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Our ref SS/288
Contact Sylvia Smith

11 September 2014

Dear Sirs

Exposure Draft, Proposed Changes to the ISAs – *Addressing Disclosures in the Audit of Financial Statements*

We appreciate the opportunity to respond to the International Auditing and Assurance Board's ("IAASB" or "Board") Exposure Draft: *Proposed Changes to the ISAs – Addressing Disclosures in the Audit of Financial Statements* dated May 2014 (the "ED"). We have consulted with, and this letter represents the views of, the KPMG network.

Our overarching comments are set out below. The appendix to this letter provides our responses to the specific questions posed in the ED.

Materiality considerations and the importance of working with other stakeholders

As we noted in our response to the Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosures and its Audit Implications*, issued by the IAASB in June 2011, we agreed with the IAASB in its observation that the complexity, subjectivity and extent of financial statement disclosures have evolved in a way that poses a number of challenges in the preparation, auditing and user understanding of these disclosures. Accordingly, we were very supportive of a project to address these issues, one of the most challenging of which is the application of the concept of materiality to disclosures, in particular, to qualitative information.

However, we acknowledge the IAASB's statement that it has not proposed changes to ISA 320, *Materiality in Planning and Performing an Audit* at this time, since it considers that any issues in this area are intrinsically linked to other aspects of a broader project on materiality that would be beyond the scope and feasibility of this ED, or the IAASB in isolation, to resolve. We recognise that it has not been feasible for the IAASB to address this issue since the IASB *Disclosure Initiative* remains ongoing.

Accordingly, given the uncertainty around the timing and outcome of the broader discussions taking place as part of the IASB's *Disclosure Initiative*, including the *Materiality* and *Principles of Disclosure* projects, we support the IAASB's decision to propose narrower scope revisions to the ISAs to address certain aspects of auditing disclosures at this point in time.

In general, we consider that the proposed amendments are a good first step in moving towards enhancing auditor focus on disclosures earlier in the audit process, and in a more holistic way during the course of the financial statement audit. However, we are concerned that without additional changes to clarify the auditor's objectives with respect to disclosures and also how materiality considerations are applied, the changes in the ED on their own may not be sufficient to significantly change auditor behaviour.

In the longer-term, we continue to believe that in order to improve the quality of disclosures in financial statements, there needs to be a concerted and coordinated effort by multiple parties to effect significant changes in behaviour by preparers, auditors, and regulators of financial statements. In particular, financial reporting and auditing standard setters need to act in tandem to address the challenge of transposing the concept of materiality to enable its application to disclosures in financial statements.

In addition to the critical involvement of the IAASB in the overall effort to reach an appropriate solution in this area, we highlight the essential role that financial reporting standard setters, in particular, the IASB, have to play in terms of establishing a framework setting out key principles to enable preparers (and auditors) to exercise their judgment in applying the disclosure requirements of the applicable financial reporting standards and in determining whether a particular disclosure is relevant.

We also continue to believe that any holistic solution would necessarily involve recognition by regulatory bodies of their potential contribution to the ever-increasing use of disclosures and the need for changes in their approach to enable preparers (and auditors) to exercise more judgement in standing back and assessing the overall balance of disclosures with regards to fair presentation of the financial statements as a whole.

We therefore encourage the IAASB to continue to reach out to other stakeholders, in particular, to liaise actively with the IASB to contribute meaningfully to their projects around *Materiality* and *Principles of Disclosure* under the *Disclosure Initiative*, and to work with regulators to reach an appropriate solution.

In working together to achieve an appropriate solution in the longer-term, we recommend that standard setters and regulators give consideration to the initiatives already underway aimed at improving corporate reporting to better meet the needs of users. This may have the effect of re-defining the purpose and boundaries of financial statements, in terms of the scope of information that is presented and disclosed within the financial statements themselves as opposed to information communicated through other channels, which may complement the material included in the financial statements, but which has a different purpose overall. It may also re-define the role of the auditor with respect to the different types of information provided.

Recommendations for further enhancement to proposed amendments

We set out below our principal recommendations for further enhancements to changes proposed in the ED in order to improve their effectiveness.

Role of management and those charged with governance

We highlight the fundamental responsibility of management for the financial reporting process, which includes the timely preparation of disclosures that comply with the requirements of the relevant financial reporting framework and are appropriate in the specific circumstances of the entity. This would enable auditors to perform audit procedures on disclosures and assess the fair presentation of the financial statements earlier in the audit process.

