07 June 2011

Our ref: ICAEW Rep 58/11

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

cc: Hans Hoogervorst, Chairman-elect, IASB
cc: Ian Mackintosh, Vice-chairman-elect, IASB
cc: Alan Teixeira, Director of Technical Activities, IASB

Dear James

DISCUSSION PAPER *THE EVOLVING NATURE OF FINANCIAL REPORTING: DISCLOSURE AND ITS AUDIT IMPLICATIONS*

The ICAEW welcomes the opportunity to comment on the consultation paper on the audit implications of disclosures published by IAASB in January 2011.

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

We set out our main points below, followed by responses to IAASB questions directed at preparers and auditors. While we have not attempted to answer the questions directed at regulators, even though ICAEW does have a regulatory role, or to questions directed at investors, lenders and other creditors, many of the answers to questions directed at others will also be relevant to these groups.

We draw your attention in this context to the recently published ICAEW-funded research published by Wiley entitled *Reaching Key Financial Reporting Decisions: How Directors and Auditors Interact* and have sent a hard copy of this to you.

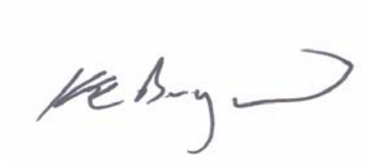
This has been a particularly difficult response to prepare. The reason is not that the questions are difficult to answer, indeed auditors have to answer many of them on each and every audit they conduct, but rather because the level of detail in the questions strays into the area of audit methodologies. IAASB might wish to consider conducting informal round-tables or private discussions on this subject prior to issuing further written material for comment as it might encourage audit firms and preparers to open up on some of the more detailed issues raised.

Please contact me should you wish to discuss any of the points raised in this response.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

Yours sincerely



Katharine E Bagshaw FCA
ICAEW Audit and Assurance Faculty
T+ 44 (0)20 7920 8708
F + 44 (0)20 7920 8708
E: kbagshaw@icaew.com

MAIN POINTS

The disclosure requirements of many high-quality financial reporting frameworks such as IFRS are not currently clear, either in their detail or conceptually. This, combined with the fact that auditors do not want to be second guessed by regulators, results in checklists, and checklists do nothing to inhibit the proliferation of disclosures. It is therefore essential that IAASB's work in this area is co-ordinated with that of the IASB and not merely run in parallel because the cross-over is too close and the issues of materiality for financial reporting and auditing purposes need to be addressed in tandem. There are too many disclosures period, and too many unhelpful disclosures that neither preparers nor auditors are prepared to omit for fear of regulatory action. Such disclosures sometimes serve to hide the important ones and all of this diverts attention from the real needs of users whose needs are clearly not being met by the current disclosure regime. Research into what users really do need would be helpful in this context as even the identity of legitimate users is unclear, they are in any case a disparate group and their information needs are complex. The somewhat muddled debate in this area might benefit from the rigour of formal research techniques. The issue also underlines the need for IASB and IAASB to work together on disclosures.

The existing auditing model is predicated on the assumption that most of what is presented in a set of financial statements is relatively hard, objective and externally checkable or verifiable information. The balance between this and relatively soft, subjective and forward-looking information that is sometimes only verifiable with reference to management intentions or complex models, has changed significantly in recent years, as a result of changes in the way businesses are run, the financial tools that are used to run them and the corresponding changes in financial reporting standards.

At one time, the tools auditors used to audit harder, usually quantitative, more objective disclosures designed primarily to support line items could be relatively easily adapted to deal with a few more subjective, qualitative items that attempt to provide useful information about line items or other numbers that are subject to more uncertainty. But now that there are many more such subjective disclosures, the weaknesses in existing tools and the need for new tools are becoming more apparent. The simplest example of this is in the difficulties associated with the adaptation of the materiality concept, designed primarily, although not exclusively, to deal with quantitative data, to the large volume and wide variety of qualitative data that now appears in audited financial statements. For a long time, the only qualitative data to which the materiality concept generally applied in the UK were transactions with related parties; the adaptation consisted of deeming all such transactions to be material (or put another way, deeming the materiality concept inapplicable to such transactions). But attempts are now being made to apply the concept to more complex qualitative disclosures, for example in the context of greenhouse gas (GHG) statements, where material misstatements are described in paragraph A47 of the recent IAASB exposure as those that '…individually, or in the aggregate, could reasonably be expected to influence relevant decisions of users taken on the basis of the GHG statement..'. Without further guidance, and without the benefit of established benchmarks, practitioners are likely to struggle with this. The overarching concept makes sense – applying it to the detail of new areas is problematic and while more experience in applying the concept will clearly help, new tools may also be needed.

