THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

QUAERE VERUM

Response from The Institute of Chartered Accountants of Scotland to the International Auditing and Assurance Standards Board

The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications

16 June 2011

INTRODUCTION

The Institute's Audit and Assurance Committee has considered the Discussion Paper *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications* and is pleased to forward its comments to the International Auditing and Assurance Standards Board (IAASB).

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Audit and Assurance Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

We have chosen not to respond to the questions directed at particular stakeholders but rather provide an overall response to the paper drawing on the different perspectives of our Committee members.

ICAS is very supportive of the IAASB's initiative to release this discussion paper. Financial statements are the responsibility of management and are framed around the financial reporting framework but in reality the auditor plays a crucial role in shaping the published financial statements.

We believe that it is crucial for the IAASB to work closely with the International Accounting Standards Board (IASB) to ensure that financial reporting frameworks are developed taking into account the impact of the audit. We commend the IAASB for releasing this paper and urge the IAASB to use the results of the consultation to take forward a constructive dialogue and debate around the whole financial reporting and assurance process.

KEY ISSUES

An Effective Financial Reporting Framework

The audit cannot be considered in isolation. A prerequisite of an effective audit is an effective financial reporting framework. ICAS has always supported principles based financial reporting standards. In the 2006 ICAS publication *Principles Not Rule: A Question of Judgement*[1], it was declared:

"The key to true and fair financial reporting is the balanced exercise of judgement. If standards setters, preparers, auditors and regulators could all exercise judgement on broadly equal terms, then this would provide the healthy tension which is needed for true and fair financial reporting and for communication with stakeholders."

The financial reporting framework under International Financial Reporting Standards (IFRS) has become increasingly complex and arguably has restricted the use of judgement by both preparers and auditors. While IAS 1 does state that disclosures are only required if they are material, this

[1] Principles Not Rules: A Question of Judgement (The Institute of Chartered Accountants of Scotland, 2006) available to download from http://www.icas.org.uk/site/cms/download/rs_Principles_v_Rules.pdf

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principle is often not applied in practice. It was noted by preparers on our Committee that IFRS 7 in particular requires lengthy disclosures which often stretch to more than 15 pages in a company where financial instruments are not core to the business strategy. It was noted by one Committee member that not one market participant has ever asked a single question on these lengthy disclosures prepared by his company.

Behavioural Issues

The discussion paper mentions the use of illustrative financial statements and disclosure checklists and asks whether the use of such tools is encouraging unnecessary disclosures. The Committee feels that illustrative financial statements and disclosure checklists are useful to both the auditor and the client – but they should be used as an aid and not a definitive checklist. By nature such tools will try to cover every eventuality and it is highly likely that many disclosures will not be applicable to a particular entity. The preparer and the auditor must be able to exercise judgement and be able to justify that judgement.

In the UK auditors are subject to unlimited liability for a statutory audit – therefore liability concerns could be driving excessive immaterial disclosures. Similarly, the possibility of an inspection by the Audit Inspection Unit (AIU) could drive behaviour. Preparers are also subject to review by the Financial Reporting Review Panel (FRRP). Preparers may well feel it is safer to simply include all possible disclosures than risk an adverse review by the FRRP.

It is noted that certain UK regulators have commented that it is often not possible to compare disclosures between different companies, in particular those of large financial institutions. There is a suggestion that auditors should be driving the comparability of disclosures. There is also a desire for auditors to provide more detail on the aggressiveness of particular valuations. If this logic was followed it could further erode the scope for management and auditors to exercise their judgement. This seems to elevate comparability from its status as an "enhancing characteristic" under IFRS.

Materiality Applied to Disclosures

ICAS is currently undertaking a project to consider IFRS disclosures and their materiality and will shortly be producing a report on its findings. We will forward this report to the IAASB as soon as it is available.

We agree that the concept of materiality can be more difficult to apply to disclosures, particularly when that disclosure is not linked directly to a line item in the financial statements. Our Committee noted there was a need to consider materiality in the context of the financial statements as a whole rather than considering each disclosure individually. For example, the pension liabilities may be material to the financial statements but the disclosures can run to so many pages that this can lend disproportionate emphasis to the pension scheme liabilities compared to the more significant items. If pension scheme liabilities amount to only 0.5% of net assets but the disclosures run to 4 pages, yet stock amounts to 20% of net assets but the disclosures run to only 1 page, this could be misleading to the user.

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Materiality is much easier to understand when it is a straightforward amount – it becomes more difficult when the auditor needs to consider whether an item is material by its nature or by its context in the financial statements. It is the latter two types of materiality which are often more applicable to disclosures. Some disclosures are now widely accepted as being material by their nature – related party transactions being one example – but there may be a need for further guidance in the standard's Application Guidance. Again this requires more use of judgement.

If there is any dispute over the materiality of disclosures, the conclusion is likely to be that it is easier just to include the disclosure.

Assurance on the Narrative

In December 2010 ICAS published *The Future of Assurance*[2]. This report was produced by a high level working group comprising a broad range of stakeholders. The report has been well received across the stakeholder spectrum. Among our other recommendations, the working group recommended that the auditor provided an additional assurance opinion on the "front end" of the annual report. The report proposed an opinion by the auditors that "front end" is "balanced and reasonable". This would not utilise any of the current IAASB audit or assurance frameworks but would require a new framework to be developed. The working group envisaged that the auditors would utilise their existing knowledge of the business to allow them to essentially opine that the annual report has not been subject to spin.

We believe that this expanded role for the auditor will require a greater exercise of judgement and a different mindset to the audit of historic financial statements. We do, however believe that auditors are capable of delivering this new assurance opinion and requiring auditors to focus on the narrative reporting which includes the business model, strategy and key risks, will be beneficial to the auditor in their audit of disclosures in the financial statements.

[2] The Future of Assurance (The Institute of Chartered Accountants of Scotland, 2010) available to download at www.icas.org.uk/futureofassurance

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