

General comments

The discussion paper touches on some fundamental issues about the nature of audit opinions, audit judgments and audit evidence. In many cases, these are not unique to disclosures.

In our view, the theoretical solution to the various issues raised can be found in applying conventional audit thinking to the problem, and incorporating this where necessary in auditing standards.

However, in practice there will continue to be a tension between the theoretical position and the practical application, for reasons such as:

- Those identified on pages 16-17 of the Discussion paper;
- Additional behavioural issues discussed by the UK Accounting Standards Board in “Cutting Clutter”;
- Not placing sufficient emphasis in the audit planning process on planning for the audit of disclosures where the information is derived from non-financial systems;
- Not reviewing and making audit judgements on disclosures at a sufficiently senior level (this task is often delegated to a relatively junior audit staff member who is inexperienced in making the appropriate judgements and who often relies on pre-prepared catch-all checklists);
- Different interpretations of accounting standards applying to the same circumstances (and often by different auditors within the same firm), combined with an excessive focus on the words used in accounting standards rather than the intent of the disclosure requirements (the latter may be a consequence of the previous dot point). This trend may be exacerbated in some jurisdictions due to the litigation environment; and
- Considerable ambiguity about the objectives of financial reporting, its users and the decisions they make (notwithstanding the current Framework project), meaning that preparers and auditors do not have a clear reference point to judge materiality and the impact of mis-statements, beyond applying the letter of accounting standard disclosure requirements.

There is also an additional dimension in respect of group (consolidated) financial statements. The disclosures required in the group financial statements may drive the disclosures to be made by subsidiaries, since they must all contribute their component information to the consolidated result. Furthermore, it is often more appropriate for this information to be audited at subsidiary level first, as this will be where the audit evidence is located. This can result in group reporting policies requiring subsidiary companies to disclose information based on group needs, rather than the needs of the subsidiary entities. This information could be more extensive than actually required to present a true and fair view of the subsidiary’s financial position.

Auditors (as well as management of a reporting entity) should really review how information is assembled and presented in the financial statements to achieve faithful representation of the entity’s financial circumstances and activities. In this respect, professional judgement is demanded on the part of both auditors and preparers to determine what is appropriate and relevant information for the users of the general purpose financial statements.

HoTARAC members are typically not experts in auditing standards, although many have an understanding of auditing. Consequently, HoTARAC is reluctant to comment specifically on the

detailed provisions of auditing standards. Where possible however, we have commented on our general agreement or disagreement with a provision of auditing standards as paraphrased in the discussion paper.

Consultation Questions for Preparers

Section II—Financial Reporting Disclosure Trends

P1) What have been the most significant challenges you have experienced in preparing disclosures?

HoTARAC has experienced financial statement disclosure requirements growing more and more onerous and cumbersome over recent years. With the addition of significant qualitative (subjective) disclosures which are generally entity-specific and not necessarily consistent across years, HoTARAC questions the usefulness of some (usually very technical) disclosures to users of general purpose financial statements - especially users of public sector financial statements. Preparers encounter difficulties in complying with such complex requirements in a way that is understandable by the broad range of users.

- Ambiguities in accounting standards, resulting in different interpretations between preparers and auditors
- Auditors not sufficiently familiar with the conceptual basis for, and requirements of, accounting standards and/or being “process/rules-bound” rather than considering the overall fair presentation
- Very extensive disclosures proposed in some standards, notably financial instruments and employee entitlements (post-employment benefit plans). These require extensive resources to research and compile information, even for entities where they are not of high importance.
- Disclosure requirements that demand information that is not otherwise collected and/or reported for entity management purposes, or the disclosure requirements are not aligned to how the entity is managed internally
- Continuing changes to disclosures, particularly in complex subject areas such as financial instruments
- For parent entities, consolidation of disclosures about management judgements and assumptions (and similar narrative disclosures) across a large number of non-homogenous controlled entities – due to widely varying assumptions, judgements and valuation methodologies across controlled entities
- The auditors not observing materiality considerations, which apply to the application of all accounting standards, at both consolidated and individual entity levels
- Particular disclosures that pose challenges include:
 - Property Plant and Equipment qualitative disclosures e.g. valuation and impairment methodologies
 - Financial risk management strategies
 - Credit risk
 - Foreign exchange risk
 - Sensitivity analysis
 - Fair value of financial instruments across the 3 levels of the fair value hierarchy

- Contractual maturities of liabilities
- Consolidating the disclosures for multiple superannuation funds
- Disclosure of discontinued operations by whole-of-Government reporting entities, due to the format of the Operating Statement under AASB1049 *Whole of Government and General Government Sector Financial Reporting*.
- Auditor limited expertise in different financial reporting frameworks e.g. AASB1049 attempts to harmonise GAAP with GFS concepts. In this latter case, HoTARAC has found that auditors have taken a long time to become familiar with the GFS disclosure requirements demanded by AASB 1049.
- AASB1049 also requires explanation of major variances between original budgeted figures and corresponding actual figures for the General Government sector. As the original budgeted figures are not audited, audit of the explanations of variances is difficult.
- Auditors sometimes require disclosures not required by accounting standards e.g. demanding disclosure in consolidated financial statements about those controlled entities that received a qualified audit report, even though this has an immaterial impact on the consolidated financial statements.
- For whole-of-Government reporting entities, consolidation of individual agency disclosures can be problematic. For example, one such reporting entity in Australia summarises controlled entity disclosures that are material to the whole-of-Government statements but often refers users to the individual controlled entity statements for further information. Such an approach is not supported by auditors.

