

Financial Reporting Context**The Applicable Financial Reporting Framework**

1. The financial reporting framework is a critical factor in the quality of financial reporting and can also influence audit quality.
2. Some believe that an accounting framework that is overly principles-based allows management too much latitude to account for transactions in a manner that suits management's objectives and makes it difficult for auditors to challenge this. [63]
3. On the other hand, others believe that over-emphasis on rules encourages a strict compliance approach to financial reporting, which may mean that it is difficult for auditors to focus on the substance of transactions and challenge the fair presentation of the financial statements.
4. Dangers of an over-complex applicable financial reporting framework are:
 - (a) It may be difficult for management to understand the accounting requirements and for those charged with governance to provide effective oversight of the financial reporting process, and [64]
 - (b) Over-complex financial reporting frameworks can absorb a disproportionate amount of the time of senior members of the audit team dealing with accounting complexities, with the risk of those members not being sufficiently involved in the direction, supervision and review of audit work.
5. Furthermore, rapid developments in financial reporting and disclosure requirements may also, at least in the short term, increase the potential for greater inconsistency in how management apply the standards and how auditors determine that they have obtained sufficient appropriate audit evidence.
6. Another important issue for audit quality is the auditability of financial reporting standards.¹ In recent years, developments in financial reporting have focused increasingly on meeting users' needs for financial information that is more relevant, even if such information may be more subjective and less "reliable". This has led in particular to a trend towards greater use of fair value measurements and other estimates, which may have significant measurement uncertainty. Disclosures regarding the underlying assumptions made and measurement uncertainty (e.g., sensitivity analyses) are an integral part of faithful representation of such financial statement amounts. But some of those disclosures are also more qualitative in nature, such as risk exposures. As a result, some question the "auditability" of all such financial information as it is less objectively verifiable as financial statements items such as cash.
7. Certainly, such measurements and disclosures may rely to a considerable extent on the exercise of judgment by management in applying the relevant financial reporting requirements, particularly when they involve assumptions, probabilities, forward looking expectations, or the use of complex models. The financial reporting framework

1 In 2009, the IAASB formalized a process by which it monitors developments in financial reporting standards. The goals of this process are to:

- (a) Provide the IASB with timely input on aspects of its proposed standards that may have potential verifiability or auditability issues; and
- (b) Assist the IAASB in determining whether matters in the financial reporting standards may affect the pronouncements of the IAASB or create a need for new pronouncements.

may be unclear on what management is expected to do to support the assumptions and judgments they make. As a result, this can make the auditor's task of gathering objective audit evidence to substantiate management's judgments more challenging.

8. For example:

- (a) The applicable financial reporting framework may provide for alternative accounting treatments depending on the entity's intended actions (for example, whether an investment is held for trading or intended to be held to maturity). Such a precondition may be difficult for the auditor to verify in practice, particularly as management may never have faced identical circumstances in the past or, even if similar situations did occur in the past, management's actions varied.
- (b) Some fair value measurements may need to be based on unobservable inputs if there is not an active market for the financial instrument. Verifying the fair value in such circumstances can be challenging because the determinants of it can involve highly judgmental assumptions and calculations involving complex models, often requiring specialized expertise.
- (c) In some circumstances, the applicable financial reporting framework may set an expectation that management consider *all* available information in developing a particular accounting estimate. Such an expectation sets an onerous benchmark to demonstrate, and verify, compliance with the requirement.
- (d) A further example is objective-based disclosure requirements.² In complying with an objective-based disclosure requirement, management must make a judgment regarding how much to disclose in relation to specific financial statement items. This is a highly judgmental process and it may be difficult for management to substantiate the basis for their judgment that the disclosures meet the objective for that disclosure in the particular circumstances. As such requirement is open-ended, it makes it more challenging for the auditor to determine what constitutes sufficient appropriate audit evidence regarding whether the entity has met the aim of the disclosure requirement

² For example, paragraph 7 of IFRS 7, *Financial Instruments: Disclosures*, requires the following: "An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance."