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Mr. James Gunn
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21 July 2011

Dear Mr. Gunn:

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

Ernst & Young Global Limited, the central entity of the Ernst & Young organization, welcomes the opportunity to offer its views on the discussion paper *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications* (Discussion Paper) issued by the International Auditing and Assurance Standards Board (IAASB).

Over the past decade, increasingly complex financial reporting requirements have been issued by accounting standard setters to respond to the information needs of financial statement users. This has been accompanied by a shift from rather simple disclosures providing additional information about line items in the financial statements to more complex and detailed disclosures intended to provide more relevant information to users. While the International Standards on Auditing (ISAs) require that the auditor address disclosures in planning and performing an audit of financial statements (including identifying and assessing the risks of material misstatement at the assertion level for disclosures), they do not specifically address the auditor's responsibility for the nature and broad range of disclosures that are presently found in financial reporting frameworks. Accordingly, there is a need for additional guidance for auditors regarding the audit of disclosures, and in particular 1) for the application of materiality to the audit of disclosures, including the evaluation of identified misstatements, and 2) for the evaluation of whether sufficient appropriate audit evidence has been obtained. We therefore support the IAASB's goal to obtain an understanding of the views and perspectives on issues relevant to auditing disclosures in a financial statement audit in order to inform possible standard-setting projects to respond to those issues.

We also stress the importance of the ongoing liaison between the International Accounting Standards Board and the IAASB to monitor the implications of proposed changes to financial reporting standards relating to disclosures and to provide input on a timely basis regarding potential "auditability" issues. This also will enable the IAASB to consider whether additional guidance for auditors or changes to auditing standards may be warranted to address new or changed financial reporting standards.

In addition, as the auditor's report on the financial statements also covers the disclosures, some users may believe that the disclosures are audited to the same level of precision as financial statement line items or even to lower materiality levels. This may contribute to the existing “expectations gap”. We suggest that the IAASB also consider, as part of its project on auditor reporting, whether the auditor’s responsibility in relation to disclosures should be clearly communicated in the auditor’s report on the financial statements.

The Discussion Paper does not address audit reporting issues in relation to disclosures, specifically as they relate to the auditor’s responsibility under ISA 705 to provide omitted material disclosures in the auditor’s report when the auditor’s opinion is modified due to the entity’s omission of such information. We believe that the IAASB should reconsider why the auditor should be required to provide information about the entity that the entity itself deliberately decides not to disclose in the financial statements, when the auditor’s responsibility is to express an opinion on those financial statements (i.e. to report whether or not the auditor believes there is a departure from the applicable financial reporting framework due to an omitted material disclosure).

Responses to the specific Consultation Questions for Auditors on which the IAASB is seeking feedback are set out below. We found that some of the questions were difficult to answer without regard to specific facts and circumstances. Accordingly, our answers to those questions are more generic but we believe that they will, in any event, adequately inform the IAASB of our views on those matters.

Consultation Questions for Auditors – Specific Questions

Section II – Financial Reporting Disclosure Trends

A1. Have you had discussions with entities about whether some of their required disclosures might be considered immaterial? What factors did you take into account? Please explain what difficulties (if any) you have experienced.

From time to time, we have discussions with entities about whether, in their particular circumstances, some of the disclosures required by the applicable financial reporting framework might be omitted on materiality grounds. Factors that are considered in making that determination are both quantitative (e.g., materiality of amounts) and qualitative (e.g., expectations of the users of the financial statements, the relative importance to the entity’s financial position, financial performance or cash flows, the prevalence of the disclosure in the industry, etc.). The potential scrutiny of regulators, in light of their expectations, as well as known trends in disclosures by peers or others may also be considered.

For disclosures that have been previously made in the financial statements, the determination as to whether to omit such disclosures in the current period financial statements because they are no longer material is not straightforward. Even though the quantitative and qualitative considerations mentioned above may lead to a conclusion that such information is not material, an entity may nevertheless elect to continue to disclose the information for comparability and consistency with prior periods.

Section III – How Do ISAs Currently Deal with Disclosures

A2. How do you approach the identification and assessment of the risks of material misstatement in disclosures?

We generally approach the identification and assessment of the risks of material misstatement of disclosures as follows:

- For disclosures that are derived from an account balance and its related classes of transactions, we identify and assess the risks of material misstatement for those disclosures in conjunction with those of the account and related classes of transactions.
- For disclosures that are derived through the financial reporting process used to prepare the entity's financial statements, we identify and assess the risks of material misstatement in conjunction with that process.
- For disclosures that are derived from ancillary reporting systems or systems that are not subjected to internal control over financial reporting, we perform our risk assessments and procedures on the disclosures separately from the accounts and the financial reporting process.

A3. Are there ISA requirements that, in your experience, pose practical challenges in respect of disclosures? Please explain your answer.