What is very clear is a direct correlation between the subjectivity of numbers in the primary financial statements and the level of related disclosure requirements. The more judgement applied in reporting a figure in the financial statements, the more users of accounts wish to understand the decision-relevant factors that led to that figure.

It is difficult to avoid the conclusion, from the questions in this DP and the answers thereto, that there is at least a need for further debate on the audit of disclosures and probably some scope for further guidance.

The *Audit Quality Forum* publication *Changes to Financial Reporting and Audit Practice*[1] highlighted the effect of changes in financial reporting standards on audit procedures, and the effect of audit procedures on auditing standards. A novel accounting treatment will often present a challenge to auditors who need to adapt existing models to new situations, but the challenge, historically, has rarely been insurmountable. The publication also highlighted the fact that whereas in the past, the extent of variation in what was believed to constitute reasonable assurance was not so great as to cause concern, the increasing extent of that variation is now causing concern and the need to communicate that variation needs to be considered.

The significant disclosure issues with which preparers and auditors often struggle are essentially the same. But user needs are not homogenous and it seems that not all users are considered equal. There is increasing emphasis on information required, desired, or called for by certain classes of analysts and investors and the continuing debate as to who should provide this information, and where it should be provided, includes the IASB disclosure framework discussions. It is clearly not possible to include all of the disclosures relevant to all users' perceptions of what is needed to achieve fair presentation but at present, there are no clear boundaries to annual reports, or to the scope of audits, and there is clearly some confusion about what is or should be audited, and what is not, and what cannot be audited.

In the UK the Financial Reporting Council has suggested establishing a financial reporting laboratory, where preparers and users can come together (under a safe harbour if necessary) to experiment with different forms of presentation and disclosure. We are very supportive of this initiative as it may start to deal with an understandable tendency for companies to do the same this year as last, or the same as their peers when in fact there may be better ways to deliver the information required. One of the problems with the push for comparability has been a tendency towards uniformity and a lack of innovation. The auditing element in this debate is likely to be very important as preparers will be keen to understand the views of auditors and regulators in deciding whether to support proposed new structures and methods for the presentation of disclosures, and ways of making decisions about materiality.

---

[1] http://www.icaew.com/en/technical/audit-and-assurance/audit-quality-forum-aqf/evolution (May 2009)

CONSULTATION QUESTIONS FOR PREPARERS

Section II–Financial Reporting Disclosure Trends

P1) What have been the most significant challenges you have experienced in preparing disclosures?

Challenges in preparing disclosures include obtaining Information that does not form part of the financial reporting system, including inputs to many valuations such as pension funds, financial instruments and share-based payments.

P2) Have you included a disclosure in your financial statements to comply with a specific disclosure requirement, even though you believed the disclosure was immaterial? What factors led you to this decision? What practical difficulties exist when deciding to omit a disclosure that you consider to be immaterial?

We believe that disclosures are sometimes included even though they are immaterial. In this context, we believe it is important to recognise the pressure applied by regulators to auditors to focus on compliance with IFRS requirements, which flows through to preparers who, faced with the prospect of being questioned by auditors and securities and other regulators, find it easier to include an immaterial disclosure than to argue the case for not including it.

A number of companies are actively considering how to take 20 or 30 pages out of their annual accounts, by seeking to identify unnecessary disclosures. Some companies are also considering how to streamline their data collection from components. This may provide challenges to auditors in determining, on large group audits, whether the data that is not collected is in fact immaterial. For example, one large group does a detailed exercise every three years to collect information on inter-group trading to check that it is still immaterial.

