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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: New York

Meeting Date: March 8–9, 2011

Audit Implications of Disclosures—Report Back and Project Update

Objectives of Agenda Item

1. The Objectives of this Agenda Item are:

   (a) To provide a report back on proposals of the Representatives on this project as discussed at the September 2010 CAG Meeting.

   (b) To obtain the Representatives' views on the key issues in the Discussion Paper issued by the IAASB in January 2011.

Papers to Be Referred to during Discussion

2. The discussion on this topic will follow the structure of this CAG Paper.

Project Status and Timeline

3. The issue of auditors' responsibilities and practices regarding disclosures has been discussed by the IAASB in December 2009 and September and December 2010, by the IAASB CAG in March and September 2009 and September 2010 and at the IAASB-National Standard Setters meeting in June 2010. In March 2010, the IAASB agreed the establishment of a working group to recommend a way forward for the IAASB on this topic.

4. The IAASB determined that it was critical to obtain further information and perspectives on audit practice and priorities in this area in a form of a Discussion Paper to properly scope the project proposal.

5. The IAASB approved a Discussion Paper titled *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications* at its December 2010 meeting. The Discussion Paper was released for public comment on January 21, 2011 and comments are requested by June 1, 2011. A link to the Discussion Paper is included as a CAG Reference Paper at the end of this paper.

6. A formal project proposal is likely to be developed after the responses from the Discussion Paper are received and discussed with the IAASB.

Background

IAASB Working Group

7. The IAASB Working Group met for the first time in July 2010. The Working Group comprises:

- Diana Hillier, Chair, IAASB Deputy Chair
- Arch Archambault, IAASB Member
- Cédric Gélard, IAASB Member
- Tomokazu Sekiguchi, IAASB Member
- John Fogarty, Deloitte & Touche, Former IAASB Deputy Chair

September 14-15, 2010 CAG Discussion

8. Below are extracts from the draft minutes of the September 2010 CAG meeting,[1] and an indication of how the Working Group or IAASB has responded to the Representatives' comments.

Representatives' Comments	Working Group/IAASB Response
Mr. Damant noted that one reason for the concerns about the audit of disclosure is that capital markets judge future cash flows, and the financial statements are only evidence for this rather than the whole answer. He explained that disclosures were critical to a proper assessment of future cash flows.	Point taken into account. The importance of disclosures in fully informing users of the financial position, performance and cash flows of the entity is described in paragraph 23[2] of the Discussion Paper.
Messrs. Attolini, Baumann, Kuramochi, Roussey, and Upton, and Ms. Sucher, supported the IAASB pursuing the audit implications of disclosures.	Support noted.
Mr. Baumann noted that the Public Company Accounting Oversight Board (PCAOB) is looking at the audit of disclosures and considering many of the same issues, and suggested this may be a key project for the IAASB and the PCAOB to work on together. He noted the increasing importance of disclosures and that the	Point taken into account. Paragraphs 79–101 of the Discussion Paper explore the range of views around materiality and misstatements. The matter is also discussed in paragraphs 19–26 below.

[1] The minutes will be approved at the March 2011 IAASB CAG meeting.

[2] Unless otherwise indicated, paragraph references are to the Discussion Paper, which is provided as a CAG Reference Paper.

Representatives' Comments	Working Group/IAASB Response
PCAOB was evaluating whether additional guidance was needed. He also noted that auditors traditionally record all unadjusted differences for assessment at the final stages of the audit, but the increasing importance of disclosures raises the question of whether this is best practice.	
Mr. Upton supported Mr. Baumann's comments on unadjusted differences and also noted that he is aware that preparers sometimes maintain that proving to an auditor that a disclosure is immaterial is extremely difficult; as a result many financial statements may contain immaterial disclosures. Mr. Koktvedgaard responded to Mr. Upton by noting that preparers often have as much difficulty convincing regulators about the immateriality of disclosures as they have convincing auditors.	Point taken into account. The difficulties in determining whether a disclosure is immaterial, and the challenges in removing disclosures is discussed in paragraphs 36–41 and 79–87 of the Discussion Paper. The matter is also discussed in paragraphs 20–21 below.
Ms. Sucher commented that fair presentation is a focus area for the U.K. Financial Services Authority, and that they consider "true and fair" to be a dynamic concept.	Points taken into account. The meaning of "true and fair" and "presents fairly" is discussed in paragraphs 95–101 of the Discussion Paper. The matter is also discussed in paragraphs 24–25 below.
Ms. Sucher recommended that the Working Group consider audit process issues, such as the timing of the review of disclosures and the appropriate person within the audit team to be reviewing disclosures.	Point taken into account. The timing of the preparation and review of disclosures is discussed in paragraphs 37–38 and 56 of the Discussion Paper. The Working Group has made note of the other audit process issues raised and believe that they are best dealt with following a formal project proposal.
Mr. Kuramochi commented that IOSCO supports this project, and noted that the Japanese Financial Supervisory Agency (JFSA) is currently deciding if Japan should move to International Financial Reporting Standards (IFRS) and one of the key issues is the enforceability and auditability of IFRS. He noted that it was important that unauditable disclosures were highlighted.	Point taken into account. Paragraphs 102–114 of the Discussion Paper discuss views about the auditability of certain disclosures. The matter is also discussed in paragraphs 27–30 below.

