



International Federation of Accountants

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Agenda Item

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Meeting: IAASB
Meeting Location: San Francisco
Meeting Date: December 7-10, 2009

IAASB – IASB Liaison— Annual Review of Trends in Financial Reporting

Objective of Agenda Item

1. To discuss trends in financial reporting which may have broad pervasive implications for auditors and to the considerations of the IAASB and its liaison efforts with the International Accounting Standards Board (IASB).

Background and Activities since Last IAASB Discussion

2. At its September 2009 meeting, the IAASB considered and expressed support for a *Terms of Reference and Working Procedures* (“Terms of Reference”) for the IAASB’s liaison initiative with the IASB. In setting out the working procedures of this initiative, the Terms of Reference provide for the IAASB to undertake an annual review of activities in this regard. This session is the first of such reviews.
3. Rapporteurs of the various working groups and the IAASB liaison representative met via teleconference in November 2009 for a preliminary discussion of matters, particularly those arising from the IASB projects which are presently being monitored by the working groups, which may be relevant for discussion by the IAASB during this annual review session.

Objective of the Annual Review Session

4. The objective of the annual review session is two-fold:
 - (i) Firstly, to briefly consider the IASB’s work program in aggregate.

Earlier on the December IAASB meeting agenda, IASB Member and IASB Liaison Representative Prabhakar Kalavacherla (“PK”) is scheduled to present to the IAASB on the IASB’s current and future agenda, and the types of issues that have come to the attention of the IASB that may have implications for auditors.

- (ii) Secondly, to identify early more pervasive broader implications of accounting proposals for the IAASB.

This is the aim of this Agenda Item. It is planned that the IAASB would discuss significant trends in financial reporting with a view to understanding how those trends could affect auditors and auditing pronouncements, including identifying possible wide-ranging

auditability/verifiability issues in practice or that may arise as a result of extant or proposed accounting rules.

Importantly, the discussion should focus on accounting matters of strategic importance to the IAASB. This is to say that as opposed to considering a single matter, the discussion should be focused on those that may have implications across a number of areas and perhaps with an emphasis on issues relating to the principles of financial reporting for example, emerging trends in financial reporting. The IAASB is *not* expected to concern itself with the technical merits of accounting rules or proposals.

Financial Reporting Issues for Consideration

5. A broad review of extant and proposed accounting developments revealed the following matters which may have broad relevance to auditors and considerations of the IAASB:

Disclosures

6. In many cases, disclosures are comprised of more detailed presentations of items summarized in the body of the financial statements. Accordingly, the application to disclosures of the concepts of materiality, risk, audit evidence, tests, etc. have been considered to be similar to the application of such concepts to the line items in the financial statements. However, required disclosures are increasing, and may now involve more qualitative descriptions of the process followed by preparers in measuring amounts recognized in the financial statements that have significant measurement uncertainty, and the underlying assumptions and significant judgments made. There are also examples of disclosures being required that provide information beyond the amounts in the financial statements (e.g., disclosure of fair values of amounts reported in the financial statements at cost, or discussion of risks).
7. Given this trend, the application of auditing concepts to the audit of disclosures is raising a number of questions, such as how materiality judgments apply, and the nature and extent of audit evidence that is needed in relation to the disclosures. As preparers continue to include more narrative information and qualitative disclosures in their financial reports in the attempt to put financial information into context for their stakeholders, auditors are faced with greater as well as new challenges.
8. The topic of disclosures is important to both the current and future work program of the IAASB. In particular the IAASB's extant project to revise IAPS 1012¹ and research on the auditor's report, and the proposed project to revise ISA 720:²
 - In the case of IAPS 1012, accounting standards addressing fair values and complex financial instruments have given rise to many new disclosures, many of which are more qualitative in nature. Guidance developed in the context of that project could have broader applicability to the auditor's work on other disclosures.

¹ International Auditing Practice Statement (IAPS) 1012, "Auditing Derivative Financial Instruments."

