BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via e-mail
edcomments@ifac.org

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

1 June 2011

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

Dear Mr Gunn

The Basel Committee welcomes the opportunity to comment on the Discussion Paper *The evolving nature of financial reporting: disclosure and its audit implications*. The Committee has a strong interest in high quality financial reporting by banking organisations that includes relevant and meaningful disclosures. We believe this timely paper raises important, issues especially with regard to the consequences for auditing. The assurance that an effective audit process brings to disclosures is critical to the overall integrity of financial reporting.

Our general comments are presented below. Additional detailed views are presented in Annex 1 and the responses to the questions posed to regulators in Annex 2. We have referred to International Financial Reporting Standards (IFRS) as the relevant financial reporting framework within which audits of disclosures are carried out.

General comments

The Committee stresses that disclosures required by a financial reporting framework should, in principle, be audited with the same rigour as that which applies to auditing the primary financial statements.

Presently, we understand that it is not always clear for the users of financial statements to understand the context in which disclosures have been audited. That is, there is a lack of clarity as to whether financial statement disclosures were audited in the context of the auditor expressing an opinion on the financial statements as a whole, or whether the auditor has verified that the financial statements contain all disclosures required by the financial reporting framework with all the necessary details (ie the "check list" approach to auditing). At this point in the debate, the Committee would prefer that the auditor express an opinion on the financial statements as a whole. We also believe that a disclosure framework would help resolve the lack of clarity. Thus we recommend that the IAASB coordinate its efforts in this matter with the accounting standard setters.

At present, there are limited pertinent International Standards on Auditing (ISA) requirements and guidance that specifically deal with audit of disclosures. We therefore believe that there is a need for more focus on auditing disclosures in the existing ISAs. We believe this focus would result in either additional requirements or additional application and explanatory material.

We share the concern raised by some that it is important for an auditor to maintain professional scepticism throughout the audit. This is particularly true when examining key areas of financial accounting and disclosure which depend critically on management judgment (cf paragraph 71 of the Discussion Paper). We also share the view, expressed in paragraph 72 of the Discussion Paper, that auditors may not sufficiently challenge management and those responsible for governance about whether all necessary disclosures are included in the financial statements.

These comments have been prepared by the Committee's Accounting Task Force, chaired by Sylvie Mathérat, Deputy Director General at the Banque of France. If you have any questions regarding our comments, please feel free to contact Mrs Mathérat (+33 1 4292 6579), or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely

Nout Wellink

Annex 1

Detailed views on disclosures and the role of auditors

Disclosures framework

We refer to IAS 1.10, which states that a complete set of financial statements comprises the primary statements (statements of financial position, comprehensive income, changes in equity and cash flows) and notes. The notes comprise a summary of significant accounting policies and other explanatory information such as, for example, supplementary schedules and other information about risks and uncertainties, resources and obligations not recognised in the balance sheet, and geographical and industry segments. Almost all international financial reporting standards (IFRS) contain disclosure requirements. They contribute to the four qualitative characteristics of financial statements: understandability, relevance, reliability and comparability. Notes form an integral part of the primary financial statements and are essential for understanding the primary statements. For example, financial statements cannot be fully understood without knowing what the significant accounting policies are. Disclosures required by a financial reporting framework should therefore form part of the auditor's overall risk assessment which determines the level of rigour to be applied to the audit.

In forming their opinion, auditors must consider whether the financial statements taken as a whole, present a true and fair view. They must also consider whether the financial statements appropriately apply all of the specific disclosure requirements of the financial reporting framework. We believe that a financial reporting disclosure framework would relieve the tension between the auditor's opinion on the financial statements as a whole and international accounting standards with expanding detailed disclosures.

The idea of developing a disclosure framework was raised by the US Financial Accounting Standards Board (FASB) in 2009. The Standards Advisory Council of the International Accounting Standard Board (IASB SAC) was informed about the project in November 2009. The FASB project's objective is twofold:

1. Establishing an overarching framework intended to make financial statement disclosures more effective, coordinated and less redundant; and,

2. Seeking ways to better integrate information provided in financial statements, Management Discussion and Analysis, and other parts of a company's public reporting package.

We see a need for such a disclosure framework that would coherently integrate existing disclosure requirements ensuring meaningful communication and a logical presentation of information, based on consistent objectives and principles. We recognise that this is a matter for accounting standard setters and encourage the IAASB to coordinate with the standard setters.[1] Such a disclosure framework should emphasise the need to apply professional judgment (including professional scepticism and challenging management when assessing whether the overall presentation is sufficient to achieve a true and fair view).