P2) Have you included a disclosure in your financial statements to comply with a specific disclosure requirement, even though you believed the disclosure was immaterial? What factors led you to this decision? What practical difficulties exist when deciding to omit a disclosure that you consider to be immaterial?

- Many of the disclosures required by AASB7 (IFRS7) and AASB119 (IAS19) in respect of superannuation plans we consider are immaterial to a fair presentation of the financial position of an entity. These are included usually as the “path of least resistance” – they are insisted upon by Audit Committees or auditors since they correspond to a checklist or a model set of financial statements.
- Other examples of disclosures that have been included in statements – despite their immateriality - are:
 - Impairment disclosures for receivables
 - Equity accounted investments
 - Discontinued operations
 - Investments in associates of controlled entities
 - Details of qualified audit reports of controlled entities
 - Financial instrument risk and sensitivity analyses, which are not as relevant in the public sector

As auditors always require working papers to prove or disprove materiality, preparers often find it entails relatively little more effort to include such disclosures in the statements, rather than enter into protracted negotiations with auditors about the value of the information to users.

Other relevant comments that you wish to make on Section II.

Nil

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

P3) Have you experienced requests from auditors for evidence to support your disclosures that you find difficult to satisfy? If so, please explain the context.

- Evidence to support fair values of investments in unlisted/untraded associates and associated disclosures, where associates are unwilling to provide information beyond that contained in their financial statements (and are not legally compelled to do so).
- AASB 1049 *Whole of Government and General Government Sector Financial Reporting* requirements to explain major variances between actual amounts presented in financial statements and the corresponding original budgeted amounts for the General Government Sector. These difficulties are partly due to the budgeted figures themselves not having been audited. The other complication is that the aggregate variance explanations relating to data for a large number of consolidated entities – individual entities will have either positive or negative variances in widely varying amounts, which makes faithful representation of the true source of the variance at whole-of-Government level difficult.

P4) 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 evidence or support do you believe you need to have as a basis for the assertions you make in the financial statements on such disclosures?

- Policy documents, internal descriptions of models and processes
- Evidence that the policies and processes have been followed (Board or committee minutes)
- Evidence of how data/information is collected, stored, analysed and reflected in disclosures
- Management representations
- (where available) Past history of the effectiveness of controls in identifying and mitigating risks
- Parent entities preparing consolidated financial statements would often rely on the audited financial statements of controlled entities as support for assertions in consolidated disclosures

The extent and strength of this evidence/support will be related to the degree to which risk associated with financial instruments has the potential to impact the “true and fair view”.

(b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65–66). In preparing financial statements, what, in your view, would be sufficient evidence for you to support your stress test disclosure? What do you believe would constitute a mis-statement of a stress test disclosure?

- Sufficient evidence to support a stress test disclosure would be data output directly from the stress-testing model, and verification of the data inputs to the model
- A mis-statement of a stress test disclosure would be where information does not align to the stress testing model's output

P5) What do you believe represents a material mis-statement of a disclosure? Please give an example of what, in your view, would constitute a material mis-statement for the following categories of disclosures:

- 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.

- HoTARAC does not believe that these can be reduced to a series of rules. The overriding consideration should be whether the mis-statement results in the financial statements not presenting a fair view of the overall financial position of the entity (see below). The exception would be where the auditor is required to report – usually as a result of local obligations - on compliance with specific legislation etc. In such instances materiality is usually not a consideration and any departure from the required standard would need to be disclosed.
- A material mis-statement of a disclosure would include errors, significant omissions or the knowing inclusion of false and misleading information that may result in a user making a decision about the entity that it wouldn't do if such a mis-statement wasn't made.
- Examples of material mis-statements would include information about risk management strategies that are not true (or omitting such information altogether), providing false information on credit risk, liquidity risk and sensitivity analysis assertions or using inappropriate valuation techniques and assumptions.

Other relevant comments that you wish to make on Section IV:

The auditors are required to provide an opinion on the financial statements as a whole. This demands that they will first understand the nature of the entity being audited, and then assess the adequacy/mis-statement of disclosures for the implications, either individually or in conjunction with other pieces of information in the financial statements as a whole, not individual component parts. The consequence of this is that the risk, audit procedures and

decisions on materiality should be made taking this “whole of statements” view in mind. As a further consequence, the levels of materiality may vary between items.

