The Institute of
Chartered Accountants
of Pakistan

HEAD OFFICE

Technical Director
International Auditing and Assurance Standards Board
New York, USA

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Subject: **COMMENTS ON DISCUSSION PAPER OF 'THE EVOLVING NATURE OF FINANCIAL REPORTING: DISCLOSURE AND ITS AUDIT IMPLICATIONS'**

Sir,

The Institute of Chartered Accountants of Pakistan welcomes the opportunity to offer comments on the above mentioned exposure draft.

Please find enclosed the comments of the relevant Committee of the Institute for your perusal.

If you require any further clarification, please do not hesitate to contact us.

Yours faithfully,

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COMMENTS ON DISCUSSION PAPER 'THE EVOLVING NATURE OF FINANCIAL REPORTING: DISCLOSURE AND ITS AUDIT IMPLICATIONS'

<u>Consultation Questions for Auditors (Page 43 – page 45)</u>

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.

As far as the discussion with the management of an entity is concerned, the response of the management varies in accordance with the prevalent corporate culture. For companies facing cash / credit crisis or other problems like going concern or where the basic shareholding concentrates in a small number of shareholders, excess / critical disclosures are not always welcome and management feels certain disclosures are immaterial. However, entities with a better corporate governance, irrespective of their corporate status being private, public listed or public unlisted; strive for improving transparency and better disclosures, whether immaterial, in their financial statements. Keeping both situations in view, the most safer and desirable approach is to keep to a minimum as required by regulators (in our circumstances an overly approach of including IASs, IFRSs, the Companies Ordinance, 1984, the listing regulations and sector specific requirements like modarabas). This approach is quite safe from both the auditors' and company's viewpoint.

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

Identification and assessment of the risk of material misstatement in disclosures, is based on two factors:

i) Information presented by the disclosure in the overall context of the financial statements
ii) Gravity of the disclosure for the reader of the financial statements including regulators

To support this, a disclosure regarding exposure from banking and leasing companies takes a different turn when the company faces a going concern problem. Likewise, a heavy quantum of related party transactions provokes different questions including dependence upon group companies, providing cheaper and safer finance to group companies and issues relating to the transfer pricing. So in our view, the identification and assessment of the risk of material misstatement in disclosures may vary from company to company and the overall corporate performance and context in which financial statements are being prepared.

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

We believe that current content of ISAs cover the audit of financial statements in quite a good manner. However, in the light of upcoming IFRSs including the one on fair values and increasing requirements on specific standards like financial instruments, existing ISAs may be reviewed.

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.

There are certain circumstances where such situations arise. To exemplify, when the disclosure regarding the production capacity of a plant is concerned, the evidence provided by the management requires more supporting evidence. In such circumstances, this is the management that provides SAAE and the auditor verifies the same and gathers further corroborating evidences;

without management providing this data auditors cannot obtain reliable SAAE through other means.

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

Following issues may be faced:

i) Assessment of fair value by the management and verifying the process adopted by the management poses difficulties

ii) When the entity makes objective-based disclosures regarding provisioning against trade receivables, inventories and cost estimations to complete a contract etc.

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?

The level of effort should remain the same irrespective where the disclosure is being made, as line item or on the face of the financial statements.

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

We believe that the onus of disclosing any fact voluntarily should not be transferred to management. All the mandatory disclosures, both generic and industry-specific, should be notified by local regulators in all the countries and an entity should be made to disclose the same.

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?

We believe that wherever, in ISAs and IASs / IFRSs, anything is left to judgment, the value and quality of the disclosure starts to deteriorate. Regarding the materiality of a disclosure, a more rigorous approach needs to be adopted. Unless a regulation, both the standards and the prevailing laws, identifies the type of entity for which a disclosure is being emphasized, the debate cannot be ended. To exemplify a very simple fact, IAS 33 states that the disclosure of EPS is only mandated for listed companies; requirements like this would make tackling the financial statements much easier. Materiality of a disclosure may only be inferred either in the context of the financial statements or where a regulation requires such disclosures to be made. Keeping in view the types of companies in Pakistan (like SMCs, private, public unlisted and public listed) or internationally as in the UK (listed on the stock exchange, listed on AIM, private companies, SMCs and close companies), the list of requirements should be made very clear for each type of company, as the ICAP has done for Small sized Entities and Medium sized Entities. Judging the materiality of a disclosure shall not be left to the judgment of the ones who prepare the financial statements.

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.**

Material misstatement is a non-disclosure / incomplete disclosure of any fact that may affect the share price of the company or leaves lacunae whilst reading a financial statement. Following may be misstatements:

i) Judgments / reasoning / assumptions / models / inputs / estimations / uncertainty / disclosure of fair value

Wherever management makes such judgments etc. it needs to disclose the entire process of making such judgment and the results of such process. Further, the management should disclose whether some expert was hired to validate such judgments or not. If the management assumes that such reasoning etc. was not material and did not necessitate the hiring of an expert, the financial impact and a rough outline of materiality should be disclosed so that the reader of the financial statement finds it adequately disclosed.

ii) Objective-based disclosures

The absence of the financial impact that would be casted in the presence / absence of such disclosure or omitting the same disclosure or inadequate disclosure of management changing the rationale of making such disclosure would amount to misstatement.

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?

Refer to answer No. 9 above.

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?

Evaluation of misstatement in forming an opinion is a culmination of both qualitative and quantitative factors. Non-compliance with laws (whether environment, corporate, regulatory or secretarial laws having no financial impact) replies from legal attorneys and review of compliance practices certainly do have an impact whilst forming an opinion. They should be reported to the BOD, Audit Committees and in Auditor’s Report if the stakeholders may get affected by such non-compliance in future. Prior year’s evaluations should also be reassessed to see if these have been resolved or continue the same way and impact in future.

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

In our view, disclosures of highly technical nature not involving financial aspect but technical / mechanical / operational nature are not entirely auditable. To exemplify, the following aspects would not be entirely auditable and would require the assistance of an expert and information provided by the management:

i) Estimate to complete a construction project
ii) Estimating stage of completion of a construction / software project
iii) Revaluation of property, plant and equipment
iv) Production capacity of a plant
v) Audit of UFGs
vi) Impairment in machinery

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?

This criteria is ever-changing, cannot reduce it to words. However, the financial statements may be evaluated in their own context and industry norm to assess fair presentation of financial statements.

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?

This would make the audit procedure more rigorous and defined. We believe that defining requirements would reduce the judgment level of auditors and help reducing auditors' responsibility of skipping the audit / inclusion of any disclosure in the audit process.