Representatives' Comments	Working Group/IAASB Response
Mr. Attolini noted that the project may help to prevent an expectation gap from developing, and that there may be different ways in which the auditor can approach the audit of disclosures. However, he expressed concern that the project should not increase the burden on smaller entities, and suggested that the IAASB should consider the need for guidance on proportionality in this area. Mr. Damant noted that IFRS for Small and Medium-Sized Entities may partly address this issue.	Point taken into account. The Discussion Paper includes a paragraph on the relevance of the paper to smaller entities and their auditors (paragraph 13). The point on proportionality will be taken into account when preparing any future project proposal.
Mr. Upton noted that auditors may attempt to make a measurement or disclosure more robust through auditing and gave sensitivity disclosures as an example. He disagreed with this approach as auditing cannot improve the quality of the inputs.	Point taken into account. Paragraph 107 of the Discussion Paper explores this view particularly. The Discussion Paper also explores the International Accounting Standards Board's (IASB) Conceptual Framework (paragraphs 22–28) and the effect of the shift from reliability to faithful representation.

Matters for CAG Consideration

9. The Discussion Paper is designed to help the IAASB gain a robust understanding of views and perspectives on issues relevant to the implication of disclosures for financial statement audits. Questions have arisen about how auditors should apply auditing concepts in obtaining sufficient appropriate audit evidence about financial statement disclosures to support their opinion on the financial statements as a whole.

10. The Discussion Paper focuses on three key areas:
    - The recent trends in financial reporting and their impact on financial statement disclosures;
    - How the International Standards on Auditing (ISAs) currently deal with disclosures; and
    - The audit issues that the IAASB has identified regarding disclosures required by a financial reporting framework.

11. The IAASB is aware that challenges in approaching disclosures do not affect just auditors. Preparers, investors, lenders, creditors, regulators and other users also need to consider their approaches to disclosures, and their perspectives on issues will be useful to the IAASB. Therefore, although the Discussion Paper is focused on the implications for auditors, the IAASB has prepared specific questions for preparers; investors, lenders and other creditors; regulators; and auditors (see pages 35–45 of the Discussion Paper).

12. Obtaining different stakeholders' views on the range of issues about financial statement disclosures will be invaluable and will assist in ensuring that the IAASB, and other stakeholders, have the opportunity to engage with different perspectives.

Trends in Financial Reporting Disclosures (Paragraphs 15–41 of the Discussion Paper)

13. Over the past decade, the nature of financial reporting has evolved to meet the changing needs of users. Business and capital markets have become more challenging, with greater complexity in business models, sources of risk and uncertainty, as well as greater sophistication in how risk is managed. This evolution reflects a desire for information that is relevant to users, even if such information may be more subjective and less reliable.

14. Financial reporting disclosure requirements and practices have also had to respond to these changes by shifting from simply providing breakdowns of line items on the face of the financial statements to providing more detailed disclosures including:

    - Significant accounting policies;
    - Components of line items;
    - Factual information about the entity;
    - Judgments and reasons;
    - Assumptions, models and inputs;
    - Sources of estimation uncertainty;
    - Descriptions of internal processes;
    - Disclosures of fair values of amounts recorded on the balance sheet using a different measurement basis; and
    - Objective-based disclosure requirements.

15. The IAASB has also heard of practical considerations that affect the preparation of the disclosures:

    - Even if a preparer believes that a particular required disclosure is not material, the preparer may nevertheless be reluctant to exclude that disclosure from the financial statements because of the uncertainty regarding whether regulators and auditors will agree with management's assessment of the materiality of the disclosure.
    - Disclosures are often prepared late in the financial reporting process, are usually less formal and less structured and, increasingly, are derived from systems which are not connected to the accounting system, such as risk management systems.
    - Detailed disclosures are often not required for preliminary announcements to stock exchanges, and so the pressure to prepare them early is reduced.

