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certified public accountants

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May 31, 2011

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Submitted electronically at: www.iasb.org

Re: IAASB Discussion Paper–*The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*

The New York State Society of Certified Public Accountants, representing more than 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned Discussion Paper.

The NYSSCPA's Auditing Standards and International Accounting and Auditing Committees deliberated the Discussion Paper and prepared the attached comments. If you would like additional discussion with us, please contact Jan C. Herringer, Chair of the Auditing Standards Committee at (212) 885-8133, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Margaret Ann Wood

Margaret A. Wood
President

Attachment

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NEW YORK STATE SOCIETY OF

CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS ON

IAASB DISCUSSION PAPER–*THE EVOLVING NATURE OF FINANCIAL REPORTING: DISCLOSURE AND ITS AUDIT IMPLICATIONS*

May 31, 2011

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New York State Society of Certified Public Accountants

Comments on

IAASB Discussion Paper–*The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*

The New York State Society of Certified Public Accountants is pleased to respond to the request by the International Auditing and Assurance Standards Board (IAASB) for comments on the proposed IAASB Discussion Paper–*The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*.

We provide the following responses to the Consultation Questions for Auditors beginning on page 43 of the Discussion Paper.

Section II
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.

<u>Response</u>:

Generally, we consider the qualitative characteristics of financial statements discussed in the IASB, *Conceptual Framework for Financial Reporting,* (paragraphs 24-46) as factors to take into account when considering whether required disclosure might be considered immaterial.

The most prevalent issue relates to those seen in practice that might be considered immaterial amounts that clients want to disclose merely to satisfy a "disclosure" requirement. Another example is a listing of all new pronouncements that are not yet effective with attendant disclosure with no anticipated effects because the client's activity does not include such transactions.

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

<u>Response</u>:

Many auditors use checklists to audit disclosures. That is, they compare required disclosures against disclosures that their clients have included in their financial statements. This procedure is driven by the significant growth in disclosure requirements and the complexity of the underlying accounting. Auditors perceive that without such practice aids disclosures required by the accounting standards will be omitted or truncated. For example, some disclosures require very granular detail such as the disclosures related to stock based compensation. For entities that make limited use of these types of compensation plans, the disclosures required likely will have little impact on users of the financial statements due to the small size of these plans.

We believe that disclosure checklists are usually a necessary tool for an auditor in assessing the fulfillment of disclosure requirements. To be a proper tool, checklists require careful thought, but often lend themselves to rote completion by engagement team members at a lower experience level than required. Further, it is important for an auditor to go beyond the checklists and consider how the financial statements, although meeting every technical standard of the reporting framework, might be misleading.

An auditor reads preliminary drafts of the financial statements (unaudited) or may read prior years' financial statements to assist in understanding the client's business, industry, and breadth and complexity of transactions as part of his or her risk assessment process. The determination of the nature, timing and extent of procedures is based on this risk assessment during the initial planning of an audit because the complexity and risks of the entity's underlying business would be evident from the financial statement disclosures.

As to quality of disclosures, a preparer and an auditor use databases of text included in public filings in areas in which preparers struggle in an attempt to see how others are providing the information. Today, numerous examples of disclosures are available online, and data searches and a focused auditor's review function are very helpful.

Further, an auditor needs to be cognizant of client capabilities. An auditor needs to think about what could influence readers; not simply ensure the standards are satisfied. Also, care needs to be taken to avoid the inference that disclosure can be used to overcome problematical measurement issues.

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

Response:

We believe there can be a number of circumstances when an auditor experiences very practical challenges. For example:

- When a clients' accounting policy in a particular area is not specifically defined—such as when control of a consolidated entity relies on implicit factors which are subject to interpretation and those factors are not clearly articulated in disclosures. A similar situation could occur when clients structure transactions to meet the form of the requirement, but assert that any risk could be mitigated by robust disclosure or, alternatively, by no disclosures (if none is required).

