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Prof. Arnold Schilder
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International Auditing and Assurance Standards Board
International Federation of Accountants
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Dear Prof Schilder

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

The IAIS welcomes the opportunity to comment on the IAASB Discussion Paper: The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications (the discussion paper). This is a topic of significant interest to the IAIS.

Attachment 1 provides the IAIS' detailed comments on the discussion paper.

If you have further questions regarding this letter, please contact Peter Windsor at the IAIS Secretariat (tel: +41 61 280 9196; email: peter.windsor@bis.org) or Richard Thorpe, Chair of the IAIS Accounting and Auditing Issues Subcommittee (tel: +44 (0) 20 7066 3160; email: richard.thorpe@fsa.gov.uk).

Yours faithfully

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Attachment 1 Detailed comments on the Discussion Paper

Confidence in financial statements is vital to the IAIS objectives of market confidence, financial stability and consumer protection. In a world where there is greater sophistication of business models (with increasing complexity), it is important that financial statements remain relevant and meaningful; in that context, the role of disclosure is of increased importance for financial statement users. Further, the increasing importance of management judgement and estimation in financial statements (for example in some valuation techniques), increases the importance of appropriate, high quality disclosure to properly reflect and explain the judgements and estimations applied. Such disclosures should provide information to enable users to properly appreciate, for example, the sources of risk, estimation uncertainty and judgments in the valuation of assets and liabilities.

Disclosure at an excessive level of detail may overwhelm market participants and incur unnecessary costs for preparers. The decision to make disclosures must be considered with a view to the benefits to users of the information and the costs of preparing it, including auditing those disclosures

As highlighted in the discussion paper, the notion of ‘true and fair’ is a dynamic concept. To be achieved, the concept would require constant challenge to the nature and the level of disclosures over time, depending on factors such as the wider economic environment in which the entity operates and what is judged as relevant to the users.

The outbreak of the financial crisis highlighted the problems that firms in the financial sector had in capturing, through their financial reporting, the reality of emerging problems. This led to a significant loss of confidence in the ability of some firms to manage the emerging risks and to provide timely disclosures about this.

The main reasons that contributed to this are well described in the part of the discussion paper regarding the weaknesses that could negatively affect the preparers behaviour and efficiency. It is useful to quote the following issues:

- disclosures are prepared late in the financial reporting process and may be produced using a less formal procedure;

- the lack of anticipation, the inability to stand back and the difficulty in making judgment about what is significant often leads preparers to repeat disclosures made in prior years that are no longer relevant, and to neglect to enhance disclosures to properly reflect new matters or matters that have changed in their significance ; and

- the desire to avoid lengthy debates with auditors and the fear of ‘missing something’ leading to additional disclosures without consideration of their materiality or significance.

With regard to the role of the auditors, the discussion paper raises good questions about particular challenges in obtaining sufficient appropriate audit evidence in relation to some disclosures and whether all disclosures are capable of being audited.

However, the discussion paper does not appear to bring real answers or insight for those who have suggested that auditors do not always show sufficient professional judgment and scepticism in their approach to the audit of disclosures. We believe that it is important to emphasise the emerging view that - in light of the increasing relevance of disclosures for the understandability of financial statements – the audit of disclosures is as important as the audit of the primary financial statements. We agree that ISAs are not ambiguous on this point but the application of ISAs raises some issues. Auditors need to apply adequate challenge when auditing managements' estimates, related judgments and disclosures. If the underlying estimates and judgments are not suitably explained through appropriate disclosure in financial statements, users' resulting lack of understanding about them may impede comparability across entities and impair their ability to better understand and critically assess the financial performance and position of the entity.