² International Standard on Auditing (ISA) 720 (Redrafted), "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements." A project proposal for the revision of ISA 720 is slated for the IAASB's consideration and approval at its December IAASB meeting. (See Agenda Item 9)

- In the case of the research on the auditor’s report, at least some stakeholders are asking for auditors to say more about the key risks in the audit and the entity being audited, and to play a role in ensuring the understandability of the entity’s disclosures. Under ISA 700,³ the auditor has responsibility to evaluate adequacy of disclosures, as well as the understandability of the information in the financial statements in order to be able to form an opinion on the financial statements. Under a fair presentation framework, the auditor is expected to further consider whether “fair presentation” has been achieved. In this regard, the project may explore how those judgments relate to what is reported in the auditor’s report.
- Also in the case of ISA 720, matters such as the boundary between financial statement disclosures and financial disclosures in “other information” may need to be considered. IFRS, for example, allows preparers to include some of the required financial statement disclosures together with the entity’s management commentary elsewhere in its annual report.

In 2007, the IASB commenced a project on management commentary with the objective of developing a best practice model for a narrative report that would accompany but be presented outside of the financial statements, setting out management’s explanation of the enterprise’s financial condition, changes in financial condition, results of operations, and causes of changes in material line items. As part of the IAASB – IASB liaison initiative, a working group has been set up to monitor the IASB’s progress in this regard.

Verifiable Information

9. Rapid and consistent changes in the nature, extent and range of both mandatory and voluntary disclosures have in many cases resulted in a blurring of the boundary between information included in companies’ public reports that is readily verifiable to transactions that have occurred and the underlying source documents, and those for which audit evidence for the assumptions and judgments involved may be more difficult to obtain (such as the trend towards greater use of fair values, or to base accounting judgments on whether it reflects the entity’s underlying business model). Consequently, auditors are increasingly being challenged with the question of the “auditability” of at least certain information included in the financial statements.
10. Commenced in October 2004 and to be undertaken in eight phases, the IASB jointly with the US Financial Accounting Standards Board (FASB), is working towards developing an improved and common conceptual framework with the existing frameworks of the two accounting standard-setting boards forming the foundations of this work. As part of the IAASB – IASB liaison initiative, a working group has been set up to monitor the IASB’s progress in this regard.
11. In this regard, as an auditing standards setter, the IAASB would likely have a direct interest in proposed treatment of the concept of “verifiability” within the IASB’s conceptual framework – not only as it relates to auditors and audit evidence, but also the controls and support that management need to have to support their assertions in the financial statements. Based on deliberations to date, the IASB has preliminarily decided that the concept of verifiability will

³ ISA 700, “Forming an Opinion and Reporting on Financial Statements.”

continue to be classified as an enhancing characteristic,⁴ but is no longer considered to be one of the two fundamental qualitative characteristics (which are relevance and faithful representation).

12. The conceptual framework may also influence the key performance measures in the financial statements (for example, are decisions on accounting standards influenced more by the need to properly reflect the entity's assets and liabilities the key driver, or to portray the entity's performance in any given period). Such matters could have implications for judgments on, for example, materiality and the assessments of the risks of material misstatement.
13. In this regard, consideration may be given to the following questions:
 - Do users of financial statements understand the differences in the underlying nature of the financial information that collectively comprise the financial statements? Are users able to distinguish between information that is verifiable based on past transactions and information that involves more judgment?
 - Do users value relevance over reliability? What is the right balance between them in providing financial information that is decision-neutral?
 - Do financial statement disclosures sufficiently inform users so that they are able to form judgments for purposes of their decision making and if not, do auditors have a role in whether and in what ways better communication can be achieved?
 - Is there enough emphasis in financial reporting frameworks on what preparers need to do to have sufficient support for the assertions they are making in their financial statements?
 - What might be the implications, if any, in the auditing context? For example, are there implications for the auditor's determination of materiality or for the auditor's report?

IFRS for SMEs

14. In July 2009, the IASB published an International Financial Reporting Standard (IFRS) designed for use by small and medium-sized entities (SMEs).⁵ Unlike their public companies counterparts, users of the financial statements of SMEs who are more focused on assessing shorter-term cash flows, liquidity and solvency have found the full IFRSs to be burdensome.
15. In brief, compared to the full IFRS, much of the implementation guidance has been omitted in this version for the SMEs. This is made possible through the elimination of detailed explanation and requirements relating to more complex circumstances which is generally encountered in the context of a public company and not usually applicable to an SME setting. Through application

⁴ Accordingly to the summary of decisions posted on the IASB website (http://www.fasb.org/project/cf_phase-a.shtml). The IASB's conceptual framework describes qualitative characteristics that make financial information useful. The characteristics fall into two groups namely, fundamental and enhancing characteristics. Fundamental characteristics include relevance and faithful representation and enhancing characteristics include comparability, verifiability, timeliness and understandability.