- When clients become industry leaders, a client's performance falls below set performance goals, or when whole industries experience significant technological change - a preparer and an auditor sometimes do not identify these changes or how fundamental they can be while change is taking place. Whether the business can change to meet challenges is a significant issue. It is helpful if an auditor is privy to business strategy discussions, amongst other procedures, to understand these matters better (which ultimately are included in the financial statements). A good example is the music industry. When all the legal protections broke down forcing a broad consolidation in the industry, it begs the question of what kind of disclosure would have helped creditors and investors and how that information would be audited. This example may provide more credence to place certain content outside of the financial statements.

As it relates to circumstances when financial content is included outside the financial statements, especially when such information is displayed along with the audited financial statements, we understand that auditor involvement in the "other information" is currently being considered as part of the IAASB's project to revise ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*. Extant guidance provides that an auditor considers the amounts being disclosed for accuracy and evaluates if the other information is compatible with the audited financial statements. This issue will become problematic without a disclosure or presentation framework to address it if attestation in some form is extended to such other information.

Section IV

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 the disclosure can be appropriately supported by evidence and documentation, are there factors that could nevertheless make a disclosure un-auditable? If management has not provided evidence and documentation in support of disclosure, do you believe you are able nevertheless to obtain SAAE on the disclosure? Please explain your answer.

Response:

Certain presentation and disclosures are based on management's intent while others are based on intent and ability (such as classification and disclosures for investments held to maturity and the decision to discontinue a segment of a business or to restructure a business or an operating segment). These matters are addressed by obtaining management's representations and other documents, and they are indirectly corroborated by an auditor when he or she evaluates the consistency and veracity of management assertions in other areas as the audit progresses. When assertions are contradicted by evidence and/or actions, disclosures based on intent or intent and ability are tenuous at best.

The issue that stands out most here is the going concern concept. The speed at which an entity can implode in a volatile economy can be very quick. Audited financial statements are no guarantee of sustainability. When businesses are troubled, an auditor needs concrete evidence of viable client plans. If such documents are not prepared in the early phases of an engagement and are replete with forward looking positive assumptions, they are generally suspect. Clients need to evaluate both positive and negative factors in their deliberations.

The going concern concept can be sustained (in our view) when it is more likely than not that the entity can survive beyond management's assessment period, given the assumption that no new negative events would occur during that period. From a disclosure perspective, if assets are already presented at realizable values and liabilities are conservatively determined, the significance of this assumption diminishes and the audit implications become less onerous, both in presentation and disclosure, although such conservative accounting generally would not be indicative of liquidation values.

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

Response:

The discussion about audit evidence as applied to the different types of disclosure examples is useful and informative. We agree with the discussion provided in paragraphs 60-70, except with respect to paragraph 62 which should mention that the database being used to establish the segment information to be presented is determined by the information used by the Chief Operating Officer. Segments may be organized differently and generally are focused principally on reporting issues.

We are concerned about disclosure related to stress test information. If the related disclosure is based on paragraph 65-20(a) which requires the auditor to gather evidence about the process followed by the entity, we have less concern than when the disclosure relates to a stress test "appropriately performed" under 20(b). We draw an analogy to auditing "solvency" which was not well conceived and was eventually prohibited. The documents underlying the process are generally not in an entity's financial records, and may reside in "risk management" processes. The approach to 20(a) would be a controls approach, while the approach to 20(b) would be substantive. The second alternative as we have stated is very problematical. We believe that auditor association with client "performance" would undermine "audit credibility," not enhance it.

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?

Response:

The answer to this question is "it depends." A similar issue was crystallized many years ago in the U.S. We cite this example because the question is derived from the significance of the matter to users.

In the U.S., entities that use LIFO inventory measures for tax purposes must use LIFO for financial statement purposes. (We recognize that LIFO is not acceptable under International Accounting Standards but use this example to demonstrate a point). Supplemental disclosure of inventory computed under FIFO is made by such entities, and an auditor will usually apply significant procedures to the FIFO measure. We believe this is as it should be for all *important disclosures*.