The FRC reports *Cutting Clutter: Combating clutter in annual reports* www.frc.org.uk/about/cuttingclutter.cfm and *Louder than Words: Principles and actions for making corporate reports less complex and more relevant* www.frc.org.uk/press/pub1994.html provide a good analysis of why excessive disclosures are provided and suggestions as to what might be done about it.

Section IV–Audit Issues Regarding Disclosures Required by a Financial Reporting Framework *(paragraphs 59–78 and 79–101)*

.

P3) Have you experienced requests from auditors for evidence to support your disclosures that you find difficult to satisfy? If so, please explain the context.

Where preliminary announcements are issued as audited, there sometimes significant time pressure on the audit of detailed disclosures

P4) 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 evidence or support do you believe you need to have as a basis for the assertions you make in the financial statements on such disclosures?

Evidence to support such disclosures includes sign off by those responsible for the relevant controls and policies. The evaluation of the design and implementation of controls by auditors is also relevant.

(b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65–66). In preparing financial statements, what, in your view, would be sufficient evidence for you to support your stress test disclosure? What do you believe would constitute a misstatement of a stress test disclosure?

Assuming that that the disclosures are an extract or a summary of information prepared for internal purposes, the evidence required includes sign off from those responsible for the preparation of the internal information after review and challenge through the reporting process. The evidence provided would need to satisfy the auditor that the reported outcome of the test did not conflict with his understanding of the business, is appropriate in the circumstances, and that the disclosure properly describes the process followed and its outcome. The criteria would be whether the evidence constitutes a reasonable basis for the assertions in the financial statements. We believe that the distinction between work on process and outcome as described in 66 (a) and (b) is not a clear one in practice, as in order to form a view on process, it is necessary to have regard to the outcome.

P5) 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;*

Irrelevant, misleading or inadequate explanations.

- *Assumptions/models/inputs;*

An inappropriate level or type of aggregation.

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

Irrelevant, misleading or inadequate descriptions.

- *Descriptions of internal processes;*

Descriptions that do not adequately reflect the operation of the process or descriptions of processes that do not exist. Anything that implies a higher level of sophistication and control than the auditor knows exists, or that describes a process where the auditor's own testing has shown a control to be either partially or wholly ineffective.

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

Omitting recommended disclosures where they are necessary to meet objectives or omitting explanations of relevant facts, even if not specifically required, that result in the objectives not being met or the overall picture being misleading. A misstatement in a disclosure might also constitute information that, were it provided on the face of the financial statements, would be deemed materially misstated.

- *Objective-based disclosure requirements*

Omitting recommended disclosures where they are necessary to meet objectives, and omitting explanations of relevant facts, even if not specifically required, that result in the objectives not being met or the overall picture being misleading**.**

CONSULTATION QUESTIONS FOR AUDITORS

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.

It is very difficult to judge whether a disclosure is material, particularly narrative disclosures. It is clear that not everything has to be audited to the same level, but it is often difficult to tell, without performing the audit, whether something is so immaterial that it does not have to be audited at all. Some clients and audit teams believe that if a disclosure is required by IFRS or UK GAAP, then it is, by definition, material and note that FRRP reviews and audit inspections in recent years, which have focussed on compliance with the detailed requirements of the standards, reinforce this view. Others believe that this is wrong, and that more flexibility is permitted in determining materiality, although it is very difficult to judge whether a particular disclosure is relevant to users of the financial statements. Auditors do not necessarily have a clear understanding of some of the disclosures that analysts and investors view as important and where disclosures are considered particularly important in a given industry, it is important that there is comparability - if not uniformity - across companies in such disclosures.

There may be merit in encouraging companies to state that particular disclosures have not been included because the company considers them to be immaterial. Share-based payments is a good example; if the charge is not material, all of the disclosures can be omitted (which is not the same as saying that if the charge *is* material, all of the related disclosures are similarly material).

There are concerns that even finance directors of large companies do not read all of the disclosures in the accounts - they leave them to the finance department. Audit committees probably turn the pages of the accounts, but invariably most of their comments relate to the front half of the annual report. Disclosures do not always get the attention they should from the company, but this lack of interest may reflect a lack of interest among users.

