NASBA

National Association of State Boards of Accountancy

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September 10, 2014

Kathleen Healy-Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue
New York, NY 10017 *via IAASB website-"Submit a Comment" link*

Re: **Proposed Changes to the International Standards on Auditing (ISAs)**
Addressing Disclosures in the Audit of Financial Statements

Dear Ms. Healy:

We appreciate the opportunity to provide comments on the Exposure Draft, *Addressing Disclosures in the Audit of Financial Statements* (the "Proposal") issued by the International Auditing and Assurance Standards Board ("IAASB" or the "Board") in May 2014, and the related *Preliminary Staff Publication*, *Addressing Disclosures in the Audit of Financial Statements* (the "Preliminary Staff Publication"). The National Association of State Boards of Accountancy's (NASBA) mission is to enhance the effectiveness of the licensing authorities for public accounting firms and certified public accountants in the United States and its territories. Our comments on the Proposed Statement are made in consideration of our charge as state regulators to promote the public interest.

EXECUTIVE SUMMARY

We support the IAASB on the issuance of the Proposal and the Preliminary Staff Publication to assist auditors in applying the Proposal. NASBA agrees that disclosures are a fundamental and critical part of financial reporting in order to protect the public interest. We support the direction of the IAASB to integrate the auditing of disclosures into the audit process and to enhance the standards in order to encourage the auditor to focus on disclosures throughout the audit. We do, however, have some overall concerns regarding the proposed changes. These are outlined below, along with recommendations to address the concerns.

- NASBA supports the IAASB's objectives regarding the proposed changes to the assertions to encourage auditors to perform audit procedures related to disclosures earlier in the audit; however, NASBA has concerns about whether the proposed changes will achieve the intended change in practice. Please see our detailed response in Appendix A, question 3.

- In addition, we recommend that a more holistic approach be undertaken to appropriately address the language modifications in the Proposal that have a broad impact across the ISAs. Based on the examples provided in Appendix B herein, NASBA is concerned that a consistent approach may not have been taken in using certain phrases and terminology within the Proposal. For example, while we support the change in definition of "financial statements" to make it clear that the term includes disclosures; NASBA notes that the Proposal includes references to "financial statements, *including disclosures*" [emphasis added]. Such references appear redundant in light of the definition and will likely create confusion as to whether or not disclosures are intended to be included when the term "financial statements" is used on its own. Accordingly, NASBA recommends that the defined term "financial statements" be used throughout this Proposal and the ISAs without the supplementation "including disclosures." Additional examples of inconsistent use of terms and phrases are provided in Appendix B. Overall, it is essential that all proposed language modifications are appropriate given the context within the body of literature and have been consistently applied throughout the ISAs.

These matters, along with NASBA's responses to the questions posed by the IAASB and other recommendations are included in the attached Appendices. We believe the recommendations provided herein will further enhance and clarify the Proposal and serve to achieve the Board's objectives.

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We appreciate the opportunity to respond to the IAASB Standards referenced above.

Sincerely,

Carlos E Johnson

Ken L. Bishop

Carlos E. Johnson, CPA
NASBA Chair

Ken L. Bishop
NASBA President and CEO

APPENDIX A

RESPONSE TO REQUESTS FOR SPECIFIC COMMENTS

NASBA responses to the detailed questions included in the IAASB's explanatory memo accompanying the Proposal are set forth in this section. These responses provide additional context for NASBA's perspectives contained in the "executive summary" and include more specific and detailed observations relating to the various aspects of the IAASB's Proposal.

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?

NASBA supports the efforts of the IAASB to encourage the auditor to focus on disclosures throughout the audit and agrees with the approach taken to primarily focus on enhancing the application guidance rather than establishing additional requirement paragraphs.

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 statement audit?

