Auditing Practices Board
Audit Inspection Unit
Aldwych House, 71-91 Aldwych, London WC2B 4HN
Telephone: 020 7492 2300 Fax: 020 7492 2301
www.frc.org.uk/apb

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York
New York 10017
USA

1 June 2011

Dear Sir

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

1. This is a joint response to the above Discussion Paper from the Auditing Practices Board (APB) and Audit Inspection Unit (AIU) of the Financial Reporting Council (FRC).

2. The APB is responsible for setting high quality standards and guidance for the performance of external audit in the UK and Ireland.

3. The AIU is part of the FRC's Professional Oversight Board (POB) and is responsible for the monitoring of the audits of all UK listed and other major public interest entities in order to safeguard and improve audit quality. Through its work it obtains important insights into the practical application of auditing standards and guidance and how they might be improved to enhance audit quality.

4. The comments and recommendations expressed in this response have been approved on behalf of the Boards of both the APB and the POB. In preparing this response we also consulted with our colleagues in other parts of the FRC that have an interest in this matter, including the UK Accounting Standards Board and the Financial Reporting Review Panel.

5. The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. Many of the issues addressed in the Discussion Paper are of concern to the FRC and the FRC is stimulating debate and investigating possible actions in a numbers of areas as described in our more detailed comments below. Most recently, in January 2011, the FRC issued a Discussion Paper, 'Effective Company Stewardship: Enhancing Corporate Reporting and Audit'[1]. In that Discussion Paper the FRC made seven key recommendations aimed at improving the dialogue between company boards and their shareholders, including fuller reports by audit committees and expanded reports by auditors. The FRC is currently reviewing the responses received and will publish a feedback statement in the near future.

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1 www.frc.org.uk/about/effcompsteward.cfm

Summary of our main recommendations

6. We agree that the challenges in addressing disclosures do not affect just auditors, but also preparers, investors, regulators and other users of financial statements. In particular, we believe that challenges for auditors need to be considered 'hand in hand' with those for management and those charged with governance, who have responsibility for the preparation of the financial statements. The requirements for the content of financial statements are primarily driven by accounting standards setters - auditing standards should not be used to do so.

7. It is important that the IAASB continues to work with the International Accounting Standards Board (IASB) to ensure that disclosure requirements are not developed that result in information for which auditors are not able to obtain sufficient appropriate audit evidence. We believe that the issues described in the Discussion Paper need to be treated consistently in accounting and auditing standards and will be best addressed by both bodies working together. Accordingly, we support the IAASB in strengthening its relationships with the IASB and other bodies, including the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS).

8. Another important reason for close working with the IASB is that the IAASB can help ensure that the cost of auditing disclosures is properly recognised when comparing the overall costs and benefits of providing information in financial statements.

9. An increasing volume of disclosures should not of itself be a major concern to the IAASB, but attention needs to be given to whether the ISAs establish the appropriate requirements and guidance to facilitate the effective audit of the disclosures that are given. In our comments below we identify a number of areas where requirements and/or guidance for auditors should be enhanced. In summary these are:

    - Materiality - considering materiality and judging what information is important to users. (see paragraphs11-27)

    - Fair presentation - giving more emphasis to the need to stand back and evaluate whether sufficient and appropriate information has been included in the financial statements to meet the needs of users and give a true and fair view. (see paragraphs 21 and 48)

    - Estimation uncertainty - providing further guidance to promote a more robust and consistent approach by auditors in evaluating the adequacy of the disclosure of estimation uncertainty in the financial statements, including the need for auditors to challenge management's thinking and exercise appropriate professional scepticism. (see paragraphs 33-36)

    - Audit objectives - the need for more clarity as to the objective of the audit procedures in relation to the audit of disclosures, having regard to the objectives of the disclosures themselves, particularly where those disclosures relate to the entity's internal processes. (see paragraph 38)

    - Audit approach - clarifying in the ISAs that many disclosures are not discrete items but are linked to transactions and account balances and should be audited along with the relevant line items as a package (see paragraphs 44-45).