Matter for CAG Consideration

1. Do Representatives have any comments to make on the practical considerations listed above? Are there other practical considerations that the IAASB should be aware of?

What Does Sufficient Appropriate Audit Evidence Mean for Disclosures? (Paragraphs 59–78 of the Discussion Paper)

16. Paragraph 17 of ISA 200[3] requires an auditor to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. Questions have arisen about how this is implemented in practice, in particular when dealing with certain types of disclosures. Some disclosures, such as a breakdown of a line item from the balance sheet, are drawn from the same system as the balance sheet item and thus are subjected to audit procedures while the auditor works on the related balance sheet line item. However, at the other end of the spectrum are disclosures which provide context for the financial statements, but are not related to any specific financial statement line items, such as the proposed disclosure of stress test information.[4]

17. For something like the stress test disclosure, there are two views on what audit evidence is needed:

    (a) The first view is that the auditor only needs to obtain evidence about whether the disclosure properly describes the process the entity followed in performing the stress test and the outcomes of that test (that is, whether it is an accurate description of the stress testing that was performed); or

    (b) The second view is that the auditor needs to obtain evidence as to whether the stress test was, in fact, appropriately performed (which would require suitable criteria that are available to intended users, such as direction from regulators on the parameters of the entity's stress testing, or other expectations of how such a stress test should be performed), whether the reported outcome of the test is appropriate in the entity's circumstances, and whether the disclosure properly describes the process the entity followed and its outcome.

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[3] ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

[4] IASB ED/2009/12, *Financial Instruments: Amortized Cost and Impairment* states at paragraph 20: "If an entity prepares stress testing information for internal risk management purposes it shall disclose that fact and information that enables users of financial statements to understand:

(a) the implications for the financial position and performance of the entity; and

(b) the entity's ability to withstand the stress scenario or scenarios."

Obviously, the evidence needed, and the work required to obtain the audit evidence, is significantly higher for the latter perspective than the former.

18. A further issue is management's support for their disclosures. The ISAs are premised on management assuming responsibility for (a) the preparation and fair presentation of the financial statements;[5] and (b) while not explicitly stated in the ISAs, having a sufficient basis to support their disclosures (in effect, evidence). Some suggest that management may not always have sufficient support for all disclosures in all circumstances due to the nature of some disclosure requirements, which may make it difficult for the auditor to obtain sufficient appropriate audit evidence.

Matters for CAG Consideration

2. Paragraph 17 describes two ways in which audit evidence might be viewed for a disclosure such as the proposed IASB disclosure of an entity's stress testing. Do Representatives have views on which approach they would have expected in an audit?
3. Do Representatives believe that a key to obtaining audit evidence is management's ability to provide supporting evidence for their disclosure?
4. Are there perspectives that Representatives wish to convey to the IAASB relative to the auditor's approach to challenging disclosures, including judgments about fair presentation and disclosures that are not derived from the accounting system?

How Materiality Is Applied to Disclosures, and How Misstatements Are Evaluated (Paragraphs 79–101 of the Discussion Paper)

19. There are different views on how materiality is assessed for disclosures by both preparers and auditors.

20. Paragraph 31 of IAS 1[6] notes that "An entity need not provide a specific disclosure required by an IFRS if the information is not material." One view of materiality in respect of disclosures is that accounting standard setters have applied a materiality "filter" in setting the accounting requirements and have judged them to be "material" if the related line item is "material." As such, the holders of this view would argue that all disclosures required by a financial reporting framework are material. A useful example is the disclosure related to share-based payments—these may be extensive even if the particular share-based payment is quite quantitatively small.

21. This prompts the question of whether the preparer and the auditor are able to further filter out the least important disclosures in the context of the entity to enhance the readability of

[5] ISA 200, paragraph A2

[6] International Accounting Standard 1, *Presentation of Financial Statements*

the financial statements, even if they are ostensibly required by the financial reporting framework.

22. Equally, auditors may encounter challenges in evaluating misstatements of disclosures. Misstatements of disclosures may be different than misstatements on the face of the financial statements. They vary from those that are easy to detect and discuss with management through to those that are highly subjective. For example:

- A line item, such as property, plant and equipment may not have part or all of the required disclosures.
- A disclosure may contain a factual mistake, such as an incorrect number, or may disclose an assumption or accounting policy that was not the one used.
- A disclosure may be biased, such that the disclosure does not reflect a neutral perspective.
- A disclosure may be poorly worded or confusing, such that the auditor is concerned about the understandability and fair presentation of the financial statements as a whole.
- Key information may be disclosed, but its order in the entity's overall disclosures may obfuscate its importance to a proper understanding of the entity's financial position, financial performance or cash flows.