That is why we believe that auditors should properly consider audit process issues, for example (i) the timing of discussing and challenging key disclosures with management; (ii) the timing of audit of disclosures; and (iii) the allocation of work within the audit team to audit disclosures. In particular, a greater focus might be needed in the following areas:

- training and supervising audit staff about relevant questions and difficult issues when auditing disclosures;

- the importance of the identification and assessment of the risk of material misstatement in relation to the different assertions; in particular, understandability requires separate consideration from experienced members of the audit team;

- the planning and the carrying out of audit work on draft disclosures and modifications at the planning stage of the audit;

- the planning of work to allow timely communication by the auditor to those in charge of governance (the audit committee or other committee of the entity) of the issues raised in relation to disclosures as well as those relating to the audit of the primary financial statements;

- the involvement (both from the auditor and the entity),of persons with an adequate level of experience and seniority to apply suitable professional judgment to the nature and the level of materiality of the disclosures, considering the requirements of investors and other stakeholders.

Regarding the questions raised in the, ED, our main comments are the following:

- **ISAs:** Despite being limited, we believe that the different ISAs provide adequate general requirements in respect of disclosures. However, we believe that it could be useful to issue specific IAPS with the purpose of enhancing audit practices regarding questions and issues relative to the quality of disclosures and related risks throughout the audit process, from the planning stage through to completion.

- **<u>Auditability:</u>** We believe there should be a presumption that all disclosures can be audited, in the context of the audit of the financial statements as a whole. This is the case even if they are very subjective, forward-looking, or reliant on management's intent. In certain circumstances, it may not be possible for the auditor to verify some explanations and forward-looking financial information until a future period. In this case, the auditor should ensure that the entity has disclosed adequately that fact and the underlying assumptions and factors that support the information.

Section II–Financial Reporting Disclosure Trends

R1) Have you ever encountered a disclosure which you believe was immaterial, and could have been removed to enhance the understandability of the financial statements? Please provide examples, your reasoning for why you believed they were immaterial in the context and why you believed they were not omitted.

It is relatively common for information to be provided about accounting policies applicable to certain types of transactions, which lead users to believe that such transactions were carried out by the entity whereas, in fact, that is not the case or any such transactions are insignificant.

The reason for this is that preparers try to be thorough in the description of the accounting policy and are reluctant to adapt the wording each year to the reflect reality of the operations and transactions. Due to time pressures, it is easier for preparers to modify only the figures and to keep the wording unchanged.

The more frequent examples relate to the unbundling of embedded derivatives or of hedge accounting.

Moreover, the use of boilerplate or formulaic disclosures, without adequate tailoring, and of extensive descriptions of less significant items, adds unnecessary length to disclosures. In numerous cases, the financial statements contain many hundreds of pages and can be considered too long. It is important to emphasize that enhanced disclosure does not necessarily mean more disclosure.

Furthermore, although there are challenges in preparing appropriate disclosures about key judgments, particularly given potentially numerous and diverse valuation techniques incorporating many assumptions with significant consequences, these disclosures are required where the effect of such judgments is material. Entities should summarise such information in a way that is relevant and yet not so extensive that the detail obscures the overall picture.

Section III–How Do ISAs Currently Deal with Disclosures?

R2) Do you believe the ISAs provide sufficient requirements and guidance in respect of disclosures? Please explain your answer.

Despite being limited, we believe that the different ISAs provide adequate general requirements in respect of disclosures. However, as explained in our introduction, we think that the process for preparing disclosures - being less formal and less structured than the process for preparing financial statements - has a negative influence on the audit process. We also believe that both preparers and auditors do not give the same attention to disclosures compared to the primary financial statements.

In some areas – for example valuations, provisions and disclosures - the auditor's approach seems to focus too much on gathering and accepting evidence to support management's assertions, and whether management's valuations and disclosures comply with the letter of accounting standards, rather than whether the standards' requirements have been applied in a thoughtful way that would better meet the standards' objective.

In their audit work on disclosures, auditors should look beyond whether management has complied with individual aspects of the accounting standards, and assess whether the accounts are fairly stated overall.

In this context, we believe that it could be useful to issue a specific IAPS with the purpose of enhancing audit practices regarding questions and issues relative to the quality of disclosures, the planning phase, determination of the materiality and communication without detracting from the need to audit disclosures and related risks together. In particular, where there is scope for management to exercise substantial judgment in the recognition, measurement and disclosure requirements of accounting standards, enhanced auditing standards and guidance on how auditors should audit such areas can help them to more robustly challenge management's assertions regarding financial statements.

