



ICAEW Response to IAASB on its Exposure Draft of Proposed Changes to the International Standards on Auditing (ISAs): *Addressing Disclosures in the Audit of Financial Statements*

ICAEW welcomes the opportunity to comment on the Exposure Draft of Proposed Changes to the International Standards on Auditing (ISAs): *Addressing Disclosures in the Audit of Financial Statements* published by IAASB in May 2014, a copy of which is available from this [link](#).

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MAJOR POINTS

General

1. IAASB recognises the widespread perception of a general excess of disclosures in financial statements. The issue is not straightforward and involves many stakeholders. In this context, we draw attention to our recent publication *Financial Reporting Disclosures: Market and Regulatory Failures*¹. We will continue to take every opportunity to encourage all stakeholders to take a structured and co-ordinated approach to this multi-faceted problem.
2. The DP and other papers that preceded this ED were wide-ranging and suggested some innovative solutions to the problem, including a new-style IAASB staff paper. We are encouraged by the recent publication of this paper and we noted our approval of it with some enthusiasm in our recent response to IAASB on its proposed strategy and work program. It is therefore disappointing that, after all this work, the proposed amendments to the ISAs themselves are so very narrow in scope. Amendments urging auditors to think about the issue earlier in the process and to consider the intentional use of inappropriate disclosures are helpful, but they are very limited. It would be much easier for IAASB to justify opening ten ISAs if it had fully addressed two critical issues.
3. The first critical issue – materiality – has largely been avoided. The second – evaluating misstatements – has been dealt with superficially. We fully appreciate the difficulties associated with both of these subjects, and the considerable resources IAASB has expended on them to date. But despite all of IAASB’s efforts, we fear that the proposed changes are unlikely to have any noticeable effect on audit quality. Nevertheless, we strongly urge IAASB to renew its efforts because we continue to believe that it can and should have a significant role in driving the debates in both areas.
4. There is nothing wrong with the proposed changes per se, but opening ten ISAs is no small matter, and the costs, particularly to smaller firms and in less developed jurisdictions, are significant. We do not believe that the limited benefits of the proposed changes are matched by these costs. We have noted in a number of recent responses to IAASB our belief that it should perform some sort of cost-benefit analysis on its proposals prior to exposure. The simple belief that audit quality will be improved is not enough. This is particularly important in cases such as these in which a large number of small changes are proposed. The proposed amendments are insubstantial but IAASB should not underestimate the amount of work they will create for firms in changing their methodologies and for professional bodies and standard-setters, particularly those that do not operate on a day-to-day basis in English. Changes to assertions in particular will require a considerable amount of work.
5. ICAEW is fortunate, in that we do not have to translate the ISAs. But even we can see that having to translate the changes, get the changes approved - and then incorporate them into electronic and printed copies of the ISAs, and then methodologies and the after that, into training material - is a real concern, because of the questions that will be asked by those charged with enforcing compliance with ISAs through IFAC’s Statements of Member Obligations (SMOs).
6. We copied our response to IAASB on its disclosures discussion paper (Rep 58/11²) to the chair, the vice chair and technical director of IASB. We noted the fact that the disclosure requirements of IFRS and other frameworks are unclear both in detail and conceptually. This, combined with the fact that auditors want to meet the expectations of regulators, results in

¹ www.icaew.com/~media/Files/Technical/Financial-reporting/Information%20for%20better%20markets/frd-final.pdf

² <http://www.icaew.com/~media/archive/files/technical/icaew-representations/2011/ICAEW-REP-58-11-The-evolving-nature-of-financial-reporting-disclosure-and-its-audit-implications.pdf>

checklists and a tendency to include more rather than less, 'just in case', rather than have to explain why not. We said that it is essential that IAASB's work in this area is co-ordinated with that of the IASB and not merely run in parallel, because the issues of materiality for financial reporting and auditing purposes need to be addressed in tandem. While we applaud IAASB's efforts to engage with IASB, both bodies need to ensure they address the issue in a holistic manner. This will involve more than simply observing the other body, and acknowledging that the issue cannot be dealt with by one body alone.

