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

Far, the Institute for the Accountancy Profession in Sweden is responding to your invitation to comment on the discussion paper *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*.

Far's general remarks
Far believes that materiality for all information in the financial statements must be determined systematically, based on the auditor's perception of the needs of the users of the financial statements. That implies that there cannot be any general difference in the auditor's effort to obtain audit evidence depending on whether the information is presented as disclosures or on the face of the income statement/balance sheet/cash flow statement or whether the information is classified as financial or non-financial information.

Far also believes that the section in the discussion paper regarding the worrying increase of the volume of disclosures in the financial statements is very important. This is an area where auditors can contribute to an improvement. Auditors are already making efforts to have irrelevant or immaterial disclosures deleted from the financial statements, and are also already exercising their influence on the companies so that disclosures are presented in a comprehensible way. Even though the auditors are already contributing to balanced and relevant disclosures in the financial statements, much more can be achieved. The auditor can, by engaging more in the disclosures, significantly improve the quality of how management communicates through the financial statements. Far believes that the future challenge for auditors is primarily to focus on how communication with the users of the financial statement can be improved. In Far's response to the IAASB's consultation on the "Proposed IAASB strategy and work program 2012-14" Far encouraged the IAASB to give top priority to projects concerning the auditors' communication. One project for the IAASB in line with that request is to develop a standard or other guidance on how the auditors' involvement can improve the quality of the disclosures.

Far's responses to the consultation questions for auditors can be read in the appendix.

Far

Bo Hjalmarsson
Chairman Far Auditing Policy Group

APPENDIX

Section II–Financial Reporting Disclosure Trends

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.

Far's response
From discussion with auditors in Sweden, Far understands that discussions between auditors and preparers, regarding deleting disclosures due to immateriality, are not common.

Far's experience is in line with the discussion in section II of the discussion paper, for example paragraphs 37-38, indicating that disclosures are often prepared late in the financial reporting process and that the main focus by both preparers and auditors is to determine whether all required disclosures are presented in the financial statements. Time restraints therefore often result in that deletions of immaterial disclosures are given less priority.

Far also shares the experience, in addition to time pressure, from the Financial Reporting Council's survey as discussed in paragraph 41 of the discussion paper, i.e. the difficulty for the preparer to determine when a disclosure is immaterial or not and whether the auditor and regulator will share the preparer's view.

Please provide any other relevant comments that you wish to make on Section II.

Far's response
Far has no further comment on Section II.

Section III–How Do ISAs Currently Deal with Disclosures?

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

Far's response
Material line items relying on complex routines and where alternative accounting principles are possible normally depend on disclosures for the fair view presentation, more than other items. The risk for a materially misstated disclosure is therefore often related to the risks in the corresponding line items.

Certain disclosures, however, may be significant even though they do not represent amounts that are material in relation to items in the balance sheet, income statement and cash flow statement. Misstatements in transactions with related parties, irregularities, breaching of laws etc., may significantly influence the user's view of the company even when the amounts are low relative to the company's operation.

Another aspect to this question is how materiality regarding disclosures specifically required by law or regulation should be determined, compared to disclosures required by a general purpose accounting framework. The approach to disclosures required by law and regulation probably depends on national considerations. Far believes that Swedish auditors in general give high attention to all disclosures required by law or regulation even though they generally could be regarded as less significant for the financial statements as a whole.

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

Far's response
In Far's view, guidance from ISA is primarily related to disclosures dealing with historical financial information derived from the entity's accounting system. Disclosures dealing with non-financial information are more vaguely described in the ISAs and could benefit from more guidance.

Forward-looking information and objective-based disclosures (as discussed in paragraphs 29-33) pose many practical challenges regarding verifiability (example: forward-looking information) and what criteria (example: objective-based disclosures) the information should be evaluated against.