- Audit assurance - clarifying that the same level of audit assurance should be obtained for information which is considered to be material, regardless of whether the information is disclosed on the face of the primary statements or in the notes to the accounts. (see paragraph 46)

- Audit risk model - clarifying and explaining the application of the risk based approach adopted in the ISAs to determining the areas of audit focus and levels of work required to the consideration of disclosures. (see paragraph 47)

Detailed comments on the IAASB Discussion Paper

10. The evolution of financial reporting requirements has responded to the changing information needs of users relating to a very wide range of industries. As highlighted in the Discussion Paper there can now be a broad variety of disclosures, including many that are not derived from the accounting system, relate to information that requires estimation and the exercise of judgment or are descriptive of internal policies and procedures. We consider issues related to these developments under the following headings:

    - The complexity of financial reporting and the application of materiality, including both whether immaterial information is included and material information is excluded;

    - The ability to obtain audit evidence; and

    - The application of the ISAs in planning and performing the audit of disclosures.

The complexity of financial reporting and the application of materiality

[*Our comments here are relevant to question R1 and section II in the Discussion Paper about financial reporting disclosure trends.*]

11. We support principles based disclosure requirements but recognise that these require the greater use of judgment to determine what information is relevant to users. The current complexity of financial reporting requirements as described in the Discussion Paper creates challenges for preparers and auditors to judge the appropriate information to give in the financial statements to meet the needs of users. As a result preparers may exclude material information in relation to some matters and include too much immaterial information in relation to other matters.

Material information excluded

12. Concerns have been expressed by investors and regulators that insufficient information is often given in some key areas of the financial statements involving estimates and judgments.

13. For example, the 2009/10 Annual Report[2] of the AIU states that a significant number of issues were identified regarding the audit of the impairment of goodwill and other

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2 www.frc.org.uk/pob/audit/reports.cfm

intangibles at both major and smaller audit firms and that these included "insufficient consideration of the adequacy and appropriateness of the disclosures in the financial statements relating to impairment testing". Other key areas in which the AIU has identified issues relating to the auditors' consideration of the adequacy of the disclosures provided include going concern uncertainties, fair value accounting estimates and provisioning. Other parties have questioned whether sufficient disclosures were included in the financial statements of banks to enable users to understand the emerging problems of the financial crisis as early as possible.

14. Reasons for not providing sufficient information in disclosures include difficulties in interpreting the requirements of the accounting standards. IAS 1 states that "in virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs". The high level of detail of disclosures set out in some accounting standards can lead to preparers and auditors focussing on those and, with a 'tick box' mentality, believing it is a case of 'job done' if each item is ticked off. However, IAS 1 also goes on to say that "a fair presentation also requires an entity ... to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance". We believe that insufficient consideration is often given to this more general and high level requirement.

Immaterial information included

15. It may be argued that it is better to provide users with more information than they need rather than too little. However, excessive amounts of immaterial information can obscure the key messages or make more important information harder to find. The FRC has looked at this issue in two discussion papers: 'Louder than Words'[3] issued in June 2009 (and referred to in the IAASB discussion paper) and a follow up paper 'Cutting Clutter'[4] issued in April 2011.

16. As noted in the IAASB discussion paper, when researching 'Louder than Words' reasons given to us for adopting the "include everything" style of reporting included:

    - Due to time pressures, preparers simply repeat disclosures made in prior years rather than considering whether they are still material.

    - Fear that a missing disclosure will be challenged by regulators.

    The end result can be a 'tick box' approach to disclosure, by preparers and/or auditors, using checklists or specimen financial statements to cover everything set out in the accounting standards, without really thinking about whether it actually needs to be included in the particular circumstances of the entity. This is not to suggest that checklists should not be used; rather they need to be used in a considered manner with attention given to what is relevant to the particular entity.

17. Examples of disclosures that are often immaterial include:

    - Providing unnecessary amounts of detail about accounting policies. The summary of 'significant' accounting policies required by IAS 1 often remains unchanged from

3 www.frc.org.uk/publications/pub1995.html
4 www.frc.org.uk/publications/pub2567.html

year to year, with individual policies even copied from IFRSs or illustrative accounts rather than being worded in a way that properly reflects their application by the entity.

