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September 11, 2014

Ms. Kathleen Healy
Technical Director
International Auditing and Assurance Standards
Board
529 Fifth Avenue, 6th Floor
New York NY 10017, USA

by electronic submission through the IAASB website

Dear Kathy,

Re.: Proposed Changes to the International Standards on Auditing (ISAs): Addressing Disclosures in the Audit of Financial Statements

We would like to thank you for the opportunity to provide the International Auditing and Assurance Standards Board (IAASB) with our comments on the Exposure Draft "Proposed Changes to the International Standards on Auditing (ISAs): Addressing Disclosures in the Audit of Financial Statements" (hereinafter referred to as "the draft").

As we stated in our comment letter dated June 17, 2011 to the IAASB in our response to its discussion paper from 2011, "The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications", we commend the IAASB for addressing one of the most important and pressing issues that affect audits of financial statements: the evolving nature of financial reporting through disclosures. We regarded the discussion paper to be timely and believed that the paper should be considered by accounting standards setters when deliberating the content of new or revised financial reporting frameworks and standards, as well as by accounting and audit regulators, when considering the application of accounting standards or their impact on audits.

As we pointed out in our comment letter to the discussion paper, the two main issues we identified as not receiving adequate attention by the discussion paper or accounting standards setters are the fact that financial reporting, and in particular the inclusion of disclosures, is foremost a practical exercise that needs to be based on evidence, and that the prime issue in determining the nature and extent of disclosures is the application of the materiality concept. We refer to our comment letter, and its attachments, on the discussion paper for further information.

On the basis of the feedback to the consultation paper, there appears to be general agreement that the IAASB cannot act in a satisfactory manner on this issue alone because the evidence and materiality considerations determining disclosures in the financial statements are primarily financial reporting standards setting issues – they are auditing issues only in the second instance. It is therefore imperative that the IAASB continue to pursue a dialogue with the IASB and other financial reporting standards setters with a view to achieving more appropriate requirements and guidance for preparers with respect to evidence, materiality and information overload in this context. In our view, the most recent ED from the IASB does not adequately address these issues (see the IDW comment letter to the IASB dated July 21, 2014).

We recognize that because the IASB and other financial reporting standards setters have not really begun to improve financial reporting standards as we believe is needed as described above, the IAASB's ability to act within its own standards is limited – in particular, limited to seeking to improve auditor performance with respect to audit work on disclosures. However, we ask ourselves whether the very small incremental improvements to the standards as proposed by the draft actually represent a large enough "leap" in performance to justify the number and extent of changes proposed in so many standards which, in our view, are primarily of a clarifying nature, rather than constituting any real change of substance. In particular, the changes would exacerbate the views expressed by some of our practitioners that the ISAs are somewhat repetitive of matters that are clarified in key definitions and requirements in the standards already, and therefore the readability of the ISAs suffers. The proposed changes also involve considerable work for transposition, translation, implementation and guidance and methodologies.

It seems to us that in this case, rather than stopping a project when it appears that the incremental benefit is marginal, the IAASB has persevered in seeking to deliver "something" to stakeholders, rather than risk their disappointment. In our view, it might have been better to simply recognize that the incremental benefit is not worth opening up so many standards and that a greater impact might be achieved by closer liaison with financial reporting standards setters in the long run.

However, if the IAASB decides to move ahead with the incremental improvements in the belief that these would actually significantly improve auditor performance, we do agree that the solution to address the issues in the affected standards is superior to issuing a separate standard on disclosures. However, we have a number of issues that we would like to address in this comment letter so that the proposed changes do not engender unintended consequences.

To this effect, we have responded in Appendix 1 to the questions posed in the Explanatory Memorandum and have provided additional comments in Appendix 2 by issue or paragraph. For the most part, in Appendix 1 we summarize our views, the evidence for which is provided in Appendix 2 by reference to the appropriate issue (for issues affecting more than one standard) or to the appropriate standard paragraph.

We would be pleased to discuss the contents of the letter with you at your convenience.

Yours truly,

Klaus-Peter Feld
Executive Director

Wolfgang Böhm
Director Assurance Standards,
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494/584

APPENDIX 1: Response By Question Posed in Explanatory Memorandum

Comments on specific matters

1. **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?**

   As we note in our letter, we are not convinced that the proposed changes to the ISAs will substantially change auditor performance with respect to disclosures: that will only occur if financial reporting standards setters properly deal with the evidence and systems needed to provide adequate disclosures, and appropriately deal with the issues of materiality and disclosure overload. However, we note a number of instances in Appendix 2 where we believe the changes are not appropriate (e.g., the references to the description of materiality in ISA 320 or the proposed treatment of non-quantitative disclosures therein), or could be improved (e.g., the definition of "financial statements" in ISA 200, the application material on judgmental misstatements in ISA 450).