The challenges in applying materiality and evaluating misstatements are greater for the latter items as errors may become less obvious and judgments may be more subjective.

23. Usually, in accordance with ISA 450,[7] misstatements are evaluated by considering the size and nature of the misstatements and the circumstances of their occurrence together with the effect of uncorrected misstatements from prior periods. This is often focused on determining if the misstatements affect key ratios, earnings targets or contractual covenants. However, in the case of qualitative misstatements, this is not an appropriate focus as they have no effect on ratios, targets or covenants. ISAs provide some further guidance and suggest the circumstances that may affect the consideration of a misstatement, including misstatements of disclosures.

24. Another aspect of the identification of possible misstatements that may be particularly relevant to disclosures is whether the financial statements achieve fair presentation, particularly in judging possible omissions. In essence, the concerns about applying the concept of fair presentation to the consideration of disclosures show two different perspectives: those that believe that "presents fairly" means compliance with the financial reporting framework and those that believe that fair presentation is an overarching concept that goes beyond compliance with the financial reporting framework.

[7] ISA 450, *Evaluation of Misstatements Identified during the Audit*

25. A further aspect of "presents fairly" is about the broader issues of understandability, prominence and presentation of key disclosures in the context of the financial statements as a whole. Some would like auditors to give greater focus to the understandability of the financial statements which may include the extent to which they "tell the story" of the entity's financial position, performance and cash flows.

26. Issues regarding materiality and misstatements are not limited to auditors alone; they are also relevant to preparers, investors, regulators and other stakeholders. A key objective of the Discussion Paper is, therefore, to engage those parties in dialogue and share perspectives on these issues. It is important because, given the wide diversity of disclosures, available evidence and subjectivity involved, a very real risk of expectation gaps exists.

Matters for CAG Consideration

5. Do Representatives have comments on how materiality and misstatements should be assessed in respect of disclosures? What are reasonable expectations regarding auditors' judgments in respect of "presents fairly"? When thinking about this question, it may be useful to consider the implications for the different categories of disclosures in paragraph 14 of this paper, and for:

   (a) Disclosures of the policies and procedures for managing the risk arising from financial instruments; and

   (b) Disclosures regarding stress tests.[8]

Questions about Auditability (Paragraphs 102–114 of the Discussion Paper)

27. The Discussion Paper is prepared on the preliminary assumption that all disclosures required by a financial reporting framework are capable of being covered by the auditor's opinion on the financial statements. However, to respond to these views, the final section of the Discussion Paper examines the auditability of certain disclosures and asks for input from stakeholders.

28. Central to the question of auditability of disclosures is the question of management's supporting evidence for their disclosures. If management has appropriate supporting evidence for their judgments and decisions, then it is likely that the disclosure should be capable of being audited. As such, a key question in relation to auditability of disclosures is the extent to which management has documented appropriate supporting evidence. It is clear that the extent of available evidence for both management and auditors may vary depending on the category of disclosure.

29. Some believe that some categories of disclosures, such as highly subjective or forward looking information, are so difficult to audit that there may be an expectation gap between

[8] See paragraph 17.

what the auditor can actually achieve, what users of financial statements believe auditors do in a financial statement audit, and, as noted earlier in the paper, the description in the auditor's report. For these people, it is more appropriate that some disclosures are excluded from the scope of the auditor's opinion.

30. Others have a different view, pointing out that auditors have managed to find agreement on consistent and appropriate ways of auditing challenging subject matters previously. For example, prior to the full integration of fair value information in financial reporting, some argued that fair values were not capable of being audited, particularly those fair values that were based on unobservable inputs. The holders of this view believe that auditing should continue to evolve with the financial reporting framework by finding agreement on the composition of sufficient appropriate audit evidence in respect of these types of disclosures.

Matters for CAG Consideration

6. Are there disclosures which, in the view of Representatives, are not capable of being audited? If so, is this due to the expected lack of supporting evidence for management's disclosure?
7. If there are disclosures not capable of being audited, do Representatives have views on how they should be dealt with?

Consultation Strategy (Pages 35–45 of the Discussion Paper)

31. The IAASB recognizes that this issue is important for preparers, investors, creditors and others who may not usually provide written comments to the IAASB. As a consequence, the IAASB Working Group intends to approach key players in these communities for comment to seek to understand their perspectives.

32. Member Organizations with an interest in this area are encouraged to respond to the Discussion Paper.

Matter for CAG Consideration

8. Do Representatives have a view as to who within the preparer, investor and creditor communities should be appropriated specifically for consultation?

Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

IAASB Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*	http://www.ifac.org/Guidance/EXD-Details.php?EDID=0154