- Share-based payment plans. Many companies with such plans simply apply IFRS 2 to all of them, which can result in unnecessarily lengthy disclosures.

- Extensive IFRS 7 disclosures being given for 'simple' financial instruments. Often a table may be given when a single sentence would suffice.

- Extensive disclosures of risks but without adequately highlighting and explaining the 'principal risks' in a way that would assist users to consider the relative significance of the risks and better understand the circumstances of the entity.

Getting the level of information disclosed right

18. We believe that it is important for preparers to think hard about what information is of importance to the users and for auditors to understand how management determine the level of information that should be disclosed in key areas of the financial statements. More guidance on this should be included in both accounting and auditing standards. We would expect there to be some correlation between the issues that are a focus of management's own concerns and the issues that are likely to be of importance to users. If management adopts an "include everything on the checklist" attitude and/or does not consider whether further information needs to be given, it may be an indication that management is not exercising sufficient judgment in determining which matters warrant disclosure to ensure the financial statements present a true and fair view and enable an understanding of the position of the entity.

19. When considering whether information is material or not, preparers and auditors need to think about the purpose of the information and its relevance to users (e.g. is it providing an analysis of line items in the primary financial statements, explaining uncertainties and risks, or providing contextual information such as descriptions of policies and procedures). The IASB's Conceptual Framework states that 'relevant' financial information is capable of making a difference in the decisions made by users; and information is 'material' if omitting or misstating it could influence decisions that users make on the basis of the financial information 'of a specific reporting entity'. The IASB makes clear that materiality is an entity-specific aspect of relevance based on the nature and magnitude or both of the items to which the information relates in the context of an individual entity's financial report.

20. While the fear of challenge by regulators was identified above as a possible driver of including immaterial information in accounts, it can also be a positive influence to help ensure preparers include information that is necessary for a true and fair view. Auditors have indicated that reports by regulators of their views about the appropriate treatment of matters can be influential for preparers.

21. In both accounting and auditing standards more emphasis is needed on the importance of standing back and asking whether sufficient and appropriate information has been given in the financial statements as a whole to meet the actual needs of users. This includes considering whether key messages are being obscured by the inclusion of immaterial information and also whether all the key messages and related important information have actually been included. In relation to this, it is important to be aware that 'true and

fair' is a dynamic concept and what is important information to users can change over time.

The need for a disclosure framework

22. Currently disclosures seem to be added to financial reporting requirements in a piecemeal manner. We agree that there is a need for accounting standard setters to develop disclosure frameworks so that disclosures are based on clear principles and provide a more coherent structure to the financial report. We note that the Discussion Paper indicates that projects in this area have been initiated by various bodies, including EFRAG, FASB and the CASB. While these are accounting-driven projects, the IAASB should actively contribute to facilitate a linkage with auditing standards.

Assessing materiality

23. It is possible to both give the greater detailed information that some users want and to focus attention on the important elements by appropriate organisation and structuring of the information presented. However, as observed above, there are cases where unnecessary information is currently included. To help focus preparers and auditors on the desirability of excluding immaterial information from financial statements the guidance on materiality could be expanded. This expansion should make clear that including immaterial information can be a distraction and may compromise the understandability of the financial statements as a whole. For example, the UK ASB's December 1999 Statement of Principles states that:

    > "Materiality is therefore a threshold quality that is demanded of all information given in the financial statements. Furthermore, when immaterial information is given in the financial statements the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded."

24. The IASB's statement that materiality is entity specific is particularly important. Although the accounting standards require a great many disclosures it is essential to appreciate that they are not all necessarily material to all entities, and that IAS 1 states that "an entity need not provide a specific disclosure required by an IFRS if the information is not material".

25. Some line items that are mandated to be presented separately in the primary financial statements may not be material to the users (e.g. UK Company law and IAS 1 require certain minimum lines to be presented on the balance sheet regardless of materiality). If such a line item is not actually material to the users in the judgment of the preparers and the auditors, then consideration needs to be given as to the extent to which any related disclosures may also not be material and could be excluded if they are not mandated. Further, if individual elements of disaggregated information are not material it should not normally be necessary to provide further detailed information about those elements.