We believe the auditor should direct effort based on the risk of misstatement and the materiality of the disclosure. As discussed, materiality is based on the likelihood that the disclosure will affect user decisions. In certain cases users could be more concerned with the disclosed fair value than the historical cost. Users will often substitute the fair value for the historical cost in their analysis, particularly in the case of real estate and readily marketable securities for which the framework uses historical cost. Similarly, with the disclosure of FIFO inventories, analysts frequently substitute the FIFO for the LIFO in their analysis.

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 thought 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.

Response:

We are not strongly opposed to entities disclosing such things as not holding derivatives; however, we think that such disclosures become questionable if their purpose is not understood. Driving this issue is whether an entity has, in fact, reduced its risk when, for example, derivative holdings are used as a hedge. Many of these disclosures are "risk management" driven. They can be accompanied by descriptions of why they are being disclosed, and could be grouped in one place such as in a designated note to the financial statements.

When preparers include disclosure of transactions they do not perform, the question arises, "What about other transactions they do not perform and do not disclose?" The issue generally should be resolved based on whether the disclosure is relevant to the entity.

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 ISA's?

Response:

Further discussion of this in the standards or in the disclosure framework would be useful. We understand that some larger firms use quantitative measures to create more consistency in their methodologies. For example, disclosure materiality for related party transactions could be sensitized to 50% of adjustment materiality measures as a benchmark over which the auditor would consider qualifying the audit report when a client has omitted such disclosures. Alternatively, often when a client decides to omit a detailed description of its pending litigation (which its counsel cannot currently evaluate), it makes a statement that the company has a number of lawsuits that have arisen in the normal course of business, that management believes will not have a material future effect. We think some form of benchmarking to a materiality measure is a good practice when developed on a firm level and when it is for use as a threshold for evaluating whether to modify an audit report.

When two or more substantive procedures are applied to an accounting population for the same objectives (to test the same assertion) they can be combined efficiently to reduce audit risk. The one with the greatest precision is referred to as the primary test. The additional substantive tests applied principally as a scope reduction of the primary test or to add effectiveness are known as corroborative tests. The primary test would provide the major source of evidence about the assertion while a corroborative test provides additional evidence to support and reduce the primary test. For disclosures, auditing precision for such matters as estimates takes the form of corroborative tests.

A9) What do you believe represents a material misstatement of 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.**

Response:

A material misstatement of a disclosure is one that, individually or when aggregated with other misleading disclosures, misleads users of financial statements to make decisions they otherwise would not make or would make differently. Therefore, for each of the categories listed in Question A9, examples of material misstatements would be those impacting users' decision making.

Examples of material misstatements include those that are materially misleading because they:

- are factually incorrect;
- mislead users as to measurement or presentation of the financial statement items to which they relate;
- disguise that which is nothing more than improper earnings management;
- are intentionally misstated (and, thus, qualitatively material);
- are materially inconsistent with information disseminated internally.

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?**

Response:

The following are procedures and evidence the auditor may consider to address disclosures that are relevant to an understanding of the entity, but are not related to any specific line item in the financial statements.

a. A "look back" procedure that compares the client's estimates with actual results.
b. Comments of an internal auditor on specialized projects.
c. Evaluation of capabilities and resources dedicated to risk management.
d. Results of controls testing.
e. Regulatory comments in the specific area.
f. Minutes of audit committee or others overseeing the process.
g. Unanticipated losses or write-offs.
h. Recurrent correcting journal entries.

The following may be considered misstatements.

a. Asset categories misclassified.
b. Critical assumptions misstated.
c. Assumptions omit critical assumptions.
d. Resolution or disposition of assets over unrealistically long time frames.
e. Assumptions include unrealistic growth or inflation assumptions.

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?**

We have discussed concerns about this type of disclosure in A(5). We suggest that rather than deal with misstatement, a better approach would be for the IAASB to allow this information to be "unaudited" or to be provided as supplementary information, or for the information to be included outside of the financial statements.