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

R3) What do you believe are the key issues of gathering audit evidence for the examples given in paragraphs 60–70?

- **Disclosure for the property, plant and equipment assets**

We agree that the audit evidence might more often be obtained in the course of the audit of the relevant class of transaction and balance sheet line item rather than through a separate exercise.

- **Operating segment disclosure**

The key audit issue for the auditor is to obtain sufficient appropriate audit evidence that the operating segment disclosure is reported on the same basis as used internally for evaluation of operating segment performance and deciding how to allocate resources to operating segments.

- **Disclosure related to a line item that is reflected in the financial statements at fair value**

In areas such as the fair value of financial instruments with no observable market, management has to develop a more subjective assessment for determining the appropriate fair value.

In this context, if management provides estimates of values within a range that is perceived as acceptable, making the assessment of the management decision less black and white, it is very difficult for the auditor to require any adjustment.

This is one of those difficult areas where the auditor's application of professional scepticism and the judgment of expert and experienced auditors becomes vital for an effective and robust audit. To encourage clear and sceptical thinking, auditors should be guided to document audit evidence regarding the rationale for key judgments about the reasonableness of assumptions and methods used. This should also lead them to challenge management to disclose how it arrived at the figures, the degree of judgment applied and information needed to appreciate the risk of uncertainty inherent in the valuation.

In addition to concluding on whether the valuation is acceptable (e.g. falling within a reasonable range), the auditor also has to evaluate whether management have provided sufficient appropriate disclosures of the key estimates and assumptions.

- **Disclosure of the fair value of a line item recorded on another basis, such as amortized cost**

The main risk is that the process applied for providing the information needed might be based on a less formal procedure and the use of a proxy for the determination of the values to disclose (See also our answer to R4). This has a consequent impact on the quality of audit evidence that the auditor can obtain.

- **Disclosure of stress test information**

We believe that where an entity prepares and discloses stress testing information, there is a presumption by users of the financial statement that the auditor has obtained evidence about the relevance and the appropriate performance of the stress test.

If stress testing were to be incorporated into accounting disclosure requirements, the audit implications would relate to the process undertaken to perform the stress test, the reasonableness of the assumptions used by management, and the calculation. The processes are relatively straightforward to audit, but the audit of assumptions is highly judgmental as they reflect assumptions about future economic conditions.

However, it is understandable that the entity would like to disclose some information about stress tests carried out in the context of its risk management or resulting from a regulatory requirement. Whether this information is not needed for the appreciation of the financial statements and is not required as disclosure, we believe that in order to avoid the possible belief by users that the information has been audited, it would be better to provide this information separate to the financial statements. As IFRSs are revised to require this disclosure, more audit guidance will be necessary.

- **Disclosures which mention an internal control, contain forward-looking information or express an intention of management**

If an entity describes its internal control regarding financial risk management, the entity suggests in fact that this internal control exists and is effective. In this context, we believe that it would be natural for the users to consider that the auditor has assessed not only the accuracy of the description of the internal control but also its effectiveness. However, a description of a control without an assertion on its effectiveness would not, in itself, warrant audit work on the control effectiveness.

Regarding forward-looking information, we believe that the audit evidence might likely be limited to management's own process with limited external evidence to provide confirmation or contradiction. However, the auditor should test the process and evaluate if the assumptions are reasonable. Moreover, the auditor should assess if the narrative disclosures address in an appropriate manner the fact that significant assumptions are affected by uncertainty and explain the rationale underlying the selection of the assumption.

Regarding disclosures expressing the intentions of management, it should be clear that these intentions cannot be confused with decisions. We agree that in this context it is not possible for the auditor to obtain consistent evidence except where those intentions are contradicted by other evidence. Management's intentions are normally covered by their letter of representation to the auditor, where the auditor has little other means of obtaining evidence.