We believe the following ISA requirements pose practical challenges in respect of disclosures:

- The application of materiality to quantitative disclosures when the disclosures are not related to line items in financial statements or the application of materiality to qualitative disclosures (refer to Question A8 for further comments).
- The identification and evaluation of misstatements in disclosures (refer to Questions A9 and A11 for further comments).
- The assessment of whether sufficient appropriate audit evidence has been obtained for certain disclosures (refer to Question A4 for further comments).

Section IV – Audit Issues Regarding Disclosures Required by a Financial Reporting Framework

A4. Have you encountered situations where you experienced difficulty in obtaining sufficient appropriate audit evidence for a disclosure, even though management believed it had appropriate supporting evidence for the disclosure? If management's consideration of a disclosure can be appropriately supported by evidence and documentation, are there factors that could nevertheless make a disclosure unauditable? If management has not provided evidence and documentation in support of a disclosure, do you believe you are able nevertheless to obtain sufficient appropriate audit evidence on the disclosure? Please explain your answer.

In order to obtain reasonable assurance, the auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level (ISA 200.17). Whether sufficient appropriate audit evidence has been obtained is a matter of professional judgment. The sufficiency (quantity) of audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and the appropriateness (quality) of such audit evidence. In turn, the quality of audit evidence is affected by its relevance and reliability in providing support for the conclusions on which to base the auditor's opinion.

In practice, the difficulties in obtaining sufficient appropriate audit evidence for a disclosure, even though management believes it has supporting evidence for that disclosure, are often due to:

a) the nature of the disclosure and whether it is capable of consistent evaluation or measurement against the requirements of the applicable financial reporting framework (for example, narrative information that is subjective in nature and that is measured against general disclosure requirements)
b) the inability of the auditor to gather audit evidence to support the auditor's conclusion (for example, when the documentary evidence is deemed to be insufficient or inappropriate and the auditor's procedures are limited to inquiries of entity personnel)
c) the fact that the information is internally generated and the auditor is unable to assess its reliability because there is no available information from other sources to corroborate it

A disclosure would ordinarily be considered to be "unauditable" if it is not capable of:

a) consistent evaluation or measurement against the requirements of the applicable financial reporting framework (this is the case when, for example, the information is highly subjective or when it is future-oriented, such as forecast or forward-looking information); and
b) being subjected to procedures for gathering sufficient appropriate evidence to support the auditor's conclusion.

Management is responsible for the preparation (and fair presentation where applicable) of the financial statements in accordance with the applicable financial reporting framework. That responsibility includes the maintenance of records, documentation and other matters that are relevant to the preparation of the financial statements. If management has not provided evidence and documentation in support of a disclosure, we do not believe that the auditor is in a position to obtain sufficient appropriate audit evidence on that disclosure.

A5. What do you believe are the key issues with gathering audit evidence for the examples given in paragraphs 60-70?

Please refer to Question A4.

A6. Some disclosures include the fair value of a financial statement line item measured on another basis, such as historical cost. In this circumstance, what level of effort do you believe should be applied to the fair value disclosure? Should your effort be the same as if the fair value was on the face of the financial statements?

The level of effort to apply to the fair value disclosure depends on the assessed risk of material misstatement of such disclosure, which will drive the nature and extent of procedures to be performed in response to the assessed risks. Assuming the assessed risk of material misstatement is the same for the fair value disclosure and the fair value on the face of the financial statements, the level of effort ought to be the same.

A7. What is your expectation regarding the need for disclosures not specifically required by the financial reporting framework, but which some users may believe are relevant to the fair presentation of the financial statements? Examples may include non-compliance with a critical law, even though there is no quantitatively material effect, or the fact that the entity does not have a material holding of a particular asset class, such as sovereign debt, which may be of particular interest in the current economic environment.

The ISAs are premised on management assuming responsibility for the preparation and fair presentation of the financial statements. A fair presentation framework, as defined in the ISAs, is a financial reporting framework that "acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework". The determination of whether such disclosures are needed because they are relevant to the fair presentation of the financial statements rests with management. The auditor is required to evaluate whether the financial statements achieve fair presentation. In doing so, the auditor should "stand back" and consider the overall presentation, structure and content of the financial statements.

A8. In light of the discussion in paragraphs 79-87, what do you believe is the appropriate way of applying materiality to disclosures? Do you believe there is sufficient guidance in the ISAs?

At present, we believe that auditors use professional judgment in applying the materiality concepts in ISA 320 to disclosures. We do not see only one appropriate way of applying materiality to disclosures and this suggests that more guidance in this area is needed.

A9. What do you believe represents a material misstatement of a disclosure? Please give an example of what, in your view, would constitute a material misstatement for the following categories of disclosures: Judgments and reasons; Assumptions/models/inputs; Sources of estimation uncertainty/sensitivity analysis disclosures; Descriptions of internal processes; Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis; and Objective-based disclosure requirements.

