we believe there may be an expectation gap on this between the stakeholders. As stated in our comment on A5, if such types of disclosure are required in the financial reporting framework, we believe it is important to establish an understanding between stakeholders regarding what is appropriate supporting evidence for management, as well as what audit evidence the auditor needs to obtain for such disclosure, depending on the nature of the disclosures required.

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?

(Comment)

Regarding (a) above, providing the note disclosures required under IFRS 7, sufficient appropriate audit evidence for the descriptions of controls the entity has put in place to mitigate risks would be constituted of audit evidence for "whether the description of the control is accurate".

We believe the auditor is not necessarily expected to test the effectiveness of the controls, since the auditor is required to form the audit opinion on the financial statements as a whole, rather than forming an opinion on the specific note disclosure on standalone basis. However, through performing relevant risk assessment procedures and test of controls, the auditor may obtain relevant audit evidence. Misstatements of such a disclosure would include, for example, the case when the description of the control is factually incorrect.

Regarding (b) above, we believe the approach explained in paragraph 66(a) is appropriate (the auditor only needs to obtain evidence about whether it is an accurate description of the stress testing that was performed). The auditor does not necessarily have the criteria to evaluate what stress test is suitable to the entity. Also, the auditor does not express the opinion on the process of stress test and its outcome. Misstatements of such a disclosure would include, for example, a case when the disclosure does not properly describes the process and the outcomes of that test.

However, with respect to both (a) and (b), we presume that there may be some gaps between users' expectation for the role of the auditor on such information, and what the auditor is actually doing. Also, from auditors' side, we see that there is a question as to what is appropriate auditor's response if the auditor identifies the issue that is beyond the approach described above (for example, regarding (b), if the auditor identifies that the entity applies the process that is apparently inappropriate). Although the auditor does not have a responsibility to actively identify such matters, similar to the issues on other information in ISA 720, we believe it would also be necessary to discuss as to what is the appropriate auditors' response when he/she identifies such matters. When discussing these issues, these should be discussed in conjunction with the issues of necessary criteria for the preparers, as well as the entity's appropriate supporting evidence.

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?

(Comment)

In order to form an opinion on the financial statements as a whole, the auditor takes into account the auditor’s conclusion on whether uncorrected misstatements are material, individually or in aggregate. Regarding misstatements of disclosures, it may not be appropriate to simply accumulate them with other misstatements of line items. This is because the note disclosure would influence the economic decisions of users in the context of the relevant line items or the financial statements as a whole, and the misstatement of the line items and misstatement of the note disclosure may not be simply comparable by reference to the respective amounts. Therefore, it is necessary that misstatements of note disclosures should be evaluated by taking into account the respective nature of the information required as well as relevant circumstances (Please see our comment on A8 above).

Regarding qualitative disclosures, including note disclosures describing management judgment, it is also necessary to evaluate these by taking into account the respective nature of information required. Since qualitative misstatements cannot be expressed in a manner that would be directly linked to the number on the face of the financial statements, the effect of aggregation of such disclosures cannot be accumulated numerically. However, in evaluating whether the financial statements as a whole are free from material misstatements, the auditor may conclude such misstatements constitute material misstatements, for example, when the disclosure indicates the existence of possible management bias. Also, when considering the effect of qualitative misstatements and quantitative misstatements all together, the auditor may conclude they constitute material misstatements.

Regarding the prior year’s disclosure misstatements, if such disclosures are carried forward and are included as the current year’s disclosure, the auditor may conclude they constitute material misstatements.

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

(Comment)

Broadly speaking, disclosure would be considered not auditable, if it would include the following factors:

- the guidance to prepare the intended disclosure is not sufficient, and therefore, management cannot provide appropriate supporting evidence to the auditor. In this case, the auditor cannot audit such information;
- due to the nature of the information that is required to be disclosed, there would be an expectation gap between the users’ expectation regarding the role of the auditor on that information, and the actual role of the auditor or what the auditor can actually achieve.

The issue of “Verifiability” is especially related to second bullet above. On this point, we believe the matters noted in paragraph 113 in the DP are very important. Based on the current IASB Conceptual Framework, “Verifiability” is not necessarily the same as auditability. In addition, since the disclosure provide information in conjunction with the related line item or in the context of the financial statements as a whole, it would not be possible to discuss the issue of auditability in the context of the disclosures in isolation.

However, some stakeholders may presume that the audit procedures and evidence that the auditor obtained for such unverifiable information is at the same level for other verifiable information, and this would be one of the sources of the expectation gap. Such situations would arise especially regarding disclosures that rely only on management judgment, or disclosures that include forward-looking information.

Therefore, in order to deal with the issue of auditability, we believe it is important to establish an understanding between stakeholders regarding the relationship and the difference between “Verifiability” and “Auditability”, as well as the role of the auditor for the note disclosures that relates to unverifiable information. At the same time, we believe it would be necessary to share the views and continue the discussions with the accounting standard setter about the issues that would arise from the recent development of the Conceptual Framework.

As stated in paragraph 111 in the DP, there was a discussion in Japan regarding pro forma disclosures on business combinations. When implementing such disclosures, there was a discussion as to whether the auditor could obtain sufficient appropriate audit evidence for such information, and, as a result, the disclosure rule allows, on an exceptional basis, including the information in the note disclosure with a clear statement that it is “unaudited”.

At the same time, we totally agree with the statements in paragraphs 110 and 112. Financial reporting is continuously evolving, and the audit also needs to continue to evolve with changes in financial reporting. If there is a possibility that an expectation gap may arise regarding the information that is required by the financial reporting framework, and that is included in the scope of the audit, it is necessary to establish an understanding between stakeholders about the role of the auditor for such information. On this point, we strongly support the IAASB’s strategic direction that is taking IASB liaison project as well as initiating this project.

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?

(Comment)

Based on the available information obtained during the audit, the auditor evaluates whether the financial statements taken as a whole provide adequate information that represents entity's financial position, performance and cash flows. The auditor's judgment in respect of the fair presentation of the financial statements as a whole should be assessed by considering whether this evaluation is appropriate.

In addition, the assessment of the auditor's judgment should be based on the criteria for the entity to prepare the financial statements. As stated in our comment on A7, we believe the need for disclosure not specifically required by the financial reporting framework, i.e. the expectation regarding the fair presentation, depends on the entity's environment, including the applicable financial reporting framework and relevant regulatory environment. Therefore, the criteria for the fair presentation of the financial statements as a whole should be, in the first place, considered as an issue for the preparer, and based on the preparer's criteria, an auditor's judgment should be considered.

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?

(Comment)

The enforceability by the financial reporting regulator would influence the approach to prepare the financial statements under the financial reporting framework. Therefore, the manner in which a financial reporting framework regulator enforces financial reporting requirements is one of the factors that influence the auditors' approach to the audit, including disclosures.

Sincerely yours,

Sayaka Sumida
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The Japanese Institute of Certified Public Accountants