Accordingly, we recommend making further changes to ISA 260, *Communication with Those Charged with Governance* to emphasise the role of the auditor in respect of communicating with management and those charged with governance about the quality of disclosures in the financial statements and to provide enhanced guidance to the requirement in 260.16(a) with respect to the qualitative aspects of disclosures to be communicated with those charged with governance and to extend paragraph A17 to include specific reference to considering management bias in respect of disclosures throughout the audit.

The role of the auditor is a crucial "piece of the puzzle" in supporting the overall objective of delivery of high quality financial statements to capital markets. The proposed enhancements to the ISAs may result in changes to auditor behaviour in respect of disclosures and as a corollary, to the behaviour of management and those charged with governance. However, we consider that there is a broader educational issue in respect of all those involved in the financial reporting supply chain, and therefore we encourage standard setters and other parties, such as regulators, to work together to explore an effective solution.

Other recommendations

We also recommend that the IAASB explore the following matters further, to provide enhanced guidance:

- Auditing information that is derived from sources other than the general ledger in the context of assessing the reliability and integrity of underlying information.

  We note that the IAASB is proposing that the substantive procedures in ISA 330.20(a) be expanded from agreeing/reconciling financial statements with underlying accounting records to agreeing the financial statements, *including disclosures,* with the underlying accounting records, *and information from systems or processes that are not part of the* *general ledger system* (emphasis added). We are concerned that this requirement, when considered in conjunction with the existing requirement in ISA 500.9 relating to information produced by the entity, will essentially result in expanding the auditor's responsibilities with respect to underlying information, including the systems from which such information is obtained, without having had the benefit of addressing the related principles more generally. This proposed change therefore goes beyond the intended scope of this project. Accordingly, we recommend that the IAASB remove this new requirement and related application material and explore this issue in a broader context, in conjunction with potential changes to ISA 500 since challenges in this area are not restricted to the auditing of disclosures, but also affect account balances and classes of transactions, in particular, in relation to assets and liabilities subject to fair value measurement.

- Evaluation of misstatements in respect of qualitative information, in particular, the application of the concept of materiality to such information to determine what constitutes a misstatement, and also with respect to the aggregation of potential misstatements.

  Notwithstanding our comments above regarding the need for a framework to help assess materiality in respect of disclosures, we consider that it would be beneficial for the IAASB to specifically recognise that consideration of misstatements in respect of disclosures requires the exercise of professional judgment by the auditor, when assessing and evaluating disclosures in the context of the applicable financial reporting framework and in the specific circumstances of the entity. We also recommend that the IAASB place greater emphasis on consideration of management bias in respect of disclosures.

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

Yours faithfully

KPMG IFRG Limited

KPMG IFRG Limited

cc: Jean Blascos

Appendix 1 - Specific Questions Posed by the IAASB

Question 1

Whether, in your view, the proposed changes to the ISAs are appropriate and sufficient for purposes of enhancing the focus of the auditor on disclosures and, thereby, will further support the proper application of current requirements in the ISAs?

As we state in our overarching comments, in general we consider that the proposed amendments are a good first step in moving towards enhancing auditor focus on disclosures earlier in the audit process and in a more holistic way during the course of the financial statement audit. However, we are concerned that without additional changes to clarify the auditor's objectives with respect to disclosures and also how materiality considerations are applied, as well as addressing the broader educational issue we refer to in our overarching comments, the changes in the ED on their own may not be sufficient to significantly change auditor behaviour.

Furthermore, we note that ISA 315.25 refers to identifying and assessing risks of material misstatement at the assertion level for classes of transactions, account balances and disclosures. We recommend that ISA 315 also make explicit reference to the risk of material misstatement in respect of these elements, including disclosures, at the financial statement level. The application material could, for example, include consideration of factors such as the risk of management bias and whether the financial statements as a whole fairly present information about the entity, whether the overall volume of disclosures is appropriate, and important information is not obscured. Whilst we acknowledge that the proposed ISA 450.A17a includes similar considerations, we believe that it would be helpful to introduce these much earlier to enable detailed consideration at the planning stages as well as throughout the audit process.

With regard to materiality considerations, we encourage the IAASB to continue to work closely with the IASB regarding its projects around *Materiality* and *Principles of Disclosure* under the *Disclosure Initiative*. Please refer also to our response to question 2 below.

Further to the above, we are also concerned that certain amendments may now result in undue emphasis being placed on disclosure matters, for example, the addition of paragraphs A12a and A12b to ISA 300 may place a disproportionate emphasis on considerations in respect of disclosures as part of the audit plan.