Auditing of disclosures necessarily includes judgments regarding the accuracy, completeness and presentation of disclosures. NASBA is concerned that there is not sufficient guidance relative to the auditor's evaluation of non-quantitative misstatements to allow auditors to make consistent judgments about the completeness and presentation of disclosures. The current guidance in the ISAs is tailored toward quantitative misstatements, and there is no apparent guidance in relation to non-quantitative misstatements. It would be helpful to provide the auditor with guidance on evaluating non-quantitative misstatements, for example, when a non-quantitative misstatement might be identified as clearly trivial (i.e. when an entity does not disclose a loan covenant being in default, or when a related party transaction has not been disclosed), as well as guidance relating to when an auditor might report non-quantitative misstatements to those charged with governance.

NASBA's comments regarding specific paragraphs of the Proposal and recommendations to further enhance the requirements and application guidance and improve the effectiveness of auditing disclosures are included in Appendix B.

Further, in relation to the Preliminary Staff Publication, we appreciate and commend the efforts of staff to develop a mechanism for the IAASB to respond to issues in a timely manner and provide further assistance in the implementation of standards. As currently drafted, the Preliminary Staff Publication provides a thorough summary of the proposed changes to the ISAs and will be a helpful tool when the Proposal is finalized and the changes to the ISAs are disseminated throughout the literature. Additional consideration may be given to the most effective ways to provide additional assistance to auditors, for example, whether the Preliminary Staff Publication could be further expanded to provide additional examples to address issues that commonly arise with respect to disclosures.

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

As noted in the "executive summary", NASBA supports the IAASB's objectives with respect to the proposed changes to the assertions to encourage auditors to undertake audit procedures related to disclosures earlier in the audit; however, NASBA does have concerns about whether the proposed changes will achieve the intended result in practice.

NASBA is concerned that embedding the presentation and disclosure assertions within the assertions about account balances and classes of transactions and events actually results in placing less prominence on the assertions related to presentation and disclosures and may, in practice, de-emphasize the importance of the auditor's consideration of disclosures. Further, in some circumstances, it may be appropriate for the auditor to consider the disclosure assertion with the assertions about account balances or classes of transactions and events, for example, when auditing investments. However, in other instances, disclosures provide details beyond those matters pertaining to account balances or classes of transactions and events, for example, disclosure about material subsequent events that may affect a number of accounts.

NASBA also notes ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* (ISA 315), permits the auditor to use the assertions described or to express them differently, provided all aspects described have been covered. As a result, NASBA recommends that ISA 315 be clear that the presentation and disclosure assertions may be considered as part of the other assertions or that the presentation and disclosure assertions may be considered on their own. One way of achieving this objective would be to incorporate the changes in the current text of the Proposal, while at the same time also retaining the presentation and disclosure assertions as they exist in the extant ISAs. This would not only encourage the auditor to think about presentation and disclosure while auditing related account balances, but also continue to provide prominence to the presentation and disclosure assertions and encourage the auditor to stand back and think about presentation and disclosure separately.

APPENDIX B

COMMENTS ON SPECIFIC PARAGRAPHS

NASBA also has specific detailed comments and recommendations with respect to the Proposal as enumerated below. In these comments, recommended additional text is shown using **<u>bold underline</u>**; recommended deletions to the text is shown using double ~~strikethrough.~~

ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

<u>Paragraph A4:</u> NASBA recommends enhancing paragraph A4 (which discusses fraudulent financial reporting and management override of controls) in order to focus the auditor's attention on the fact that management could override controls with respect to disclosures. This could be achieved through the following modifications:

> A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding control using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances **<u>or not appropriately disclosing the assumptions and judgments used to estimate account balances.</u>**
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- **<u>Omitting disclosures required by the applicable financial reporting framework or misstating information that is disclosed.</u>**
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

<u>Paragraphs 15 and A11:</u> There is inconsistency between the requirement in paragraph 15 which refers to "financial statements" and the related application material in paragraph A11 which refers to "financial statements, including disclosures." As noted in the "executive summary," NASBA recommends using consistent terminology as such an inconsistency between the requirement and the application material may create some confusion. A similar inconsistency was identified in ISA 315, paragraphs 25 and A119.

