Kathleen Healy
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15 September 2014

Dear Ms Healy

Exposure Draft – Addressing Disclosures in the Audit of Financial Statements

The Financial Reporting Council (FRC) welcomes the opportunity to comment on proposed changes to the International Standards on Auditing (ISAs) in the exposure draft "Addressing Disclosures in the Audit of Financial Statements" (the 'Exposure Draft').

Overall, conditional on our recommendations set out below, we are very supportive of the changes proposed in the Exposure Draft. Subject to refinement and clarifications as determined through due process, we strongly encourage the IAASB to finalise the proposed amendments to the ISAs as soon as possible.

As requested in the explanatory memorandum, we have provided responses to specific questions posed below. Our recommendation for editorial changes to the Exposure Draft is included in Appendix 1.

1. **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?**

We understand that the amendments proposed by the IAASB are intended to clarify the requirements in relation to the audit of disclosures in order to support the proper application of the requirements and enhance the auditor's focus on disclosures. The IAASB has also published a draft Staff Bulletin that when finalised would provide a more holistic view for auditors of how the audit of disclosures should be undertaken once the proposed changes to the ISAs were implemented.

Subject to our response to question 2, we strongly support the proposed changes to the ISAs, as an important first step in addressing the identified challenges relating to the quality of financial statement disclosures and their audit.

As explained further below, however, many of these challenges cannot be solved by amendments to the ISAs alone. In our response letter to the IAASB 2012 Discussion Paper '*The Evolving Nature of Financial Reporting: Disclosures and its Audit Implications'* (DP) we said that the challenges for auditors need to be considered 'hand in hand' with the challenges for preparers. For example, one key challenge is a lack of a disclosure framework to guide preparers in determining the nature and extent of disclosure that is appropriate. The development of such a framework is critical to preparers, audit committees and auditors alike in helping them make judgments about the relevance and materiality of individual disclosures and whether the financial statements as a whole contain the appropriate disclosures to achieve fair presentation.

We understand that the IAASB is collaborating with the International Accounting Standards Board (IASB) on its Disclosure initiative which includes considering 'Disclosure Principles' and the application of materiality. We strongly support the ongoing collaboration between the IASB and IAASB in this area.

However, despite the actions already taken, and continuing to be taken, by the IAASB, we anticipate that some stakeholders may question whether more should be done now with the existing suite of standards. Some stakeholders may want to see, for example, more in the requirements and some may still prefer to see the development of a new ISA addressing the audit of disclosures. Others may question whether the cost of implementing the proposed changes into audit firm methodologies and related training is justified, because they may perceive the proposed changes to be relatively minor compared to, say, the introduction of a new standard.

Our view is that, with the exception of the matter discussed in response to question 2 below, the requirements in the ISAs do adequately address disclosures in principle. We would not agree with those who believe that a separate ISA on disclosures is needed. A separate standard would result in repetition of requirements within the ISAs and would in our view risk implying that auditing disclosures is a separate exercise, rather than one that is integral to the audit.

We also would not share concerns about the cost of implementation relative to the likely benefits. Evidence from the responses to the IAASB's Discussion Paper suggests there are real issues to address in relation to disclosures and that changes in auditor behaviour could make a significant positive contribution to addressing them. The potential benefits are therefore substantial though of course immeasurable.

The ISAs already appropriately reflect a risk-based approach to disclosures in the audit and addressing disclosures should already be integrated into audit methodologies. We do not therefore believe that the costs of implementing changes to the firms' methodologies would be significant.

Any implementation costs of training and similar implementation activities to encourage auditors to understand and effect behavioural changes to respond to the proposed ISA changes would directly respond to the concerns raised by Respondents to the DP who called for a higher standard of professionalism and diligence in relation to the audit of disclosures. Indeed, in our view it is evident that the proposed changes to the ISAs are unlikely to influence auditor behaviour to the extent desired, without such implementation activities.

We believe that successfully changing auditor behaviours in this area is critical and will depend on effective implementation. The issuance of the IAASB Staff Bulletin will help because it will complement the changes and provide a more holistic view for auditors of how the audit of disclosures should be undertaken once the changes to the ISAs have been implemented.

We also propose that the IAASB should consider some further activity to support and encourage effective implementation. This could involve outreach to a number of national

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standard setters, and firms, about their intentions in implementing the proposed amendments respectively in national standards and firm audit methodologies to highlight the key behavioural changes intended to be achieved and to support them in doing so by enabling information about such activities to be shared internationally. This could also provide an early indication of whether other actions are needed to facilitate the successful implementation of the revisions to the guidance in the ISAs.