Far also believes there is a need to explain the relation between ISAE 3000, *Assurance engagements other than audits of historical financial information*, and ISA concerning non-historical financial information presented in the audited financial statements. Far believes it should be considered whether an auditor really can express an opinion over the financial statements as a whole, considering the great differences in the nature of disclosures. One possibility that should be investigated is therefore to split the financial statements into two parts, one part dealing with historical financial information and other financial information, and another part dealing with disclosures of non-financial information character. The audit of the information in the first part would be within the scope of ISA, while the audit of part two would be within the scope of ISAE 3000. In a scenario when the financial statement is split into two, the auditor might present an opinion over the non-financial information either in the auditor's report in the section "Report on Other Legal and Regulatory Requirements" or in a separate assurance report. Naturally, it would be a challenge to sort out non-financial information from the financial information, but this might be necessary in order to make the audit more understandable and relevant.

The discussion paper also discusses whether all disclosures can be sufficiently verified and sufficient appropriate audit evidence can be obtained for the information as such. Even though the main assumption in the discussion paper is that sufficient appropriate evidence can be obtained, it could occasionally be a problem to obtain sufficient appropriate evidence for prospective and other information. Far believes that in such situations, it should be considered whether it would be more relevant for the auditor to express an opinion over the entity's process to compile that information rather than over the information itself. Compare the ED ISAE 3420, Assurance Reports on the Process to Compile Pro Forma Financial Information Included in a Prospectus.

Please provide any other relevant comments that you wish to make on Section III.

Far's response
Far has no further comment to Section III.

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

A4)

1. *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?*

2. *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?*

3. *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.*

Far's response
The discussion in paragraph 74 of the ED, regarding what is adequate support (evidence) for a disclosure in the eyes of the management versus what is sufficient appropriate audit evidence in the eyes of the auditor, is important for auditors as well as preparers. Further discussion is needed on how the management's need of evidence (in relation to Generally Accepted Accounting Principles) relates to audit evidence (in relation to Generally Accepted Auditing Standards).

1. Areas where Far anticipates that management and auditor may have different views of what is sufficient evidence are disclosures for fair values of financial instruments in industrial enterprises, transfer pricing between related parties and future oriented information. Different views can especially be identified for disclosures to goodwill, depreciated intangible assets and to items valued at fair value that are not traded in an active market and are valued based on valuation techniques with mainly entity-specific inputs. It could be discussed whether an auditor can issue an opinion, with reasonable assurance over the financial statements as a whole, if the balance sheet items in high degree contain such items. In any case, there is a possibility that users of the financial statements in those situations have higher expectations of the level of assurance than the auditor can actually provide.

2. Far has no example on disclosures that are unauditable when management has sufficient evidence for the information.

3. Far believes that if management has not been able to present sufficient evidence for a disclosure, the auditor will normally be unable to audit the information.

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

Far's response
1. Disclosures for property, plant and equipment: Information required for the impairment of assets would be the key issues here.

2. An operating segment disclosure: The information over operating segments is normally derived from the accounting system. However, depending on an entity's accounting system some information may originate from other sources and the gathering of audit evidence from those sources will be key issues.

3. Fair value line item disclosure: Descriptions of valuations models, sensitivity analysis and alternative measurement basis are normally not derived from the accounting system. All disclosures to significant items valued at fair value in an inactive market are problematic, and must be regarded as key issues.

4. Fair value disclosure for a line item recorded on another basis: When disclosures are presenting significant items valued on another basis than on the face of the profit and loss statement and balance sheet, those disclosures require as much attention from the auditor

as the values presented in the profit and loss statement, balance sheet and cash flow statement.

5. Stress test information disclosure: The audit approach to information regarding stress testing for internal risk management purposes should be that the auditor obtains evidence whether the description of the process is proper. Far also believes that the auditor, in order to meet the expectations from the users, in addition to verifying the description of the process, needs to make some testing whether the stress test was appropriately performed. Hence, Far is more in favour of alternative (b) than alternative (a) in paragraph 66 in the discussion paper.

6. Internal control disclosure including forward-looking information **or** management intent: The discussion paper is discussing in paragraph 67 whether the auditor for a disclosure describing the internal control should test that the control is operating effectively or just check whether the description of the control is accurate. In Fars view, the auditor should only obtain evidence over how effectively the control operates when the board/management in the disclosure has expressed their evaluation over the subject. Far has issued a national standard (RevR 7) regarding assurance over the Board's evaluation of the internal controls in a separate report. The Board's evaluation is not part of the financial statements and not integrated with the audited financial statements. Based on this standard the auditor expresses an opinion with limited assurance. A key issue in Sweden would therefore be to determine how to deal with a disclosure including such an evaluation included in the audited financial statements.