26. Careful consideration should be given also as to whether information that is not mandated for disclosure but that some users may consider important is actually needed before including it. The example in the Discussion Paper of disclosing the fact that an entity does <u>not</u> have a material holding of particular asset class with high related risk falls within this category. For investors in a bank, explicit confirmation of nil or low exposure to particular sovereign debt may be considered important; but investors in other

industries where there is no reason ordinarily to expect the possibility of such exposure should not need explicit confirmation of its absence. These are matters that could be clarified by accounting standard setters and industry regulators.

27. We are pleased to observe that the IASB is aware of the concerns about the levels of disclosure requirements in existing IFRS and has asked the Institute of Chartered Accountants in Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA) to research the problem and recommend deletions and changes to those requirements.

The ability to obtain audit evidence

[*Our comments here are relevant to questions R3 – R11 and sections IV and IV in the Discussion Paper about audit issues regarding disclosures required by the financial reporting framework and auditablility.*]

Sources and nature of information to be audited

28. There do not appear to be significant issues with obtaining audit evidence about factual and objective information derived from the entity's books and records and formal information systems in relation to transactions and account balances. However, where information is more subjective, and may not be derived from the books and records and formal information systems or directly relate to a line item, there may be more challenges in obtaining audit evidence and limited, if any, independent sources of evidence. This gives rise to a risk of 'auditing' through discussion with management, which is unacceptable – for example, ISA 580 makes clear that although written representations provide necessary audit evidence they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

29. Areas where this creates particular difficulty include those in relation to (i) quantitative information which require the exercise of judgement and the making of assumptions and where there is significant uncertainty; and (ii) descriptive information such as descriptions of internal policies and procedures.

Determining materiality

30. Materiality for disclosures is an important consideration both for determining what information should be included in the financial statements and for evaluating disclosure misstatements. For quantitative information the same principles as set out in ISAs 320 and 450 should apply. For descriptive information, such as the categories highlighted in question R7, we do not think there is an easy answer, and certainly not a formulaic one, but it is an issue that needs to be addressed in the ISAs. In general, a material misstatement will exist where information is incorrect or omitted and the effect could reasonably be expected to influence the decisions of the users taken on the basis of the financial statements. As we indicate above, it is necessary for preparers and auditors to judge what information is actually of importance to the users – further guidance to assist making these judgments will be helpful. This is an issue that also needs to be addressed in accounting standards and it is important that the IAASB works with the IASB on this.

31. ISA 450 indicates that auditors do not need to accumulate misstatements identified during the audit that are 'clearly trivial'. While primarily affecting what is communicated to management and those charged with governance, rather than the auditor's opinion on the financial statements, it may be helpful to have some guidance on how the concept of 'clearly trivial' is applied to disclosure errors and omissions, including descriptive disclosures. The experience of the AIU is that auditors often do not consider this concept in relation to disclosure matters.

Obtaining and evaluating audit evidence

32. As far as obtaining audit evidence is concerned the Clarity ISAs, in particular the recently revised ISA 540, should help. However, we are concerned that improvements are still needed, including in ISA 540, in significant areas.

33. Our primary concern is that in general the ISAs do not make sufficiently clear the need for auditors, in exercising professional scepticism, to challenge management's thinking when evaluating disclosures relating to line items and other matters that require estimation and involve uncertainty. This issue was explored in two discussion papers issued in 2010 – Discussion Paper 10/03, issued jointly by the FRC and FSA, entitled 'Enhancing the Auditor's Contribution to Prudential Regulation'[5] and the APB Discussion Paper 'Auditor Scepticism: Raising the Bar'[6]. Feedback papers on both these Discussion Papers were published in March 2011.