2. **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?**

   In our view, in proposing these changes the IAASB has done almost all it could have done through the revision of the requirements and guidance of the ISAs to improve the effectiveness of audits of disclosures. That being said, the changes proposed are not enough to justify opening up so many standards for incremental changes, and to add the words "and disclosures" in such a repetitive manner: this will not substantially improve auditing of disclosures.

3. **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?**

   We believe that in practice auditors have already adapted the assertions in ISA 315 so that the proposed changes are already being appropriately addressed when auditing disclosures. Hence, these minor changes to the assertions will not substantially improve auditor performance in the audit of disclosures, even if it is not detrimental to have improved the completeness of the assertions.

Comments 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.**

(b) ***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.**

Since we do not represent preparers or developing nations, we have no comments on Questions 4 and 5.

(c) ***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.**

We refer to our comments in Appendix 2 on the definition of "financial statements" in ISA 200 and on the use of words in a consistent manner in the ISAs (including the use of present tense with complicated constructions to seek to avoid hidden requirements).

(d) ***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.**

We agree that the effective date should be aligned with the other changes resulting from the auditor reporting project so that changes to translations, transpositions of standards, implementation guidance, and audit methodologies need amendment only once.

APPENDIX 2: Responses By Issue, or Standard and Paragraph

By Issue (for Matters Relevant to More Than One Standard)

Reference to description of materiality in ISA 320

We support the thought introduced by the draft in proposed ISA 315.A128b and ISA 700.A4b that the auditor's consideration of the risks of misstatement or the fair presentation, respectively, of disclosures ought to be affected by their materiality. However, we note that ISA 320 intentionally does not define materiality for the financial statements as a whole[1], but in paragraph 2 describes how financial reporting frameworks generally explain materiality because financial reporting frameworks define materiality differently: the IAASB did not want to "cross the line" into accounting standards setting by defining materiality. For this reason, we believe it to be inappropriate for the application material in ISA 315.A128b to refer to "… could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole" or for the application material in ISA 700.A4b to refer to "…relevant to the economic decisions of users of financial statements…". By including these phrases, the IAASB would be defining materiality for the financial statements as a whole, which the IAASB refrained from doing in ISA 320. The project on disclosures is, in our view, not the appropriate forum to be making fundamental changes to how the IAASB treats the issue of materiality for the financial statements as a whole: that ought to be part of a project for a fundamental revision of ISA 320. Hence, the noted phrases should be replaced with "are material to users taken on the basis of the financial statements as a whole" and "are material to the users of the financial statements…", respectively.

Use of Words Inconsistent with Application of Clarity Conventions in Other Standards, and Hidden Requirements in the Application Material

We note a number of instances in the draft in which the wording in the application material is in the present tense and hence suggests a hidden requirement, or the wording does not align with how the application material is written in other ISAs, which leaves the impression that there is a different degree of authority attached to these words compared to those in the other ISAs. These instances include:

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1 ISA 320.10 does, however, effectively describe materiality for particular classes of transactions, account balances or disclosures, but this was done to avoid a tautology in the requirement.

- ISA 450.A2a, which represents a hidden requirement with the use of the words "Misstatements in disclosures are also accumulated…" and "they are still evaluated individually and collectively…". These words could be written differently by aligning them closer to the requirements in paragraph 5 and 11 and thereby demonstrate that only a clarification of the requirements in ISA 450.5 and .11 is being provided, for example:

  "The requirement in paragraph 5 to accumulate misstatements identified during the audit applies to all misstatements, including misstatements in quantitative and non-quantitative disclosures. Such accumulation may assist the auditor in evaluating the effect of such misstatements on the disclosures and on the financial statements as a whole. Although misstatements in non-quantitative disclosures cannot be accumulated in the same matter as misstatements in quantitative disclosures, the auditor is nevertheless required by paragraph 11 to determine whether these uncorrected misstatements are material, individually or in aggregate with other misstatements."