Role of auditors

We share the view expressed in paragraph 72 of the Discussion Paper that auditors may not sufficiently challenge management and those in charge with governance about whether all necessary disclosures are included in the financial statements. The paragraph notes that there may be a perception that auditors use checklists to ensure completeness without applying professional judgment regarding whether all of the disclosures are necessary in the context of the specific entity. We also believe that auditors should use professional scepticism when auditing disclosures, including qualitative disclosures.

Paragraphs 34 to 41 of the Discussion Paper make several important observations regarding disclosure preparation. These include:

1. Most audit firms prepare disclosure checklists that, while being seen as welcome practice aids by financial statement preparers, are also seen as encouraging unnecessary disclosures and impeding continuous improvement.

2. Disclosures are often prepared late in the financial reporting process. This creates a disincentive for both preparers and auditors to make any changes in them, including those that might be considered immaterial or changes that improve the understandability of the financial statements as a whole. It also has an impact on the audit of disclosures and the practical ability of auditors to gather sufficient audit evidence and apply the appropriate degree of challenge.

3. To address some of these challenges, the US Securities and Exchange Commission recommends that larger US issuers develop, maintain and regularly evaluate the effectiveness of disclosure controls and procedures. It further recommends that issuers create a committee with responsibility for considering the materiality of the information and determining disclosure obligations on a timely basis.

In this regard, the IAASB should consider how the planning of the audit is affected by the fact that disclosures are often prepared late in the financial reporting process. This leaves little time for assessing the disclosures in the context of the financial statements as a whole but rather as a “checklist” exercise. The IAASB could consider additional audit requirements, eg when agreeing on the terms of an audit engagement (ISA 210) to ensure more timely preparation of disclosures and more active involvement of senior management in the continuous improvement of the disclosures that are relevant to the entity.

[1] Paragraph 16 of the discussion paper contains a useful categorisation of disclosures in contemporary financial statements and may be helpful to the accounting standard setters.

Annex 2

Responses to Consultation Questions for Regulators

R1. Have you 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.

We understand that entities often continue preparing disclosures that are no longer necessary due to perceived pressure from users. The Committee believes that, along with materiality, relevance should be a criterion in determining the need for disclosures.[2] For example, “boiler-plate” disclosures are often included even if they are not relevant. So-called immaterial (ie quantification amount) items can be very relevant in a specific reporting period to ensure users of the financial information receive timely information to aid in the understanding of a bank’s position at the reporting date. For example, current concerns regarding a bank’s exposures to sovereign debt can be addressed by disclosing positions – regardless of materiality – to ensure a clear picture of possible risk to a bank (see also our response to R6).

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

There are currently a limited number of ISA requirements dealing specifically with the audit of disclosures. Most existing ISAs were drafted when disclosures were both fewer in number and covered mainly significant accounting policies and components of line items (ISA 540 is a recent notable exception). As shown by IFRS 7 (the first international standard that solely addresses disclosures), disclosures are changing in nature and number, making the information they provide critical for the assessment of an entity's performance and financial position.

The number of ISAs dealing with disclosures is limited and the way they deal with this issue varies. ISA 200 (*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*) includes references to disclosures in its paragraph 13, which defines the terms used in the ISAs (not in its requirements section). ISA 315 (*Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Entity*) and ISA 700 (*Forming an Opinion and Reporting on Financial Statements*) contain a reference to disclosures in the requirements section. Most other language in the ISAs about disclosures is in the Application and Other Explanatory Material, including ISA 450 (*Evaluation of Misstatements Identified during the Audit*). The exception to this is the recent ISA 540 (*Auditing Accounting Estimates, Including Fair Value*

[2] IAS 1.31 states that an entity need not provide a specific disclosure required by an IFRS if the information is not material.

Accounting Estimates, and Related Disclosures), that deals quite explicitly with disclosures (as the title indicates).

Therefore, we believe that there is a need to develop provisions related to auditing disclosures in the existing ISAs. These developments could result in either additional requirements or additional application and explanatory material, or simply more emphasis in some cases.

Auditing disclosures should be embedded in the general approach to an audit. It is particularly important that the auditor's work on disclosures be considered, firstly, in the planning phase of the audit (ISA 300 – *Planning an Audit of Financial Statements*), and secondly, that a risk-based approach to the audit of disclosures is used. This approach is in line with the requirements of ISA 315 (*Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment)* and ISA 330 (*The Auditor's Responses to Assessed Risks)*. In particular, we see a need to include additional guidance on obtaining sufficient appropriate audit evidence covering:

1. Qualitative disclosures;

2. Materiality in the context of disclosures (when are disclosures material?);

3. Aggregation of misstatements; and,

4. Whether the effect of a disclosure on the financial statements is pervasive (see also paragraph 51 of the Discussion Paper).