7. Objective-based disclosure: To obtain sufficient appropriate audit evidence to objective-based disclosures is a matter of professional judgement to be able to determine when the information strikes the right balance and meet the objectives from the users' perspective. A key issue for the auditor is to develop a methodology for how to determine the proper balance.

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?

Far's response
The opinion paragraph in the auditor's report states whether the financial statements fairly present a) the financial position, b) the financial performance and c) the cash flows. A fair presentation is according to IFRS and the Swedish Annual Act, achieved by the statements and the disclosures in combination. In Far's view, there is therefore no support for giving disclosures generally less attention than the financial statements line items.

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.

Far's response
Far believes that materiality regarding what disclosures are required to reach a fair presentation must be determined as stated in ISA 320, i.e. the materiality should be determined for the intended users as a group. The information that specific individual users may need shall not be the basis to determine what information an entity must disclose.

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?

Far's response
The definition of materiality in ISA 320.9 is fundamental also for materiality in disclosures. However, Far believes there are many aspects of disclosures identified in this discussion paper that need to be clarified and an additional guidance will help auditors further improve the audit approach for the various kinds of disclosures.

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.*

Far's response
It is not possible to point out any specific circumstances that constitute material misstatements in the various categories. The materiality must be determined case by case based on the auditor's judgement of what is material to the intended users of the financial statements.

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?

Far's response
(a) Far believes that sufficient and appropriate audit evidence is normally obtained by verifying the disclosed information with the auditor's knowledge based on the entities documentation of the policies and procedures and from testing them in action. The auditor determines by reading the disclosures whether the disclosed information is understandable for the intended users and whether the policies and procedures are applied as described. A description of the policies and procedures related to significant line items that does not meet all these requirements would normally constitute a misstatement.

(b) Far believes that audit evidence over disclosures regarding stress tests should include both the description of the process and that it was appropriately performed. Hence, Far believes that the view described in paragraph 66 (b) in the discussion paper is necessary to meet the expectations from the users. See also Far's response to question A5.5.

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?

Far's response
The evaluation of the accumulated effect on the opinion on the financial statements as a whole from qualitative and quantitative misstatements is a thought process that is difficult to define other than that it is depending on the auditor's professional judgement.

Far believes that disclosed information should be consistent over the years, but believes that prior year's misstatements in disclosures play a rather small role on the evaluation on the disclosures in the current year's financial statements.

Please provide any other relevant comments that you wish to make on Section IV.

Far's response
Far has no other comment to Section IV.

Section V–Questions about Auditability

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

Far's response
Far shares the starting point in the discussion paper that all disclosures are auditable, i.e. that it should be possible to agree on a reasonable and reachable level of what is sufficient appropriate audit evidence for all types of disclosures. This assumption is made under condition that management in their turn has sufficient supporting evidence for their disclosures.

Far believes that a scope restriction for certain categories of disclosures would not benefit audit quality. For certain categories of disclosures, guidance would be needed to describe what constitutes sufficient appropriate audit evidence. Categories that especially require more guidance would typically be what constitute sufficient appropriate audit evidence for objective-based information and forward looking information.

However, Far has raised an idea, in the response to question 3, that the auditor for certain disclosures provides assurance over the entity's compilation process rather than on the information itself.

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?

Far's response
See Far's response to question A11.

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?

Far's response

Far believes that auditors may adapt their audit approach in order to prevent criticism against the company from a financial reporting regulator or the auditors' supervisory board. Such criticism may indirectly be directed against the audit of the financial statements.
As stated in question A1 above, the uncertainty of how a regulator assesses materiality may result in excessive disclosures only intended to avoid potential discussions with and criticism from a regulator.

Please provide any other relevant comments that you wish to make on Section V.

Far's response
Far has no other comment on Section V.