7. The proposed amendments are not adequate in the face of the changes that have taken place in disclosures and disclosure requirements in recent years. What is required is a much more radical retooling to deal with the wholly different types of disclosures auditors now face. We are disappointed by these proposals because it was evident in the papers leading up to this ED that IAASB understands the magnitude of the issues very well.
8. ***While the proposals are unobjectionable per se, we do not think they should be implemented because the cost of their implementation is wholly out of proportion to their likely benefit.*** IAASB should take these proposals forward and all of the good work undertaken prior to them, and incorporate them into a more comprehensive set of proposals when further progress has been made with other stakeholders and it is in a position to address more robustly the two critical issues of materiality and the evaluation of misstatements. Currently, the proposals are insufficient for the purposes of enhancing auditor focus on disclosures and we do not agree with IAASB's assessment that the ISA requirements are sufficient to meet the objectives stated in the standards.

Evaluating misstatements and materiality

9. The critical issue with the evaluation of misstatements is the judgement call that determines *when* a qualitative disclosure either alone, or in the context of the financial statements as a whole, becomes so poor, vague, misleading or wrong as to constitute a misstatement. IAASB helpfully provides examples of areas in which this might be a problem in proposed paragraph A128 in ISA 315, but nowhere does it guide or provide auditors with a framework as to *how* to use their judgement in this area. Proposed paragraphs A2a and A13a in ISA 450 state that:

...Although misstatements in non-quantitative disclosures cannot be aggregated in the same manner as misstatements of amounts, they are still evaluated individually, and collectively, with other misstatements.

...Incorrect descriptions of information about the objectives, policies and processes for managing capital could, for example, be material for entities with insurance and banking activities.

10. The former is a statement of the obvious and gives no clue as to how disclosures might be aggregated. The latter begs the question as to when or how a description might become so bad, as described above, that it becomes 'incorrect'. It simply provides an example of the importance of context. The term 'incorrect' is used several times in ISAs but usually in the context of hard facts or numbers. We do not believe that the term is used appropriately in the context of qualitative disclosures.

Scattered references to obscuring the significance of critical matters, intentionally or otherwise, through opaqueness or clutter

11. We note numerous, scattered references to opaqueness and clutter in disclosures that serve to obscure the significance of critical matters. This is an important issue. When IAASB returns to make further proposals in this area, the following paragraphs need to be consolidated:

ICAEW Representation 102/14: Exposure Draft of Proposed Changes to the International Standards on Auditing (ISAs): *Addressing Disclosures in the Audit of Financial Statements*

ISA 240 - A11 *A consideration of the risk that management may attempt to obscure information by presenting disclosures that are not clear and understandable.*

Appendix 2 to ISA 315 - second amendment: *Omission, or obscuring, of significant information in disclosures.*

ISA 450 - A17a: *Misstatements in disclosures could be indicative of, for example:*

- *Bias in management's judgments that results in misleading disclosures; or*
- *A trend towards duplicative or uninformative disclosures that may obscure significant information in the financial statements.*

ISA 700 - A3b: *Evaluating the understandability and relevance of the information presented in the financial statements includes consideration of matters such as whether:*

....

- *The disclosures undermine the overall presentation of the financial statements by including information that is not relevant or that is presented in a manner that may obscure a proper understanding of the matters disclosed.*
- *The placement of significant disclosures gives appropriate prominence to them (for example, when there is perceived value of entity-specific information to users), and whether the disclosures are appropriately cross-referenced to draw attention to related matters, where appropriate.*

12. It is important that a single central statement is made regarding the need for *auditor consideration of whether disclosures as a whole obscure the significance of critical disclosures, intentionally or otherwise, either through opacity or as a result of the volume of disclosures.* If this point has to be made in several different places, consistent terminology should be used with cross-references to the central statement.

Smaller entities

13. Disclosures are less likely to be a significant problem for smaller entities than they are for larger entities and changes to ten ISAs will simply add to the number of boxes to tick with less effect on audit quality than for larger entities.
14. The cost to smaller firms of making these changes is likely to be high by comparison with the cost to larger firms. We are nevertheless encouraged by the recent publication of the preliminary staff paper which may well be at least as useful to auditors of smaller entities as the proposed amendments themselves.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Whether, in your view, the proposed changes to the ISAs are appropriate and sufficient for purposes of enhancing the focus of the auditor on disclosures and, thereby, will further support the proper application of current requirements in the ISAs?