⁵ The IASB's IFRS for SMEs may be accessed from the IASB website. (<http://www.iasb.org/IFRS+for+SMEs/IFRS+for+SMEs+and+related+material/IFRS+for+SMEs+and+related+material.htm#english>).

of the IFRS for SMEs, companies will be able to achieve significant simplification of their financial reporting process for example, recognition and measurement, and disclosure obligations. It is important to note that IFRS for SMEs is a self-contained standard which incorporates all mandatory requirements for SME financial statements.

16. In this regard, consideration may be given to the following questions:

- What, if any, specific considerations are required in the conduct of the audit when financial statements are prepared using IFRS for SMEs?
- What, if any, are the implications for the auditor's report for example, reference to compliance with IFRS for SMEs as opposed to compliance with IFRS?

Financial Statements Presentation

17. Commenced in 2006, the IASB jointly with the US FASB, is collaborating on a project to establish a standard that will guide the organization and presentation of information in the financial statements.⁶ Depending on the outcomes of the project, the manner and extent in which entities classify income, expenses and cash flows items may experience changes. Notably, the project is proposing a 'management's approach' to the classification of assets and liabilities and their related changes so as to better reflect the way the items are used in the context of the entity and its segment where applicable. To illustrate, in addition to classifying items of income and expense into operating, investing and financing categories, under the new proposals, preparers may be required to consider disaggregation of the business and financing sections by function (for example, cost of sale or administration), nature (for example, materials, labor or depreciation), and measurement bases in the financial statements as a whole.
18. Application of the proposed 'management approach' to the presentation of financial statements items may bring about challenges in the context of the external audit. For example, difficulties may be encountered in auditing management's classification of assets and liabilities within the different sections and categories. Further, the retrospective application of the proposed management approach may also be problematic.
19. The reorganization of the financial statements to separate different aspects of an entity's performance – which has already started to a certain degree with the separation of profit and loss and other comprehensive income, but could now be further disaggregated by, for example, separating performance into operating, investing and financial categories – raises questions about the perceived key performance indicators in an entity and, in so doing, the bases on which materiality should be judged.

Pace and Complexity of Changes to Financial Reporting

20. The nature and extent of changes to accounting rules have been rapid and consistent. This trend is expected to continue based on that fact that at present the IASB has more than 20 projects in progress ranging from its conceptual framework project to projects addressing fair value issues. Auditors need to keep abreast of both changes in auditing standards and changes to financial reporting rules.

⁶ In October 2008, the IASB issued a discussion paper, "Preliminary Views on Financial Statement Presentation."

21. When taken together, the pace as well as complexity of changes to financial reporting presents both preparers and auditors with the challenge of staying current. It may create the need for greater usage for management to seek the advice of management's experts. Similarly in some cases, auditors may need to seek the input from an auditor's expert. As highlighted in the IAASB Working Group's comments to the IASB on its fair value exposure drafts, the availability of necessary expertise in emerging economies could raise both financial reporting and auditing challenges.
22. In this regard, consideration may be given to the following questions:
 - Whether the IAASB should consider financial reporting matters in the context of an audit as a key input to its future work program (for example, the need to provide additional or new guidance)?
 - Whether the IAASB should encourage or collaborate with other functions in IFAC such as the Public Accountants in Business (PAIB) Committee⁷ as they explore avenues to provide greater assistance to professional accountants in connection with financial reporting matters (for example, by providing input in regards to verifiability considerations associated with financial reporting requirements)?

Matters for IAASB Consideration

1. What are the IAASB's views on the implications of the accounting trends and developments outlined in this paper for auditors in general and to the IAASB's considerations?
2. Are there other financial reporting trends or developments that should be considered and monitored by the IAASB?
3. Are there other linkages to extant or future IAASB or IASB activities which should be noted?

Action Requested

23. The IAASB is asked to consider the matters presented in this paper and to provide input on the direction on the way forward.

⁷ As per the PAIB's *Operational Work Program, 2010-2012*, the PAIB is slated to consider undertaking projects in two areas namely management commentary and preparer-auditor interface. The proposed objective of the management commentary project is to support PAIBs in their role relating to management commentary through the provision of practical guidance. The objective of the project on preparer-auditor interface is to raise awareness of the financial auditor's work to other parties, such as preparers, and to consider particular issues around the preparer auditor interface.