- The term "such as" in connection with the present tense is not the usual phraseology used in connection with guidance in the application material, and leaves the impression that the text sets forth some form of "light requirement". Examples of these and suggestions as to how these might be worded differently include:
  - ISA 450.A13a and ISA 700.A4b, in which the words "takes into account matters" prior to the words "such as" indicate that there is a hidden requirement to take into account matters, but that the matters listed are examples thereof. The words could be changed to read:

    "may involve consideration of such matters as…"

  - ISA 700.A3a, .A3b, and .A4, in which the words "includes consideration of matters such as" signify a hidden requirement to consider matters, but that the matters listed are examples thereof. The words could be changed to read:

    "may include consideration of matters such as"

  - ISA 700.A4b, in which the words "includes consideration, for example" indicate that there is a hidden requirement to consider something, of which the matter thereafter is an example. The words could be changed to read:

    "For example, the evaluation may include consideration of…"

- ISA 450.A13a and .A17a, in which the use of the word "could" rather than the usual "may" appears to suggest a different meaning than usual, which could cause difficulty upon translation, since in other languages these words will be construed as having different meanings. We therefore suggest that the word "could" be replaced with "may".

Reference to the "general ledger system"

We support the additional proposed clarification in ISA 210.A11 and .A23 (seventh bullet), ISA 300.A12a and its Appendix (11th bullet after the heading Significant Factors…), ISA 315.A89a, and ISA 330.20 (a), that in performing audit procedures in respect of disclosures the auditor may be required to take into account certain systems and processes beyond the general ledger system, since the source of many disclosures come from these other systems and processes. However, we believe the phrase "general ledger system" is an oversimplification and that it would be more helpful to use the phrase "general ledger system <u>or its sub-ledger systems</u>" to clarify that this information comes from systems and processes that most laypersons do not consider to be a part of the accounting system, even though, by definition, if used to prepare disclosures, those systems and processes are a part of the accounting system.

<u>By Standard and Paragraph</u>

ISA 200

13 (f) We welcome the clarification that the term "financial statements" is to be understood as including all disclosures, whether these are added onto the face of a statement, in the related (accompanying) notes, or by cross-reference where permitted by the applicable financial reporting framework.

However, we believe that the definition of "financial statements" in extant ISA 200, with which one of the undersigned was involved in drafting in the Special Reports Task Force of the IAASB as part of the Clarity Project, did not properly reflect the original intention when the definition was first drafted. The original draft of the definition was adapted from the AICPA Auditing Standard AU §623.02, which properly defines the term "financial statement" singular, The reason for the IAASB not following AU § 623.02 was the view that the ISAs are written in the context of "financial statements" plural, rather than a single financial statement singular, which is dealt with in ISA 805. However, the transfer of the definition in

AU § 623.02 to “financial statements” plural in ISA 200 has caused considerable difficulty to users of ISA 700 (in particular, ISA 700.23 (e)) and ISA 805 and upon translation, as we identified in our comment letter to the IAASB as part of the Implementation Monitoring of the Clarity Project. Furthermore, the definition in extant ISA 200 is technically incorrect by referring to financial statements plural, since a single financial statement may be intended to communicate an entity’s economic resources or obligations at a point in time (e.g., a balance sheet or statement of financial position), the changes therein for a period of time (e.g., an income statement or statement of comprehensive income) or both (e.g., a cash flow statement, which not only depicts the cash flows for a period of time, but also the cash at both the beginning and end of the period). If the IAASB were to choose to change the definition of “financial statements” as part of the disclosures project, it should use this opportunity to correct the definition in line with the mandate under the Implementation Monitoring Project.

One of the problems with the definition as proposed by the draft is the inherent circularity of the inclusion of the term “financial statements” within the definition by referring to “the face of the financial statements” when seeking to clarify where disclosures may be found. We note that ISA 700.23 (c) circumvents this problem by distinguishing between the “statement” (i.e., without the notes) and the “financial statement” (with the notes). This approach could be extended to the definition proposed in the draft so that the term “statement” refers to the structured representation without the disclosures on its face, in the related notes or incorporated by cross reference. A conforming amendment to ISA 700.23 (e) so that it refers to “statement” rather than “financial statement” would be helpful in this respect to users of ISA 700, too.