We therefore suggest that the IAASB consider whether the material could be improved to better balance audit considerations in respect of disclosures with those relating to account balances and classes of transactions.

Question 2

Are there any specific areas where, in your view, additional enhancement to either the requirements or guidance of the ISAs would be necessary for purposes of effective auditing of disclosures as part of a financial statements audit?

Application of materiality

We believe that one of the most significant challenges auditors face when auditing disclosures is the application of the concept of materiality, in particular, to qualitative disclosures. We recognise that a disclosure framework would help auditors address this challenge because it would provide both preparers and auditors with a basis for applying disclosure requirements and exercising judgment in determining whether a particular disclosure is relevant, in order to communicate meaningful information to users. A framework would enable better balancing of the competing considerations of "completeness" and "relevance" and would help to shift the focus towards overall understandability. It would also help to address the ever-increasing volume of disclosures included in financial statements and discourage the use of "boilerplate" disclosures that may obscure important information.

We believe that the development of such a framework is primarily the responsibility of the financial reporting standard setters. Accordingly, we do not consider it appropriate to include guidance in the ISAs that is more explicit or onerous than that set out in financial reporting standards in an attempt to enhance financial reporting standards.[1]

In relation to the above we are therefore concerned that in certain instances the IAASB may have attempted to "fill the gap" in the absence of significant progress by the IASB on its *Disclosure Initiative* by including specific enhancements. In particular, we believe that the examples added to ISA 315.A128c, ISA 450.A1 and ISA 700.A4 may place undue emphasis on specific disclosure matters; may contribute towards a "checklist approach" being taken by auditors, and may also suggest specific disclosure objectives that go beyond current IFRSs. This may not be aligned with the IASB's *Principles of Disclosure* project[2] and the intended "decluttering" where disclosures are not considered relevant in the circumstances of the entity.

We therefore suggest that the IAASB either delete these specific examples, or include these within Appendix 2 to ISA 315 and we further recommend that the lead-in to ISA 315.A128c

[1] ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, is clear in stating, in paragraph A6 that "*the requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as the basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework*".

[2] The *Principles of Disclosure* project is one of research projects under the IASB's *Disclosure Initiative*

highlight the importance of considering the significance of a matter in relation to the financial statements as a whole.

Consideration of misstatements

We note that the IAASB proposes changes to ISA 450, for example:

- ISA 450.A2a acknowledges that "although misstatements in non-quantitative disclosures cannot be aggregated in the same manner as misstatements of amounts, they are still evaluated individually, and collectively, with other misstatements".

- ISA 450.A13a refers to misstatements in non-quantitative disclosures and their "overall effect on the relevant disclosures" as well as the "overall effect on the financial statements as a whole"

However, the ED does not propose further guidance to assist auditors in making these overall evaluations. It also remains unclear how the term "*incorrect descriptions*" in ISA 450.A13a, which is used elsewhere in the ISAs when referring to data or factual information, would be applied to qualitative or subjective information.

We recognise that it is difficult for the IAASB to make significant enhancements in the absence of broader clarification regarding the application of materiality in evaluation of misstatements. However, we believe the proposed changes could be improved if the IAASB were to explicitly acknowledge that consideration of misstatements in respect of disclosures, in particular, in respect of qualitative disclosures, involves the exercise of professional judgement by the auditor when evaluating disclosures in the context of the applicable financial reporting framework and in the specific circumstances of the entity.

We also recommend that the IAASB place greater emphasis on consideration of management bias in respect of disclosures. Please see below.

Role of management and those charged with governance

We highlight the fundamental responsibility of management for the financial reporting process, which includes the timely preparation of disclosures that comply with the requirements of the relevant financial reporting framework and are appropriate in the specific circumstances of the entity. This would enable auditors to perform audit procedures on disclosures and assess the fair presentation of the financial statements earlier in the audit process.

Accordingly, we recommend that the IAASB make further changes to ISA 260 to emphasise the role of the auditor in respect of communicating with management and those charged with governance about the quality of disclosures in the financial statements and to provide enhanced guidance to the requirement in ISA 260.16(a) with respect to the qualitative aspects of disclosures to be communicated to management and those charged with governance.