ISA 260, Communication with Those Charged with Governance

<u>Paragraph A13:</u> NASBA recommends deleting the proposed additional language "and how they effect, for example, the overall presentation, structure and content of the financial statements, including the

relevance, reliability, comparability and understandability of the financial statements" in the fourth bullet point as such actions do not appear to be owned by those charged with governance. In addition, NASBA recommends adding a bullet point to incorporate "Changes to the entity's business and the effects thereof on the disclosures in the financial statements," such that paragraph A13 is as follows:

A13. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.
- The views of those charged with governance about:
    - The appropriate person(s) in the entity's governance structure with whom to communicate.
    - The allocation of responsibilities between those charged with governance and management.
    - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
    - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
    - Significant communications between the entity and regulators.
    - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters~~, and how they effect, for example, the overall presentation, structure and content of the financial statements, including the relevance, reliability, comparability and understandability of the financial statements~~.
- The responses of those charged with governance to previous communications with the auditor.
- Details of the documents comprising the other information that the entity intends to issue and when the documents are expected to be made available to the auditor.
- **<u>Changes to the entity's business and the effects thereof on the disclosures in the financial statements.</u>**

ISA 300, Planning an Audit of Financial Statements

<u>Paragraph A12b:</u> NASBA recommends adding an additional bullet point to the list in paragraph A12b [or to ISA 600] to consider the involvement of component auditors, as follows:

A12b. Consideration of disclosures early in the audit assists the auditor in giving appropriate attention to, and planning adequate time for, addressing disclosures in the same way as classes of transactions, events and account balances. Early consideration may also help the auditor to determine the effects on the audit of:

- Significant new or revised disclosures required as a result of changed in the entity's environment, financial condition or activities (for example, a change in the required identification of segments and reporting of segment information arising from the acquisition of a significant new subsidiary);
- Significant new or revised disclosures arising from changes in the applicable financial reporting framework;
- **The need for involvement of component auditors in relation to performing procedures on the disclosures to the group financial statements.**
- The need for the involvement of an auditor's expert to assist with audit procedures related to particular disclosures (for example, disclosures related to pension or other retirement benefit obligations).
- Matters relating to disclosures that the auditor may wish to discuss with those charged with governance

ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

Paragraph A89a: NASBA is concerned that the reference to "valuation reports by experts" in this paragraph may be confusing as experts in this context would ordinarily be understood to be third parties. It is not clear what the implication on the auditor is – does the auditor have an obligation to understand the information system the expert used to generate the information? Further, the amendment specifically refers to fair value information about items held at cost in order to emphasize the disclosure aspects, but equally this may be relevant to items actually recorded at fair value based on such information.

To remove the ambiguity, NASBA recommends rewording paragraph A89a as follows:

A89a. ~~Information in t~~**T**he financial statements may contain information from systems or processes that are not part of the general ledger system. These systems or processes may include:

- An entity's risk management system.
- Production of valuation **information** ~~reports~~ by **internal** experts, **or information extracted from reports produced by external experts,** relating to**, for example,** the disclosure of the fair value of an amount that is recorded on the balance sheet at cost.
- Models or other calculations used to develop estimates recognized or disclosed in the financial statements, including the underlying data and assumptions used in those models, for example, assumptions developed internally that may affect an asset's useful life, or that may be affected by factors outside the control of the entity, such as interest rate data.
- Sensitivity analyses derived from financial models to demonstrate that management has considered alternative assumptions.

Paragraph A124a: As noted in NASBA's response in Appendix 1, question 3, NASBA recommends retaining the presentation and disclosure assertions. Accordingly, NASBA recommends that this paragraph be deleted.