For these reasons, we strongly recommend that the IAASB distinguish, in the definitions, between a financial statement singular and financial statements plural, and distinguish between a statement and its related disclosures, regardless of where they are found. On the basis of this recommendation, the definitions would read as follows (marked-up from those proposed in the draft):

> “Financial statement~~s~~ – A structured representation of historical financial information, including disclosures, intended to communicate an entity’s economic resources or claims against the entity at a point in time or the changes therein for a period of time in accordance with a financial reporting frame-

> work. Disclosures comprise explanatory or descriptive information on the face of the ~~financial~~ statement~~s~~, ~~information~~ in the related notes, or ~~information~~ incorporated by cross-reference when permitted by the applicable financial reporting framework. ~~The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.~~”
>
> “Financial statements – The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but may also refer to single financial statements.”

ISA 210

A23. In the seventh bullet, the phrase after the comma starting with the words “recognizing that this includes…” represents a dangling modifier (verbal phrase), that does not clearly refer to the previous part of the sentence. The sentence therefore needs revision to clarify its meaning.

ISA 260

A13. In the fourth bullet, the reference to the “relevance, reliability, comparability and understandability of the financial statements” is not correct because it applies the qualitative characteristics of decision useful *information* (relevance, reliability, comparability and understandability) to the financial statements, rather than to the *information* presented *in* the financial statements. Therefore the words after the word “understandability” should read “…of the information presented in the financial statements”. This would align the wording to that proposed in ISA 700.A3b.

ISA 315

A19. In the fourth bullet point, we note that difficulty in performing the necessary audit procedures may not only relate to complexity, but in particular due to the difficulty in obtaining audit evidence. For these reasons, we suggest that the following be inserted at the end of the sentence: “or difficulties in obtaining evidence.”

ISA 320

6. The proposed change in the draft to insert the word “all” in between “detect” and “misstatements” and the following sentence suggest that audi-

tors are able to design audit procedures to detect most (even if not all) misstatements that could be material solely because of their nature. However, we would like to suggest that there are in fact many types of misstatements for which an auditor is not able to design audit procedures with which to detect them when these types of misstatements are material solely because of their nature. In many cases, it would be like "searching for a needle in a haystack" because an auditor cannot possibly design procedures for the identification of many events or conditions of which the auditor is not aware that may have a material impact on the financial statements. This is not to say that auditors are not able to design procedures to detect some types of misstatements that are material solely because of their nature because the auditor may be aware of them due to the requirements of the financial reporting framework or due to the auditor's understanding of the entity and its environment. We therefore suggest that these two sentences be amended to read (marked up from the draft):

> "It is not practicable for the auditor to design audit procedures to detect ~~all~~ misstatements in relation to risks of material misstatement of which the auditor is not aware where such misstatements ~~that~~ are material solely because of their nature. However, consideration of the nature of potential misstatements in non-quantitative disclosures is relevant to the design of audit procedures to address risks of material misstatement when the auditor is aware of these risks."

ISA 330

20 (a) Aside from our comment above in relation to the use of the term "general ledger system", we suggest that grammatically the beginning of the sentence should read: "Agreeing the financial statements, including disclosures with, and reconciling these to" because one reconciles matters "to" other matters, not "with" them.

A59. The draft inserts the words "as required by the financial reporting framework" in relation to the use of the terminology used. We would like to point out that not all financial reporting frameworks require the use of certain terminology in every instance. Furthermore, some financial frameworks do define the level of detail required and the level of aggregation and disaggregation of amounts and classification of items, but these items are not affected by the words "as required by the financial reporting framework". For these reasons, we believe that the insertion "as required by the financial reporting framework" causes more issues than it resolves, and would therefore recommend its deletion.

ISA 450

A3. In our view, the description of judgmental misstatements falls short by not including some of the other judgments that management needs to make – in particular, judgments about recognition, derecognition, and presentation. For this reason, we suggest that the description be expanded to read as follows:

> "Judgmental misstatements are differences arising from judgments of management concerning the recognition or derecognition of assets, liabilities or equity; the measurement of accounting estimates; and the presentation and disclosure of matters in the financial statements (including the selection and application of accounting policies) that the auditor considers unreasonable or inappropriate."

A17a. It is not clear to us how "misstatements in disclosures" can be indicative of a trend towards duplicative or uninformative disclosures that may obscure significant information in the financial statements. It appears to us that voluminous disclosures, even if they are not misstated, are a better indication thereof. The paragraph requires amendment accordingly.

ISA 700

A4c. Since this paragraph relates to fair presentation frameworks, rather than compliance frameworks, the words "misleading information" in the second bullet point should be replaced with "information being not fairly presented".