Furthermore, extant paragraph A17 highlights that judgment is involved in preparing and presenting financial statements disclosures, which we suggest to expand, when referring to "*open and constructive communication about significant qualitative aspects of the entity's accounting practices*" to include specific reference to issues such as:

- Potential management bias in respect of preparation of disclosures (for example, if management estimates are consistently at the more aggressive end of a range); and

- Whether disclosures are presented in a way that may obscure information (for example, as a result of the volume of disclosures).

Lastly, given the fundamental responsibility of management for the financial reporting process which includes the timely preparation of appropriate disclosures, we believe that in order to effect meaningful changes to the behaviour of management, as well as auditors, it is critical that the IAASB work in tandem with other parties, in particular the IASB to address the area of disclosures. We do not believe that changes to the ISAs alone will be a sufficiently effective vehicle to drive such behavioural changes.

We also consider that there is a broader educational issue in respect of all those involved in the financial reporting supply chain, and therefore we encourage standard setters and other parties, such as regulators, to work together to explore an effective solution.

Auditing information that is derived from sources other than the general ledger

The ED includes proposed changes in respect of auditing information derived from sources other than the general ledger, in a number of ISAs in particular:

- ISA 210.A11 and A23 include reference to the expectation that management will provide access to all information (of which management is aware) that is relevant to the preparation of financial statements, recognising that this includes information from systems or processes that are not part of the general ledger system;

- ISAs 300.A12a and ISA 315.A89a acknowledge that the source of information about disclosures may affect the assessed risks and the nature, timing and extent of related audit procedures, and provide examples of such sources; and

- ISA 330.20(a) expands the substantive procedures from agreeing/reconciling financial statements with underlying accounting records to require the auditor to agree/reconcile the financial statements, *including disclosures*, with the underlying accounting records *and information from systems that are not part of the general ledger system* (emphasis added).

We are concerned that the above changes, in particular the amended requirement in ISA 330.20(a), when considered in conjunction with the existing requirement in ISA 500.9 relating to information produced by the entity, will essentially result in expanding the auditor's responsibilities with respect to underlying information, including the systems from which such information is obtained, without having had the benefit of addressing the related principles more generally. As stated in our overarching comments, we consider that this is a wider issue, not limited to disclosures, that goes beyond the intended scope of this project. Accordingly, we recommend that the IAASB remove the new requirement in ISA 300 and the proposed changes to application material and explore this issue in a broader context, in conjunction with potential changes to ISA 500, since challenges in this area are not restricted to the auditing of disclosures, but also affect account balances and classes of transactions, in particular, in relation to assets and liabilities subject to fair value measurement.

Question 3

Whether, in your view, the proposed changes to the assertions will help appropriately integrate that work on disclosures with the audit work on the underlying amounts, thereby promoting an earlier and more effective audit of disclosures?

We believe the changes made to ISA 315.A124 to remove the separate category of assertion for presentation and disclosure and instead integrate the relevant assertions relating to disclosures would be helpful to change auditor behaviour to take a more holistic approach to the audit to consider disclosures when auditing related accounts and classes of transactions.

Furthermore, we highlight that, in the absence of a disclosure framework as noted above, there may be difficulty in practice in terms of application of disclosure-related assertions, in particular, achieving an appropriate balance between "completeness", where the ISA refers to "*whether all related disclosures that should have been included in the financial statements have been included*" and "presentation", where the ISA refers to "*whether related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework*". In this regard, we also note that it would be helpful for standard setters, in particular, the IASB and the IAASB, to work together to align the definitions and usage of the terms "presentation" and "disclosure". It may also be helpful if the IAASB includes examples in the standard, to illustrate the proposed changes to assertions.

Question 4

Effective date – Recognising that the proposed changes to the ISAs affect some of the same ISAs as other IAASB projects currently being finalised, the IAASB believes that to the extent possible, the effective date should be aligned with these other projects, namely the IAASB's Auditor Reporting project and the project to revise ISA 720. Accordingly, the IAASB believes that an appropriate effective date for the standard would be 12-15 months after issuance of the final standards, but may be longer or shorter to align with the effective date of the revisions arising from the auditor reporting and ISA 720 projects. Earlier application would be permitted. The IAASB welcomes comment on whether this would provide a sufficient period to support effective implementation of the changes to the ISAs.

We agree with the effective date proposed by the IAASB. Although in the main the proposed changes do not establish new requirements, but rather provide enhanced guidance regarding existing requirements, we recognise that since changes are proposed to a number of ISAs, auditors will require some time to consider the effect of the proposed changes on their existing methodologies, in particular, the guidance set out therein, and to update this accordingly.