The existence of pro-forma illustrative financial statements and checklists contribute to the tendency to over-disclose. Checklists include every disclosure and leave it to the preparer to make the decision as to whether to omit an item on materiality or any other grounds. Small finance teams have a wide range of responsibilities of which the year-end financial statement preparation process is just one. With the increasing volume of changes in standards and standards with very detailed disclosure requirements, teams can find themselves swamped. At the same time, at least for listed entities, auditors are limited by independence requirements in the extent of accounting assistance they can provide and there are costs associated with engaging other expert advisors. Many such entities therefore take the example accounts available as an easy and time-efficient solution to preparing their financial statements which, at least in their eyes, ensure a reasonably high level of compliance with disclosure requirements some of them may not fully understand. They will therefore sometimes find it difficult to discern which disclosures could be omitted. Because disclosures are typically audited late in the overall audit process, it is often the case that there are material and significant disclosures that the preparer should be making and which are either missing or drafted inadequately. Audit effort has to be focussed on these disclosures and as such, the removal of immaterial items becomes a ‘nice to have’ in discussions with the preparer rather than a ‘must have’ which could have a direct bearing on the audit opinion, given the limited time available to both auditors and preparers.

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 have not obtained responses from firms on this question.

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

Presentation and disclosure are essential elements of the audit of both line and non-line items and there is increasing focus on both. Nevertheless, although ISAs require assessment of risk at the assertion level for disclosures, the level of formality of this in practice is less than it is for account balances and classes of transactions.

The use of disclosure checklists often results in excessive focus on compliance at the expense of the clarity of disclosures. At a recent meeting a UK regulator accepted some blame for the clutter in financial statements, because auditors are nervous about allowing companies to omit disclosures if they then face criticism from regulators. That regulator indicated that auditors should challenge inspectors' findings if they consider disclosures immaterial.

Documentary support for disclosures, particularly narrative disclosures, is variable. Even for qualitative note disclosures, company procedures are not always as rigorous as they are with disclosures on the face of the financial statements.

Determining the impact of components on group materiality can be challenging in large group audits and the ISA 705 requirement for auditors to include omitted disclosures in audit reports is widely resisted, despite the permitted exemptions. ISA 540 on accounting estimates has a large section on disclosure which covers many difficult judgemental areas.

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 SAAE on the disclosure? Please explain your answer.

Situations in which management believes it has evidence but where the auditor cannot find sufficient audit evidence are not uncommon in practice – evidence relating to qualitative IFRS 7 disclosures are particularly problematic. The difficulty is often with smaller clients where management describe procedures and policies in the financial statements, but where the lack of formality of their structures make it difficult to see how they operate in practice. Manuals can often be less than complete and meetings less than formal, and while the auditors' instincts and knowledge of the client might lead them to believe that the disclosures are at least in part aspirational, it can be hard to prove.

Where items are recorded at fair value, auditors require information about the method of valuation, what model is used and the assumptions and sensitivities surrounding the valuation. Sometimes preparers will not have this information to hand and will be challenged by auditors over the valuation if they cannot provide it. This is also true of impairment testing where auditors request that detailed impairment reviews are performed and expect to be able to review the assumptions used and test the sensitivities. In some cases these will not have been considered by preparers.

Where management has determined that an item is not material, and has not therefore prepared the relevant disclosure, it can be difficult to determine the materiality of the item. Furthermore, management often regards internal processes as sufficient for the preparation of a disclosure where the auditor will seek supporting evidence, and while evidence from the audit of the related line item may suffice in some cases, it may not in others.

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

A note disclosure for the property, plant and equipment asset (see paragraph 61);

Most of the evidence will come from the audit of the relevant line item, particularly where properties have been revalued. Issues arise where the revaluation has been performed by directors, rather than independently. This is particularly important given the increased attention being paid to banking covenants which often incorporate valuation elements.

