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Contact Sylvia Smith

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Dear Sirs

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

We are pleased to have the opportunity to comment on the above Discussion Paper (DP) issued by the International Auditing and Assurance Standards Board ("IAASB"). This letter represents the views of KPMG International and its member firms.

The DP is thought provoking. We agree that the complexity, subjectivity and extent of financial statement disclosures have evolved in a way that poses many challenges in the preparation, auditing and user understandability of these disclosures. We agree that the IAASB has identified the key issues and challenges. Therefore we are very supportive of an initiative to address the evolving complexity of financial statement disclosures. However, we believe that this cannot be done solely by the IAASB; addressing the issues raised will require action by the International Accounting Standards Board ("IASB") and regulators, and support from investors and preparers. As the IAASB described in the DP when it solicited responses from these various stakeholder groups, this is not "just" an audit issue.

Our letter sets out our views on the issues identified in the DP and our recommendations on how the IAASB might move forward with this initiative. Specifically, we focus on the importance of fully engaging the accounting standards setters and regulators in order to address some of the challenges identified in the DP. We also provide our observations and recommendations as to where guidance in the International Standards on Auditing ("ISAs") can be enhanced to specifically address disclosures.

In this letter we focus on the reporting requirements of International Financial Reporting Standards ("IFRSs") as established by the IASB, but the issues and concerns raised by the IAASB in the DP and our responses apply equally to many national financial reporting frameworks that require a fair presentation (a "fair presentation framework").

Importance of fully engaging the IASB

IFRSs define notes to the financial statements as containing information in addition to that presented on the face of the financial statements and as "narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements."[1] Many IFRSs establish specific disclosure requirements. Additionally, paragraph 17 of IAS 1, *Presentation of Financial Statements* states that "in virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs" and 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."

Under IAS 1.31, "an entity need not provide a specific disclosure required by an IFRS if the information is not material." In defining "material", IAS 1.7 states that "omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor." The IASB's "exception" to providing disclosures and the definition of material above and in the Conceptual Framework refers to "information" or "items" and the relevance of the items to which the information relates. However, there is no explicit guidance as to how this definition applies to disclosures that are required by specific IFRSs and whether the reference to "information" for exceptions or "items" for the purposes of determining materiality is intended to be the disclosed information, or the account balance or transactions to which it relates. Accordingly in practice, if the related account balance or class of transaction is material, then the disclosure items required by the relevant accounting standard are likely to be included, even if they are determined to be of low relevance to users based upon the industry or circumstances of the entity.

We therefore concur with the suggestion in the DP, that in today's environment preparers and auditors tend to focus on the completeness of disclosures and are reluctant to have required disclosures omitted even when those disclosures are determined to be of low relevance to financial statement users. We believe that this is because of a concern that, in the absence of guidance, judgements will be questioned and that therefore it is "safer" to focus on the completeness of disclosures in order to avoid being second guessed with respect to the relevance of any omitted disclosures.

However, the focus on completeness is in many ways also encouraged by the standards themselves since many, in particular the more recently issued standards, include the objective of the disclosures and then include minimum detailed disclosure requirements. In the absence of a broader framework to guide application of such requirements to an entity's particular circumstance, entities and their auditors more likely will gravitate towards the completeness of detailed disclosure requirements. Some examples of disclosure requirements that we believe lead to an over-emphasis on completeness at the cost of relevance and understandability are IFRS 3, *Business Combinations* and IFRS 7, *Financial Instruments: Disclosures.* These

[1] IAS 1, *Presentation of Financial Statements* paragraph 7 Definitions

standards set out the objective of the disclosures for preparers. However, the standards then go on to list numerous disclosures that shall be made with a requirement for additional disclosures if deemed necessary for the understanding. This tends to result in a "checklist" approach.

As we noted above, in practice, the materiality of a disclosure often is evaluated by reference to the quantitative materiality of the financial statement line item to which the disclosure relates. In some cases disclosures relate to line items that are material. However, all such disclosures may not be considered relevant to users in view of the industry or specific circumstances of the entity. For example property, plant and equipment disclosures may be material and relevant to certain entities (e.g. those involved in manufacturing or other capital intensive industries) but may be voluminous and less relevant to other entities (e.g. those involved in financial services). Similarly, some of the IFRS 7 disclosures are very significant and relevant for entities providing financial services and less relevant for entities that do not hold complex financial instruments.

We therefore support initiatives aimed at helping preparers and auditors shift the focus of disclosures from completeness to relevance and understandability. To make significant progress in this area, guidance on disclosures and assessing their materiality needs to be developed.

However, this is not an area that can be addressed effectively solely by the IAASB. We are very supportive of recent cooperation between the IASB and the IAASB. We recommend that the IAASB share the results of this consultation with the IASB. We also recommend that the IAASB encourage the IASB to work with other standard setters that currently are working on disclosures to undertake a project aimed at developing overarching guidance that enables preparers to assess the importance of required disclosures in specific IFRSs in view of the entity's specific circumstances and to omit them if they are deemed not necessary and do not have an impact on the fair presentation of the financial statements.

This may be achieved by the development of an accounting disclosure framework that provides criteria for including disclosures in the financial statements and acknowledges the need to balance considerations relating to completeness, relevance and understandability in assessing the nature, extent and presentation of disclosures. Such criteria may, for example, be based on the categories of disclosures described in the DP.