Whatever the result of this discussion paper on the future evolution of the audit standards, we believe that it is important for the users of the financial statement to have a clear view of the different levels of audit evidence obtained by the auditor and how the auditor has exercised their professional judgment where the information is based on less objective evidence. Indirectly, the auditor should obtain assurance that this subjectivity is clearly and appropriately explained in the narrative disclosure.

In the same way, if an insurance entity provides some sensitivity analyses based on embedded value, it is useful for the users' assessment of the data to be aware that the embedded value model has not been audited. In this context, if the outputs of the sensitivity analysis are material for the understanding of the entity risks, we believe that it would be adequate that the audit report give information about how the auditor exercised his or her judgement (see R8 and R9).

- **An objective-based disclosure requirement**

We agree that the increased use of objective-based disclosure requirements creates particular challenges for preparers and auditors.

This increased use challenges preparers to demonstrate to the auditor how they have developed their analysis and which factors have influenced their judgments in context. We believe that this situation creates the need for the auditor to challenge the choices made by preparers considering the points of view of the different categories of users. Thus, the circumstances of the audit will be more challenging for the auditor than if they can use a simple check-list and may increase the need to use an experienced person for this part of the audit.

We believe that this evolution should lead the IAASB to provide more guidance about the way to exercise judgement in this context, helping to document the rationale and the reasonableness of the judgments. We believe also that this evolution should lead to more active communication and exchanges with the governance bodies of the entity.

R4) 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 expect an auditor to apply on the fair value disclosure? Should the auditor's effort be the same as if the fair value was on the face of the financial statements?

We believe that the level of audit effort should be determined by the auditor's assessment of risk of the particular financial statement element. Given the same level of risk, the auditor should obtain the same level of evidence about disclosed fair values as they would for those recognised on the face of the financial statements.

From the point of view of the investor and other stakeholders such as regulators, information on fair values can be particularly important and, if judged by the auditor to pose a risk of material misstatement, it should devote sufficient audit attention to it.

R5) Does the shift in the IASB Conceptual Framework away from reliability and towards faithful representation change what you expect of preparers and auditors? Please explain your answer.

The evolution of the IASB Conceptual Framework does not change our expectation regarding the duties of the preparers and auditors. Uncertainties and the use of estimates introduced by the accounting standards could negatively affect the reliability of information.

However, this evolution should be concurrent with a strengthening of the reliability of systems and processes resulting in adequate internal control over financial reporting. There should also be a better understanding of the measurement methods and the related uncertainty, to give an expanded explanation of the limitations of the measurement approach.

Information about risks, and especially forward-looking information, is however based on a lot of estimates and uncertainties, which would make the information less reliable and therefore more difficult to use. To increase the reliability and quality of information it is important to disclose the methods and assumptions used in certain analyses, for instance in sensitivity analyses.

R6) 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.

We believe that for an objective-based disclosure requirement, an entity should communicate to the users of the financial statement all the information about matters which are able to have a material impact on the activity or the financial position of the entity in the future. This information could be, for example, relative to its reputation or, for a regulated activity, the fact there is a risk that it will no longer be able to meet the criteria to carry on that activity.

Regarding disclosures with no quantitative material effect, management remain responsible for determining matters to disclose. The example of holding of sovereign debts, could be useful information for certain users insofar as this holding could have a material impact in the future and helps the user to assess management's risk appetite for exposures to various geographical areas.

This information may also be useful for the users to be informed that the entity is not concerned by an issue that affects all its competitors.

Disclosures provide important context for the estimates and judgments reflected in the financial statements. They also sometimes highlight risks and uncertainties outside of the statements that could impact financial performance in the future.

Moreover, prudential regulators' requirements relating to public disclosures may create heightened expectations about the usefulness, accuracy and thoroughness of those disclosures since they are required by regulators. We can understand that in an objective-based disclosure approach, not all the disclosures required by the regulator are considered for inclusion in financial statement disclosures including by cross-references. However, we believe that the entity and the auditor should document and justify their judgment on this aspect.