An operating segment disclosure (see paragraph 62);

Difficulties with operating segment disclosure include inconsistencies between narrative reporting in the annual report and the numerical reporting supporting the financial statements. There are also difficulties in determining what management actually regards as a segment, rather than what it purports to. It can be difficult to discern which levels of information are really considered by management. Management information that the auditor can review includes management accounts and minutes of meetings, but this information is often highly disaggregated and can be difficult to relate to what is being shown in the accounts. Auditors may consider that there are more segments than the client is disclosing, but it can be difficult to prove this with reference to the information received from and considered by management.

A disclosure related to a line item that is reflected in the financial statements at fair value (see paragraph 63);

Regulators have suggested that auditors need to challenge the assumptions underlying fair values more and auditors may need help with this, as they may with sensitivity analyses where management has not considered an appropriate range of alternatives, and with determining what is sufficient appropriate evidence for fair value estimates.

A disclosure of the fair value of a line item recorded on another basis, such as amortized cost (see paragraph 64);

Further debate on the extent to which fair value disclosures require the same attention as fair value line items would be helpful, as opinions differ.

A proposed disclosure of stress test information (see paragraphs 65–66);

Generally, auditors will report on the process and outcome of the test, rather than what constitutes an appropriate test.

Disclosures which mention an internal control, contain forward-looking information or express an intention of management (see paragraph 67); and

An objective-based disclosure requirement (see paragraph 70).

Auditors do not opine of the effectiveness of internal control but on the description thereof, and can only look at the ability of management to achieve the stated intentions rather than at management's state of mind. Omissions in such disclosures are important.

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?

It is difficult to avoid the impression that level of materiality applied depends on the location of the disclosure. Many users appear to focus on the face of the financial statements rather than the notes. Some take the view that all disclosures should be audited to the same level because investors, analysts and regulators expect it. While it is arguable that auditors should obtain the same level and quality of audit evidence about primary statement items and the disclosures prepared under an alternative measurement basis, the fact is that auditors do not always do so, and it is also arguable that such a requirement would be unnecessary or even unreasonable. There appears to be a genuine expectation gap in this area and the subject warrants further exploration.

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.

While in principle, the notion that disclosures of interest, such as the second example given, are relevant, negative disclosures such as statements that, '…we do not have/have not…', etc., are likely cause more clutter unless they have a clear purpose and are clearly and closely defined. A UK regulator (the FRRP) ruled some years ago against a company which failed to disclose details of a fine imposed which was not material in quantitative terms. The FRRP considered the matter important enough for disclosure in the context of the potential fine and the fact that it had been previously disclosed as a material contingency, but this is a rare example.

It is sometimes difficult to persuade a company to include additional disclosures when there is no relevant requirement in the financial reporting framework, sometimes because of the litigation risk or commercial sensitivity, sometimes to avoid further 'clutter' and sometimes simply because the company has a different judgement as to what is material.

We note in our main points above the increasing emphasis on information required, desired, or called for by certain classes of analysts and investors. It is clearly not possible to include all of the disclosures relevant to all users' perceptions of what is needed to achieve fair presentation but at present, there are no clear boundaries to annual reports, or to the scope of audits, and there is some confusion about what is or should be audited, and what is not, and what can and cannot be audited. In this context, if auditors are increasingly asked to opine on non-financial information, sourcing the skills set required of auditors will need to be considered.

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?

We note in our main points above that a new materiality model may be needed for qualitative disclosures because of the difficulties associated with the adaptation of the materiality concept designed primarily to deal with quantitative data, to qualitative data. The guidance in ISA 450 focuses on qualitative factors affecting the auditors' judgement regarding the materiality of an item that is not quantitatively material. It does not deal with the materiality of disclosures that have no quantitative element whatsoever. Attempts are now being made to apply the concept to complex qualitative disclosures, for example in the context of greenhouse gas (GHG) statements, where material misstatements are described in paragraph A47 of the recent IAASB exposure as those that '…individually, or in the aggregate, could reasonably be expected to influence relevant decisions of users taken on the basis of the GHG statement..'. Without further guidance, and without the benefit of established benchmarks, practitioners are likely to struggle with this. The overarching concept makes sense – applying it to the detail of new areas is problematic and new tools may be 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 disclosure:

- *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.*

In all cases, statements that are apparently false, misleading, partial or biased might alone or together constitute misstatement. It is important to remember the limits of the extent to which a line item or disclosure can be described as materially misstated, given that the auditor provides an opinion on the financial statements as a whole.