We believe that the definition of a material misstatement as stated in ISA 320 can also be applied to disclosures (i.e., misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements). Misstatements of disclosures would include circumstances such as the following:

- Omission of required financial statement disclosures (either quantitative or narrative information)
- Incomplete or inaccurate financial statement disclosures (understatement or overstatement of quantitative information or discrepancies in narrative information)
- Disclosures (narrative information) that may be misleading when considered in relation to the financial statements as a whole

A10. Some disclosures are relevant to an understanding of an entity but are not related to any specific line item in the financial statements. Below are two examples of these types of disclosures:

a) Financial statements may include disclosures of the policies and procedures for managing the risk arising from financial instruments. Such disclosures may, for example, discuss the controls the entity has put in place to mitigate risks. What do you believe would constitute sufficient appropriate audit evidence for such a disclosure? What do you believe would constitute a misstatement of such a disclosure?

For this type of disclosure, we would expect the auditor to obtain and read the description of the entity's policies and procedures for managing the risk arising from financial instruments and, from the understanding obtained, to evaluate whether such description is fairly reproduced or summarized in the financial statements. With regards to the controls the entity has put in place to mitigate risks, we would expect the auditor to determine, through inquiries and other procedures, such as observation and inspection of records, that the controls have been implemented. A misstatement of such a disclosure would include:

- An incomplete or inaccurate description of key aspects of the entity's policies and procedures for managing the risk arising from financial instruments
- Controls that have not been implemented by the entity to mitigate risks but are nevertheless included in the description of the policies and procedures (this could include controls that have not been in operation for the entire reporting period but are not identified as such in the description)

b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65-66). What work would you expect to do in relation to the proposed stress test disclosures? What do you believe would constitute a misstatement of a stress test disclosure?

For this type of disclosure, we would expect the auditor to confirm with the entity that it prepares stress testing information for internal risk management purposes and obtain evidence to that effect. That being the case, the auditor would, using professional judgment, evaluate the entity's disclosures, focusing on the completeness and accuracy of the information as it relates to implications for the financial position and performance of the entity, as well the entity's ability to withstand the stress scenario or scenarios. The extent of the auditor's evaluation of the disclosures would depend on the supporting documentation prepared by the entity. A misstatement of such a disclosure would include:

- An incomplete or inaccurate description of the information
- Errors in the computation of the stress scenario or scenarios
- Inappropriate or inadequate scenarios

A11. How do you evaluate both qualitative and quantitative misstatements in forming an opinion on the financial statements as a whole? Is it possible to accumulate misstatements of disclosures, particularly when they relate to qualitative or judgmental disclosures? How do prior year's disclosure misstatements affect the evaluation of the current year's financial statements?

Quantitative misstatements are evaluated, both individually and in the aggregate, to determine their effect on the financial statements as whole. In addition to the quantitative misstatements, qualitative misstatements are evaluated individually, and considered together, when forming an opinion on the financial statements as a whole.

We also believe that it is possible to interpret and apply the definitions in ISA 450.A3 of factual and judgmental misstatements to disclosure misstatements. For example:

- Factual misstatements may be errors in disclosed amounts, or omissions of disclosures required by the financial reporting framework, about which there is no doubt
- Judgmental misstatements may be differences between the auditor's expectations and those of management regarding the content and extent of disclosures for which the financial reporting framework allows the application of judgment (e.g., objective-based disclosures)

Regarding the evaluation of prior-year disclosure misstatements on the current-year financial statements, we believe that such an evaluation would be largely qualitative in nature. For example:

- Misstatements in prior-year amounts that are presented comparatively could be evaluated for the effect on consistency and comparability of the current-year disclosed amounts
- Misstatements may be time-related, such that a misstatement in a prior-year disclosure, may no longer be relevant to the current-year financial statements

Notwithstanding the above considerations, laws and regulations in certain countries may specify whether a disclosure is deemed to be material in all circumstances (for example, the Dutch law specifically states that the remuneration of executives is a material disclosure, regardless of amount.)

Section V – Questions about Auditability

A12. What are the characteristics of disclosures that, in your view, would not be auditable?

As indicated in our response to Question A4, in our view, a disclosure would ordinarily be considered to be "unauditable" if it is not capable of:

a) consistent evaluation or measurement against the applicable financial reporting framework; and
b) being subjected to procedures for gathering sufficient appropriate evidence to support the auditor's conclusion.

A13. What criteria do you believe should be used to assess an auditor's judgment in respect of the fair presentation of the financial statements as a whole?

The criteria can be found in the requirements of ISA 700, paragraphs 10 to 15. Those requirements apply when the auditor is forming an opinion on the fair presentation of the financial statements as a whole.

A14. Some believe that the manner in which a financial reporting regulator enforces financial reporting requirements may influence how auditors approach their audits, including how they may approach disclosures. What is your view?

Auditors are typically apprised of current and prior matters of regulatory scrutiny (e.g., US SEC comment letters) affecting their clients, and to varying extents, those matters affecting other entities. We would agree that the knowledge of current or emerging views of regulators is a consideration in the audit of disclosures.

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We would be pleased to discuss our comments with members of the International Auditing and Assurance Standards Board or its staff. If you wish to do so, please contact Dan Montgomery (+1 216 583 2949), Denise Esdon (+1 416 943 2982) or Denise Weber (+ 1 216 583 4814).

Yours sincerely,

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