15. Some of the proposed changes are helpful but they are piecemeal and inadequate.
16. For example: references to information and disclosures being generated in systems outside the general ledger are helpful but they do not go far enough in recognising that some information and disclosures are effectively generated outside the entity, with all of the associated difficulties regarding access to evidence by auditors.
17. Consideration of timing by management and auditors is welcome, as is the elimination of the word 'size' from ISA 320. But the proposed ISA 330 requirements to agree disclosures to the

underlying records will in many cases be a significant additional requirement, particularly where the underlying records, as noted above, are outside the business.

18. We make it clear in our major points about that we do not believe that the proposals are sufficient for the purposes of enhancing the focus of the auditor on disclosures, and that the proposals should not be implemented until further progress has been made with other stakeholders and IAASB is prepared to address more robustly the two critical issues of materiality and the evaluation of misstatements.
19. We also note in our major points the importance of a single central statement regarding the need for *auditor consideration of whether disclosures as a whole obscure the significance of critical disclosures, intentionally or otherwise, either through opacity or as a result of the volume of disclosures*. If this point has to be made in several different places, it is essential that consistent terminology is used with cross-references to the central statement.

Q2: Are there any specific areas where, in your view, additional enhancement to either the requirements or guidance of the ISAs would be necessary for purposes of effective auditing of disclosures as part of a financial statement audit?

20. We note in our main point above our belief that two critical areas – materiality and the evaluation of misstatements – have been largely avoided.

Q3: Whether, in your view, the proposed changes to the assertions will help appropriately integrate the work on disclosures with the audit work on the underlying amounts, thereby promoting an earlier and more effective audit of disclosures?

21. The proposed changes to assertions are helpful but absent consideration of other equally, if not more important issues such as materiality and the evaluation of misstatements, we do not think they should be implemented.

RESPONSES TO QUESTIONS ON GENERAL MATTERS

(a) *Preparers (including Small- and Medium-Sized Entities (SMEs)) and Other Users*—The IAASB invites comments on the proposed changes to the ISAs particularly with respect to the practical impacts, if any, of the proposed changes to the ISAs.

22. We note above our belief that disclosures are less likely to be a significant problem for smaller entities than they are for larger entities and that changes to ten ISAs will simply add to the number of boxes to tick with less effect on audit quality than for larger entities. We also note the cost to smaller firms of making these changes which is likely to be high by comparison with the cost to larger firms. However, we are nevertheless encouraged by the recent publication of the preliminary staff paper which may well be at least as useful to auditors of smaller entities as the proposed amendments themselves.

(b) *Effective Date*—Recognizing that the proposed changes to the ISAs affect some of the same ISAs as other IAASB projects currently being finalized, the IAASB believes that to the extent possible, the effective date should be aligned with these other projects, namely the IAASB's Auditor Reporting project and the project to revise ISA 720.21 Accordingly, the IAASB believes that an appropriate effective date for the standard would be 12–15 months after issuance of the final standards, but may be longer or shorter to align with the effective date of the revisions arising from the auditor reporting and ISA 720 projects. Earlier application would be permitted. The IAASB welcomes comment on whether this would provide a sufficient period to support effective implementation of the changes to the ISAs.

23. We have no comment on the proposed effective date.

(c) *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment on

the proposed changes to the ISAs, in particular, on any foreseeable difficulties in applying these in a developing nation environment.

(d) *Translations*—Recognizing that many respondents may intend to translate the final changes to the ISAs for adoption in their own environments, the IAASB welcomes comments on potential translation issues respondents may note in reviewing the proposed changes to the ISAs.

24. We note in our major points above the fact that ICAEW is fortunate because it does not have to translate the ISAs. ICAEW's members are predominantly English-speakers. For those member bodies whose members are not, we believe that it is imperative that the substantial burden of translating the changes - getting them approved, and incorporating them into copies of the ISAs, methodologies and training material - is matched by benefits in terms of improved audit quality. We do not believe that the proposed changes will have any significant impact on auditor behaviour. The cost of translation is therefore not justified. The burden of translation is likely to be particularly onerous for developing nations who lack resources but who are still required to comply with the most recent version of ISAs under IFAC's Statements of Member Obligations (SMOs).