A10) 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?

Auditors report on the appropriateness of the risk disclosures made in the light of their understanding of the business, rather than on their operating effectiveness. Risk reporting is not financial reporting, but there is clearly a boundary issue here which the IASB and IAASB should address together.

(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?

Again, auditors focus on the outcome of the stress tests but do not re-perform the stress test or audit the inputs or assumptions. As noted above, the evidence would need to satisfy the auditor that the reported outcome of the test did not conflict with his understanding of the business, is appropriate in the circumstances, and that the disclosure properly describes the process followed and its outcome. The criteria would be whether the evidence constitutes a reasonable basis for the assertions in the financial statements. The distinction between work on process and outcome as described in 66 (a) and (b) is not a clear one in practice, as in order to form a view on process, it is necessary to have regard to the outcome.

Section IV– Audit Issues Regarding Disclosures Required by a Financial Reporting Framework (paragraphs 59–101).

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?

We note in our main points above that more guidance is needed on qualitative misstatements. The evaluation and accumulation thereof is a case in point, and the starting point for this has to be in the requirements of ISAs that deal with management bias. We do not believe that auditors are employing novel techniques in this area, which is one in which IAASB could be seen to be leading, rather than following best practice.

Some qualitative evaluation is possible if the matters relate to a single issue. For example, there may be missing disclosures relating to debts or contingent liabilities which individually are not material, but which together might constitute important information about the going concern status of the entity.

If there were many disclosures missing, 'except for' or adverse opinions might be appropriate even if the omission of no single individual disclosure would warrant a qualification. While there is little evidence of this in the UK, the issue does arise elsewhere.

In practice, companies will sometimes, but not always, include the disclosures if their omission would lead to a qualification of the auditor's report. In the UK, there have been instances concerning segmental analysis and related parties in which companies agreed to include the necessary disclosure, having previously not included it.

Where errors are found in prior year disclosures, such as missing or inadequate disclosures or simple wrong numbers in disclosures, auditors are often fairly tolerant in not requiring adjustment, however, more attention should be paid to current year figures in such circumstances.

Section V–Questions about Auditability

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

There are difficulties with some disclosures, and some are clearly more difficult to audit than others. Results of stress tests, value at risk disclosures, historic information within acquisition tables, and aspects of pensions disclosures are more complex and subjective than those relating to inventory, for example. In the context of related parties it is sometimes very difficult to establish if a related party is material to the other party, such as an individual director.

The quality of audit evidence obtained is sometimes lower for disclosures than it is for line items in the financial statements, but this needs to be considered in the context of reporting on the financial statements as a whole.

If something is *unauditable*, it should be outside the financial statements. Labelling it as 'unaudited' within the financial statements is likely to confuse readers. But if the disclosure is required by the financial reporting framework, it must to be in the financial statements, and within the scope of the audit opinion. It is therefore essential that accounting standard-setters take auditability into account. The *Audit Quality Forum* publication *Changes to Financial Reporting and Audit Practice*[2] highlighted the effect of changes in financial reporting standards on audit procedures, and the effect of audit procedures on auditing standards. A novel accounting treatment will often present a challenge to auditors who need to adapt existing models to new situations, but the challenge, historically, has rarely been insurmountable. The publication also highlighted the fact that whereas in the past, the extent of variation in what was believed to constitute reasonable assurance was not so great as to cause concern, the increasing extent of that variation is now causing concern and the need to communicate that variation needs to be considered.

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?

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?

As noted above, UK regulators rarely require correction of disclosures that are not material in quantitative terms, but they do, like other regulators, take an interest in an issue reminders from time to time on what should be disclosed, such as a recent FRRP paper on acquisition disclosures and the interest the UK's Financial Services Authority takes in bank disclosures.

[2] http://www.icaew.com/en/technical/audit-and-assurance/audit-quality-forum-aqf/evolution (May 2009)