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

Auditability should not be the only factor in determining if an item should be subject to disclosure. If information is relevant and meaningful to users of the financial statements then it should be disclosed and subject to audit. In this area we acknowledge the various key issues raised in the discussion paper. We also agree that it may be more difficult for the auditor to obtain sufficient appropriate audit evidence for:

1. Information derived through processes other than accounting processes as the internal controls surrounding these data may be less rigorous (though this may not be true in all cases);

2. Management judgments and assumptions unless management provides an adequate audit trail;

3. Qualitative disclosures including descriptions of internal processes;

4. Risk management and regulatory capital disclosure.

However, we would suggest that these disclosures be required and audited.

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?

Auditors should consider the level of risk involved in the disclosure and the materiality of the disclosure when determining the level of effort to apply in auditing disclosures. In principle, the approach that should be taken is similar to auditing fair values on the balance sheet, where the risk of misstatement and the materiality of the line item are equally important. Management may often apply a different valuation methodology for disclosed fair values compared to items measured at fair value. This approach, when taken by management, should have an impact on the audit procedures performed.

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 Committee's position on this shift was expressed in a comment letter to the IASB in November 2006 about the *Conceptual Framework.*[3] We believe that using "reliability" rather than "faithful representation" would be a better way to convey the crucial need for well balanced, objective and experienced professional judgment and due care for assessing estimates in financial reporting. The Committee also believes that the concept of verifiability should be markedly strengthened in the *Conceptual Framework*. We believe that disclosures are of equal importance to the financial statements as they are to the primary statements. Our concern, therefore, about the shift from reliability to faithful representation is equally valid to disclosures as it is to measurement, classification and presentation.

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 all relevant information should be disclosed, even when a disclosure is not specifically required by the financial reporting framework. This is particularly true for banks in the context of financial stability. The IAASB rightly observes in paragraph 81 that some disclosures may be useful even if they are not quantitatively material to the entity. The Discussion Paper notes, "*For example, in the present climate, a disclosure of the fact that a financial institution has no material exposure to a particular asset class, such as sovereign debt, could be considered of particular interest to investors*." The Committee is of the view

[3] The comment letter related to the November 2006 IASB discussion paper - "Preliminary views on an improved conceptual framework for financial reporting: the objective of financial reporting and qualitative characteristics of decision-useful financial reporting information". The letter is available on the BIS website at www.bis.org.

that these types of disclosures are relevant, not only in the context of the financial statements of a specific bank but also from a financial stability perspective that encompasses all banks and their interconnections.

We also observe that the relevance of disclosures will evolve over time and also depends on the specific circumstances of an entity.

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:

- **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.**

As a general principle, disclosures are materially misstated if they are misleading (eg incorrect, incomplete, inadequate, unreasonable) or insufficient to achieve a relevant picture of the entity's financial position and risk taken at a point in time. This implies that all relevant disclosures should be presented and the omission of a relevant and material disclosure is therefore a material misstatement.

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?

(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?

Our response to both examples is as follows:

- Example (a): The auditor should obtain sufficient appropriate evidence from inquiries about the content of the disclosures, reading and understanding the entity's internal guidelines and verification whether the entity complies with its guidelines, if the disclosure asserts compliance with the guidelines (rather than just describing the design of the controls).

- Example (b): The first approach described in paragraph 66a of the discussion paper is, in our view, the minimum evidence the auditor should obtain. That is that the auditor only needs to obtain evidence about the process the entity followed in performing the stress test and the outcomes of that test. In addition, we would also expect an auditor to assess and obtain evidence of the reasonableness of the assumptions used by management.

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

We understand that some disclosures are more difficult to audit than others because it can be difficult to obtain sufficient and appropriate audit evidence for certain types of disclosures. Examples of such disclosures are those that involve significant judgment or are dependent on management's intent or future developments. However, audit procedures can be applied to all disclosures. What will vary is the quality of available evidence. However, the auditor needs to consider the overall level of comfort on the financial statements as a whole.

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 noted that ISA 200.A26 states that "*Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report*". We invite the Board to reflect on the thought that readers of financial statements may expect that auditors having the same high level of training, knowledge and experience would arrive at basically the same conclusion when being in the same or very similar situations.

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?

We believe that, ideally, the manner in which a financial reporting regulator enforces financial reporting should have no impact on how the audit of disclosures is conducted.