34. Paragraph 15(a) of ISA 540 requires the auditor to evaluate, in relation to estimation uncertainty, how management has considered alternative assumptions or outcomes. However, this requirement is restricted to accounting estimates that give rise to significant risks. The determination of significant risks is very judgmental and, in the AIU's experience, there is considerable variation among auditors as to the extent to which risks are determined to be significant. The scope for inconsistent auditor judgment in this area is increased by the fact that paragraph 11 of ISA 540 requires the auditor to determine whether, in the auditor's judgment, accounting estimates that have been identified as having high estimation uncertainty give rise to significant risk.

35. Whenever there is a high level of estimation uncertainty for an accounting estimate that is, or could be depending on the outcome of the uncertainty, material individually or in aggregate, we believe that it is important for the auditor to consider whether there are alternative supportable assumptions. If so, the auditor should evaluate whether management's chosen position is appropriate and whether there are indicators of possible management bias. It is also important to consider the related disclosures and evaluate whether sufficient information is provided to enable users to understand matters such as the degree of estimation uncertainty and key assumptions made by management.

36. We recommend that the IAASB develop further guidance in this area to promote a more robust and consistent approach by auditors in evaluating the adequacy of the disclosure of estimation uncertainty in the financial statements.

37. While recognising the importance of allowing time for review and evaluation of the effectiveness of the Clarity ISAs in practice, the APB has decided to undertake work in relation to how the application of scepticism is addressed in auditing standards. Further

[5] www.frc.org.uk/publications/pub2302.html

[6] www.frc.org.uk/apb/publications/pub2343.html

details of this are given in the feedback paper on 'Auditor Scepticism: Raising the Bar'. We will feed back the results of our work to the IAASB in due course.

38. In relation to the audit of disclosures about policies and procedures for managing risks or the performance of stress tests, there needs to be more clarity as to the objective of the audit procedures having regard to the objectives of the disclosures. For example, where there is a requirement for a description of controls to mitigate risks we believe that, absent a specific requirement for the disclosure to report that the controls are effective, the auditor's objective is to evaluate whether the controls are properly described but not to obtain assurance on their operating effectiveness. This is particularly important where the effectiveness of those controls is not actually being tested to provide audit evidence. Misstatements in these areas would exist when the disclosure is incorrect or information is omitted that is necessary for the users' proper understanding of the disclosure. For example, even when the auditor's objective is not to obtain assurance about the effectiveness of a described control, a misstatement would exist if there was a known significant deficiency but disclosure of this fact was omitted.

39. We are not aware of any currently required disclosures that are not capable of being audited, although the inherent limitations of an audit mean that the quality of audit evidence that can be obtained will be less for some items than for others. Where material financial statement items involve subjective decisions or assessments or a degree of uncertainty, the auditor should evaluate whether sufficient information is disclosed to enable the users to understand the possible variability of these items.

40. It is important for the IAASB to work with the IASB to ensure that future accounting requirements do not include disclosures in relation to which it is not feasible to obtain sufficient appropriate audit evidence. However, we consider that, generally, if entities can employ a reliable and robust process to produce disclosures, then it should follow that they can be audited. Therefore, the focus should be on ensuring that disclosures are capable of being prepared and the ability to audit them will normally follow.

41. Outside the current requirements of financial reporting frameworks, there may be circumstances where management seek to disclose subjective comments and assessments within the notes to the financial statements which cannot be audited in accordance with auditing standards. Such statements might include general statements such as 'our processes are some of the most rigorous in the industry' as well as imprecise descriptions such as 'our reconciliations are monitored on a regular basis' (instead of, for example, 'our reconciliations are monitored monthly'). If management has included such subjective statements in information that is to be audited, the auditor should ask management to amend them. If management refuses to amend such statements the auditor will need to consider the possible implications for the auditor's report depending on whether the information in the statements is considered material to the users (information that cannot be audited gives rise to a limitation in audit scope).

42. A factor that can contribute to audit difficulties is when disclosures are produced relatively late in the financial reporting process. Management's commitment to reporting deadlines may seem to limit the time available to auditors to audit the information. In such circumstances auditors need to be robust in ensuring that they obtain the evidence they consider necessary to give an opinion before signing their audit report. Such issues may be mitigated by management and the auditor considering them together when the timetable for the audit is being determined. Ultimately, in the UK, the responsibility for the accounts giving a true and fair view rests with those charged with governance (the

directors of a company) and it is important that their attention is also drawn to this matter sufficiently early in the process.