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?

<u>Response</u>:

We deal with quantitative measurement misstatement two ways: 1.) in a misstatement evaluation and 2.) in client communications.

The second question is counterintuitive. By definition, qualitative measurements are not quantifiable or quantifications are irrelevant. They may have a significant impact on the client's business such as an illegal act raising licensing concerns or an inability to continue doing business in a particular jurisdiction. For measurement issues, an auditor typically maintains a schedule of waived adjustments and informs clients of matters identified during their engagements under various communication standards. Omitted or incomplete disclosures are generally resolved at a granular level, that is, a reason is documented. Alternatively, the items may be inserted into other schedules such as a listing of deficiencies which are further evaluated and which may require changes to audit plans and to considerations underlying an audit report.

With respect to the third question, if we presume that the misstatement(s) are pre-issuance in the current year, there are a number of auditing and reporting considerations. This circumstance would require an analysis of the significance of the misstatement(s), how it would be corrected, and its impact, if any, on the auditor's report. The prior year disclosure misstatements need to be evaluated as to their cause. Are they intentional, how were they discovered? Are they pervasive? In most instances, once these questions are answered satisfactorily, the auditor may respond to this situation by adding experienced personnel or other review procedures and considering other steps to assure that this area is improved by the client when the discovery is early in the audit process. If discovered later, it could call for revisions in the audit plan in one or more financial statement cycles. In both instances an analysis and disposition of the matter is warranted.

Section V – Questions and Auditability

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

<u>Response</u>:

One could say that all characteristics of every disclosure are auditable should an auditor abandon the cost/benefit analysis and the inherent audit risk associated with an audit. Perhaps the issue is how prone management is to risk taking, and how that inclination is disclosed. If management's risk inclination is not disclosed it certainly will become evident over time.

The most difficult issues pertain to estimates especially when companies are new and may lack the requisite experience to provide "reasonable" estimates. Auditing estimates involves an evaluation of what preparers believe to be the best estimate. This applies to both measurements recorded in the basic financial statements and to disclosures. Most times, there is a range of acceptable estimates. When the auditor calculates his or her own range of estimates, the client's estimate may fall outside of the range. In this case, the auditor may propose an adjustment. An adjustment might be made to the nearest range value in the midpoint of the range, which an auditor uses when the client's estimation process is weak.

When complex estimates are used such as when disclosure measurements relate to fair values of certain financial instruments, auditing becomes more difficult and many times an auditor has policies that require review by specialists. Along those lines, many firms maintain industry data bases of common size measures derived from client's recent filings. Several countries have established such databases and with XBRL filings coming on line, an auditor can utilize such databases to anchor their estimates. The Board might consider an implementation guide of a "best practices" alert, for these very subjective issues.

We also reiterate our comment that auditing management's intent is a function of client representation and "look back" procedures.

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?

Response:

The criteria that underlies judgments used in fair presentation are the knowledge obtained in the auditor's risk assessments, the review and evaluation of the findings linked to significant assertions in significant risk areas, the research used to corroborate the client's position when specific guidance is lacking, and the experience of the firm and the engagement team in providing consensus on the client's accounting disclosure and level of documentation used in the engagement. The preparer and the auditor should always ask, "Do the disclosures make the financial statements more transparent and more meaningful?"

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?

Response:

Regulators use checklists to enable a more consistent approach to their work. "No" answers create questions and issues, and, thereby, create a "mindset" for an auditor subject to such regulation. It would be very helpful if regulators would include preparers in their discussions because preparers are responsible for the content of the financial statements. As principles driven accounting standards become the platform, an auditor will need to think through the issues more robustly. Documenting every judgment, ultimately, will not be a practiced solution. Auditing regulators want to see a roadmap of the major issues encountered and decided in an audit; and regulators who both issue auditing standards and enforce those standards have a particularly difficult task in maintaining an appropriate balance.