Consultation Questions for Regulators, Including Audit Oversight Bodies (noting that HoTARAC members regulate the financial statement disclosure and sometimes assess compliance with it for the public sector; and have no role in oversight of auditors)

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.

In many cases disclosures required under IFRS 7 are irrelevant to public sector entities, because they are not exposed to the same risks, or the same consequences of risks materialising, as private sector organisations.

Many of the accounting policy descriptions are redundant as they re-state the accounting standards. Lengthy accounting policy notes hinder understandability by making the financial statements appear more complex than they are.

Other relevant comments that you wish to make on Section II.

Nil

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.

No comment

Other relevant comments that you wish to make on Section III.

Nil

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?

- The assumption is that the disclosure is required based on judgement that it might impact on presenting a “true and fair view”. (If not, it could be omitted without prejudice).
- Judgement needs to be made about the extent to which a mis-statement would impact a true and fair view. This may or may not relate to whether it is simply a description of a process, a disclosure about a value other than that included in a line item, or other matters. This will depend on the circumstances.

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?

If the information about the fair value has the potential to impact on a true and fair view, the same level of audit evidence should be required as if the value was on the face. An example might be where the figures recognised in the financial statements only just support a going concern assumption, and the fair value disclosure has the potential to make this going concern assumption less tenable.

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.

No. The differences are in practice largely semantic. It is how this is applied that is important.

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.

Non-compliance with a critical law should always be disclosed. It should be clear to both preparers and auditors what the critical laws are.

The example of the absence of a particular condition is more problematic, as it will not always be clear what is relevant. Just being of "particular interest" is not sufficient in itself to require disclosure in financial statements – the concept of "true and fair view" should be the over-riding consideration in financial statements. If regulators other than accounting standard-setters require additional information in particular circumstances (or even on an ongoing basis), this should be built into the relevant regulatory framework rather than into accounting and auditing processes.

R7) What do you believe represents a material mis-statement of a disclosure? Please give an example of what, in your view, would constitute a material mis-statement 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.

See comment in preparers' section for corresponding question

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 mis-statement of such a disclosure?

See comment in preparers' section for similar question

(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 mis-statement of a stress test disclosure?

No comment

Other relevant comments that you wish to make on Section IV.

Nil

Section V—Questions about Auditability

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

HoTARAC views auditability in relation to the definition of an audit – an audit is an assurance engagement where the risk associated with the financial statements is reduced to an acceptably low level. In this respect it may be possible in some circumstances to identify some disclosures that are not capable of audit – not because they cannot be subject to audit procedures, but because the nature of the audit procedures and the collection of audit evidence is such that the degree of risk is not reduced to “acceptably low” – there may only be limited risk reduction. Where this is critical it should be identified in audit reports.

However, HoTARAC does not believe that any of the types of disclosure that are emerging and that are identified in the paper are inherently unauditably, although they may require development of alternative audit procedures, more sophisticated judgements, and targeted improvements in auditing and assurance standards to address gaps (including management judgements).

This does not mean that there will not be disclosures that are difficult to audit. These will exist and HoTARAC attempts to be pro-active on this issue when commenting on the disclosure requirements of proposed accounting standards.

There is a “stigma” attached to different audit views being raised in audit reports. Therefore, HoTARAC recommends that the IASB and IAASB work together to identify those existing IASB-required disclosures that are inherently difficult to audit, and either determine an audit solution or a more appropriate place to disclose such information (e.g. outside the audited financial statements).

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?

No comment

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?

In our experience this can occur in some circumstances. Auditors of public sector financial statements do (from time to time) seek the regulators’ views on the intent of required disclosures as part of their process of coming to judgement on a situation. However, we would expect auditors to consider this as only one input to their judgement – it should not detract from the overall independence, professional judgement and risk assessments expected of and demonstrated by auditors.

Other relevant comments that you wish to make on Section V

Nil



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Dear Sir

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

The Australian Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to provide comments on the International Auditing and Assurance Standards Board (IAASB) Discussion Paper: *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*.

HoTARAC is a committee that represents the Commonwealth and State/Territory Government Treasuries in Australia, in financial reporting matters for public sector entities. In this respect, HoTARAC members are both preparers and regulators of financial reports.

HoTARAC notes that audit of disclosures can be a complex issue, particularly in circumstances such as those outlined in the paper. HoTARAC is of the view that the over-riding goal of presenting a “true and fair view” can be used to guide the principles used to assess disclosures, although this may require further work on both auditing standards and on the behavioural/process aspects of auditing to achieve satisfactory outcomes.

Comments by HoTARAC on questions from the discussion paper are attached. We note that some of the comments may be specific to the Australian context.

If you have any queries regarding HoTARAC’s comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on 02 6215 3551.

Yours sincerely

for

Grant Hehir
CHAIR

HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

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