R7) 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 disclosure:

We believe that a material misstatement exists if the disclosure or its omission is as such that it could influence the decision made by the users of the financial statement.

- **Judgments and reasons**

Regarding insurance and investment contracts with participation features, valuation of a deferred participation asset and deferred tax asset on the unrealised losses relative to bonds classified in available for sale without explaining adequately the presentation in deduction of the liabilities and the modalities of the recoverability of those assets.

- **Assumptions/models/inputs**

An entity discloses sensitivity analysis based on embedded value but uses assumptions determined in a way that avoids setting up a significant impact on embedded options and guarantees.

- **Sources of estimation uncertainty/sensitivity analysis disclosures**

An entity discloses sensitivity analysis to interest risk based on the balance sheet without explaining that there is a substantial accounting mismatch (e.g. financial instrument at fair value and technical provision discounted with a locked-in interest rate).

- **Descriptions of internal processes**

An entity describes specific internal control processes regarding insurance risk management that don't exist as described.

- **Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis**

An entity discloses that the fair value of a significant portfolio of long term loans recognised at amortised cost is not different from the amortised cost without explaining the approach taken to determine the fair value.

- **Objective-based disclosure requirements**

An insurance entity gives information about the principles relative to the unbundling of embedded derivatives but does not explain that no embedded derivatives are required to be unbundled and does not give information about risks related to those embedded derivatives that are material and not measured at fair value

While all the contracts have a similar surrender option, an insurance entity provides information about maturity based on estimated timing for insurance contracts and based on the contractual maturities (ie the 1st January if the closing date is the 31st December) for investment contracts without explaining the inconsistency and giving more relevant information.

See also "Judgments and reasons" above.

R8) Some disclosures are relevant to an understanding of the 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?

The auditor should assess if the description of risk management activities and organisation are consistent with reality. The auditor should also obtain sufficient evidence about appropriateness of the design of controls and about the effectiveness of the controls in terms of risk mitigation if the disclosure asserts that they achieve this.

Inaccurate descriptions of controls or false assertions of effectiveness would constitute a misstatement.

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

See our response to R3 for a discussion of the challenges in auditing stress test disclosures. These would be considered misstated if there were errors in the compilation of the data presented, inappropriate conclusions drawn, or possibly if there were unreasonable assumptions employed.

Section V–Questions about Auditability

R9) Are there disclosures which, in your view, are not capable of being audited? Please explain your reasoning.

We believe there should be a presumption that all disclosures can be audited, in the context of the audit of the financial statements as a whole. This is the case even if they are very subjective, forward looking, or reliant on management's intent. Disclosures are not opined on separately and what constitutes sufficient, appropriate audit evidence varies according to the item subject to audit. What might also vary is the level of comfort that users can obtain from that audit. A valuation subject to significant uncertainty does not become any less uncertain because it has been audited.

Where disclosures cannot be supported, it is important that such disclosures be highlighted distinctly in the financial statement report or preferably removed from the disclosures. In any case, the auditor would have to assess the impact on his or her audit opinion.

R10) 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?

We believe that the auditor should assess if the financial statements as a whole are both relevant and fairly presented. In this context, the auditor should ensure that the financial statements are compliant with the financial reporting framework and beyond this compliance provide the users with all the disclosures needed for a fair and relevant presentation

A fair presentation can lead the entity to prescribe that some disclosures required might not be adequate in the context of the entity.

Moreover, we agree that the concept of fair presentation gives a greater focus to the notion of understandability. This implies that all relevant information is adequately presented within the disclosures, regardless of whether or not there are any specifically prescribed disclosure requirements for that information.

In certain circumstances, it may not be possible for the auditor to verify some explanations and forward looking financial information until a future period. In this case, the auditor should ensure that the entity adequately discloses the fact as well as all the underlying assumptions and factors that support the information.

R11) Some believe that the manner in which a financial reporting regulator enforces financial reporting requirements may influence how auditors approach the audit of financial statements, including disclosures. What is your view?

IAIS not being a market regulator, we declined to comment this question.