Paragraphs 5 and A1: Paragraph 5 requires the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of material misstatements at the financial statement and assertion levels. In the related application material, the fourth bullet point of paragraph A1 provides as an example, identifying areas of the *financial statements (including related disclosures)* [emphasis added] where special audit consideration may be necessary. The first bullet point of paragraph A1 provides the example, assessing risks of material misstatement of the *financial statements* [emphasis added]. Similar to our prior comments, NASBA believes consistent terminology should be used and questions whether, by inconsistently highlighting disclosures, confusion may be created.

ISA 320, Materiality in Planning and Performing an Audit

<u>Paragraph 6:</u> NASBA is concerned that the proposed revisions to paragraph 6 inappropriately change the intent of extant ISA 320, *Materiality in Planning and Performing an Audit* by focusing the auditor on non-quantitative disclosures only. NASBA believes the intent of the IAASB is to focus the auditor on both quantitative and non-quantitative disclosures. To achieve this, NASBA recommends reinstating extant paragraph 6 and adding a new sentence addressing non-quantitative misstatements at the end of the paragraph, such that revised paragraph 6 would be worded as follows:

> 6. In planning the audit, the auditor makes judgments about misstatements that will be considered material. These judgments provide a basis for:
>
> (a) Determining the nature, timing and extent of risk assessment procedures;
> (b) Identifying and assessing the risks of material misstatement; and
> (c) Determining the nature, timing and extent of further audit procedures.
>
> The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. <u>**Although it**</u>~~It~~ is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature<u>**,**</u>~~. However, consideration of the nature of potential misstatements in non-qualitative disclosures is relevant to the design of audit procedures to address risks of material misstatement. In addition, when evaluating the effect on the financial statements of all uncorrected misstatements,~~ the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence<u>**, when evaluating their effect on the financial statements. In addition, consideration of the nature of potential misstatements in non-quantitative disclosures is relevant to the design of audit procedures to address risks of material misstatement**</u>.

ISA 330, The Auditor's Responses to Assessed Risks

<u>Paragraphs 20 and 30</u>: Paragraph 30 requires the audit documentation demonstrate that the financial statements, *including disclosures*, agree or reconcile with the underlying accounting records [emphasis added]. However, the words "and information from systems or processes that are not part of the general ledger system" need to be included, in order to be consistent with the addition of such words in ISA 330, paragraph 20. Further, consistent with NASBA's overarching concerns highlighted in the "executive summary," NASBA recommends deleting the words "including disclosures" from paragraphs 20 and 30.

ISA 450, Evaluation of Misstatements Identified during the Audit

Paragraph A13: NASBA does not agree with adding "of and amount" in this paragraph as such change limits this paragraph to quantitative disclosures only and excludes non-quantitative disclosures. NASBA recommends paragraph A13 be worded as follows:

> A13. Each individual misstatement ~~of an amount~~ is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materially level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

ISA 700, Forming and Opinion and Reporting on Financial Statements

Another example of an apparent inconsistency in the use of terminology is the use of the terms "adequate disclosures" and "appropriate disclosures." NASBA noted that in many, but not all instances, "adequate disclosures" has been changed to "appropriate disclosures" in the Proposal. For the references to "adequate disclosures" that have not been changed, it is unclear whether this was intentional or not, for example, ISA 700, paragraph 13(a) refers to appropriate disclosures, whereas paragraphs 13(e) and A4 refer to adequate disclosures. In addition, we noticed that ISA 315, paragraph A30 refers to "adequate disclosure." Further, there are several other references to "adequate disclosure" or similar in the ISAs that are not addressed in the Proposal.[1] In addition, it is unclear whether the IAASB intends that there be a difference in work effort in the auditor's consideration of whether a disclosure is adequate compared with whether a disclosure is appropriate. As stated previously, NASBA recommends consistent terminology be used, and based on the many other references to "adequate disclosure" and similar phrasing within the ISAs, the IAASB may want to re-consider maintaining the use of that phrase throughout the Proposal

[1] See for example, ISA 510 paragraphs 3, 88, 11, 12; ISA 540, paragraphs 6, A120, A122, A123; ISA 570 paragraphs 19, 20, A26, among others.