A framework also would provide important guidance to management, auditors and other stakeholders, including audit committees, in helping them make judgements with respect to the evaluation of materiality of individual disclosures and whether the financial statements as a whole achieve a fair presentation.

Importance of fully engaging the regulators and others

We agree with the DP that the actions of regulators influence the behaviour of both preparers and auditors. Any plan to move to a model that places more emphasis on the understandability of disclosures as opposed to completeness will need the full "buy in" of securities and audit regulators. We therefore recommend that the IAASB work with the International Organization of Securities Commissions ("IOSCO") and the International Forum of Independent Audit Regulators (IFIAR) to help ensure that the objectives of any future projects on disclosures are understood and accepted. It also would be helpful if the IAASB explored what action IOSCO and IFIAR could take to help reinforce acceptance of these objectives with its members.

We also recommend that the IAASB work closely with national auditing standard setters, in particular the US Public Company Accounting Oversight Board, to help ensure that any guidance developed is as globally consistent as possible.

Observations and recommendations as to where guidance in the ISAs can be enhanced to specifically address disclosures

Disclosures have always been considered to be an integral part of financial statements. The auditor evaluates whether the financial statements as a whole are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This requires the auditor to evaluate whether the disclosures:

- include significant accounting policies selected and applied,
- are relevant, reliable, comparable, understandable, and adequate to enable the intended users to understand the effect of material transactions and events, and
- when prepared in accordance with a fair presentation framework, evaluate whether the financial statements achieve fair presentation.

As noted in the DP, financial statement disclosures have evolved to meet the changing needs of users of financial statements and to respond to the increased complexity of business models. This has led to introduction of disclosures that go beyond providing factual information about significant accounting policies, breakdown of account balances presented on the face of the primary financial statements or factual information about the entity. Some of these additional disclosures provide more information about significant assumptions and judgements made by management, they may relate to estimation uncertainty and sensitivity analysis and, as described in the DP, they may include information derived from systems outside traditional financial reporting systems.

Notwithstanding the evolution in types of disclosures required by financial reporting standards, the auditing requirements and guidance related to financial statement disclosures have not changed significantly over the same time period nor has application guidance been developed to address some of the related challenges identified within the DP.

In providing guidance and requirements, the ISAs do not differentiate between classes of transactions, account balances and disclosures. Auditors are expected to apply professional judgement in adapting requirements to these items. However, application of requirements relating to materiality, audit evidence and evaluation of misstatements to disclosures can be particularly challenging.

Further, the evolution of the categories of disclosures identified within the DP, such as judgments and reasons, assumptions/models/inputs, sources of estimation uncertainty/sensitivity, descriptions of internal processes, fair values, and objective-based disclosures has made application of existing audit requirements more judgmental.

Materiality is applied in planning and performing the audit and in evaluating the effect of identified misstatements. Currently ISA 320, *Materiality in Planning and Performing an Audit* discusses the determination of quantitative materiality based on relevant benchmarks such as assets, liabilities, revenues or profit as a starting point. However, such benchmarks may not always be directly relevant to disclosures, especially disclosures that are intended to provide additional information about account balances on the face of the primary financial statements, e.g., fair value disclosures, sources of estimation uncertainty/sensitivity analysis, assumptions/models/inputs.

In practice, professional judgement is required in applying materiality concepts to disclosures, especially since with disclosures qualitative factors affecting materiality usually play a more prominent role than quantitative factors. Therefore, we believe that auditors would benefit from guidance on the application of requirements in ISA 320 to disclosures.

Additionally, we believe that there would be benefit to providing auditing application guidance related to examples of the nature and types of procedures that may be performed to gain sufficient appropriate audit evidence for categories of disclosures such as descriptions of internal processes and judgements and reasons, aligned with the relevant assertions in ISA 315, *Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment*. In particular, we believe application guidance related to the nature and extent of audit procedures for disclosures of risk management policies and practices, stress testing, sensitivity analysis and complex models such as 'value at risk' would provide for more consistency in the application of auditing requirements.

Furthermore, in accordance with ISA 450, *Evaluation of Misstatements Identified during the Audit*, a misstatement in a disclosure would include a difference between the disclosure made (or omitted) and a disclosure that is either required by the financial reporting framework or determined to be necessary to enable users to understand the effects of material transactions and events or to achieve fair presentation. We believe that guidance on the aggregation of misstatements and evaluation of misstatements specifically for disclosures also would be beneficial.

Responses to consultation questions for auditors

Included in our letter above are our overarching comments in response to the DP. We have not provided detailed responses to the consultation questions for auditors within the DP. In considering responses to the specific consultation questions we noted that many times our responses would be to state the auditing requirements of the International Standards on Auditing or it would be necessary to have a detailed understanding of the entity, the industry in which the entity operates, the facts and circumstances of the related transaction, the users of the financial statements, the totality of the audit work performed, the relevance to the financial statements as a whole and other facts and circumstances in order to formulate responses to consultation questions related to specific disclosure categories or items.

Therefore, we have provided our overall responses and recommendations on how the IAASB might move forward with this initiative.

Please contact Sylvia Smith at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours truly,

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cc: Jean Blascos, KPMG
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