The shift from reliability to faithful representation

43. The IAASB Discussion Paper asks whether the shift in the IASB Conceptual Framework away from reliability and towards faithful representation changes what is expected of preparers and auditors. We believe that, currently in the UK and possibly other countries outside the US, faithful representation is a term that is less familiar and consequently less well understood than reliability. However, we do not believe that the shift should cause a change in practice of what is expected for financial statements if the requirement to give a true and fair view is to be achieved.

The ISAs in planning and performing the audit of disclosures

[*Our comments here are relevant to question R2 and section III of the Discussion Paper about how ISAs currently deal with disclosures.*]

The use of assertions

44. ISA 315 requires that the auditor shall assess and identify the risks of material misstatement at the assertion level for classes of transactions, account balances and disclosures (paragraph 25(b)). Paragraph A111 indicates that assertions used by the auditor fall into three categories:

    (a) Classes of transactions and events;

    (b) Account balances; and

    (c) Presentation and disclosure.

45. This suggests that disclosures are a discrete consideration when in reality many are linked to transactions and account balances. We believe that it would add clarity if 'related disclosures' were added to each of the classes of transactions and account balances categories – this would help drive auditing of these items and the related disclosures as a package. Category (c) would then include 'other disclosures' that are not linked to transactions and account balances; such as amounts that are not currently recognised but could be recognised in the future (e.g. in relation to contingencies and commitments).

The level of audit effort

46. The Discussion Paper indicates that there are differences of view as to the level of effort auditors should apply to particular disclosures with some disclosures in the notes to the accounts possibly receiving less effort by virtue of being deemed less significant by the auditor than the items on the face of the primary statements or in relation to other note disclosures. Indeed, we have seen evidence in practice where less effort is applied to some note disclosures. Our view is that, if information is considered to be material to the users, the level of assurance obtained by the auditor should be consistent regardless of whether the information is disclosed on the face of the primary statements or in the notes

to the accounts. This would include, for example, disclosures that present the fair value of a financial statement line item measured on another basis.

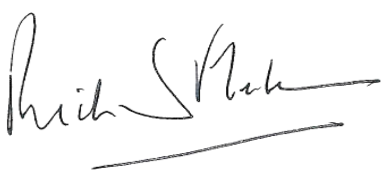
47. The ISAs adopt a risk based approach to determining the areas of audit focus and levels of work. This works well for the quantitative information, but we are concerned that the ISAs do not clearly explain how it is applied to the consideration of other information. For example, the control risks will be different where management does not have formal processes for determining what needs to be disclosed and where descriptive information to be audited is based more on judgment than fact. More guidance is needed to help auditors assess risks of misstatement and determine the areas of audit focus and levels of work required in the audit of these disclosures.

The stand back review

48. There should be a stronger emphasis in the ISAs on the need for the auditor to stand back and consider the overarching assertion that the financial statements give a true and fair view or “present fairly”. ISA 700 requires the auditor to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements. It does not, however, make clear that the auditor needs to have performed sufficient work to be able to evaluate whether the other required disclosures, not linked to transactions or balances, are complete and free of material misstatement. While the definitions make clear what is a “fair presentation framework” it would also be helpful to include a statement in the requirements section of ISA 700 to emphasise that it is not sufficient for the auditor to conclude that the financial statements give a true and fair view solely on the basis that the financial statements were prepared in accordance with accounting standards and any other applicable legal requirements. We do include such a statement in our ISA (UK and Ireland) 700. This helps address the concerns of particular investors and other parties who believe that it needs to be emphasised more strongly in auditing standards that presenting a true and fair view may, in certain circumstances, require the disclosure of information which is not mandated by accounting standards.

49. If you wish to discuss our comments please contact Marek Grabowski (Telephone +44 (20) 7492 2325).

Yours faithfully



Richard Fleck | Paul George
Chairman, APB | Director of Auditing and Director, POB