2. **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 statement audit?**

As indicated by many respondents to the DP, integral to the topic of disclosures is how the concept of materiality should be applied in relation to them. Many observed that making judgments about the appropriate disclosures to include in financial statements is a key challenge, for both quantitative and non-quantitative disclosures.

We note that the IAASB debated the need for a new requirement in ISA 320[1], under which the auditor would be required to make a preliminary determination of materiality for non-quantitative disclosures that could reasonably be expected to influence the economic decisions of users.

However, the IAASB determined it was not needed because such a change is intrinsically linked to some of the other issues identified in applying ISA 320 in practice. Instead, the IAASB have placed new application material addressing such considerations in ED ISA 315[2] (ISA 315.A128b) in the context of the auditor's risk assessment and response to risk for non-quantitative disclosures.

We do not agree with this conclusion. We believe that such a requirement should be added to ISA 320, for a number of reasons:

(a) ISA 320 is the standard that addresses the *application* of the concept of materiality in relation to planning and performing the audit. Although we support the proposed changes to ISA 320, without such a requirement, the ISA would remain largely focused on quantitative aspects of materiality when it is evident that many of the most challenging issues relate to non-quantitative aspects of disclosures;

(b) A requirement would be more effective than the proposed ISA 315 application material alone, in encouraging the auditor to reflect on the types of matters that may be material from a non-quantitative perspective earlier in the audit process. This would be consistent with the IAASB's aim to encourage an earlier focus on disclosures by the auditor;

(c) We believe it would also be more effective in encouraging dialogue about materiality judgements on non-quantitative disclosures between auditors, management and audit committees, and that this would contribute to a positive change in audit quality and the quality of financial statement disclosures;

[1] ISA 320, Materiality in Planning and Performing an Audit
[2] ISA 315(Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

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(d) It would respond more strongly to stakeholder concerns and signal that the IAASB believes this is a challenge that needs to be addressed urgently. This could encourage innovation by auditors to address these questions directly whilst the IASB takes forward its projects in this area in collaboration with the IAASB. They could, for example, engage with investors and other users of the financial statements about the impact of disclosures on their economic decisions to better understand what would be material to them. Greater engagement about these matters between auditors and investors could contribute positively to the IASB project on Disclosures.

We therefore propose that the IAASB should introduce a new requirement in ISA 320 as set out in the table below, with appropriate supporting application material.

<u>Considering Non-Quantitative Disclosures When Planning the Audit</u> <u>11a. The auditor shall make a preliminary determination of those non-quantitative disclosures, the misstatement of which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.</u>

3. Question 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?

We strongly support the proposed changes to the assertions. We are aware that respondents to the DP had noted that there was insufficient guidance on performing risk assessments on note disclosures. We believe the proposed changes to the assertions will meet some of the concerns of respondents. In addition, the changes will not only further promote earlier auditor focus on disclosures during the planning stage of the audit but will also improve consistency in application.

4. Responses to Questions on General Matters

(a) Preparers (including Small- and Medium-Sized Entities (SMEs)) and Other Users
(b) Translations
(c) Developing Nations
(d) Effective Date

We have no further comment on these matters.

5. Other Matters

Sources of Information for Disclosures, and Sufficient Appropriate Audit Evidence

As highlighted in the explanatory memorandum, the issues raised in response to the DP in relation to sufficient appropriate audit evidence for disclosures largely related to the nature of evidence that can be gathered for certain types of disclosures, for example, forward looking statements, descriptions of models used in fair value measurements, descriptions of risk exposures and other narrative disclosures.

Respondents to the DP acknowledged that such disclosures pose some of the most challenging aspects of preparing and auditing disclosures, often because of the availability of

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underlying evidence relating to these matters. In addition, some of the issues and concerns raised relating to sufficient appropriate audit evidence are not solely limited to disclosures, but also may be applicable to the audit of the underlying amounts recognised in the financial statements. We understand that similar issues were raised in response to the IAASB's post-implementation review of the Clarity ISAs.

In response, the IAASB have made a number of changes to the ISAs that impact the gathering of audit evidence. In addition to this, the IAASB suggested that further guidance on sufficient appropriate audit evidence for specific disclosures might be developed (ideally in tandem with the development of a Disclosure Framework by the IASB) and this would be considered by the IAASB as it finalises its future Strategy 2015–2019 and Work Program 2015–2016 later in 2014.

The IAASB's intention to enhance the audit procedures relating to disclosures through changes proposed in the Exposure Draft will improve the quality of disclosures through a more consistent and effective approach to auditing them. However, we believe that further consideration should be given to developing more specific guidance in relation to the most significant areas of concern around sufficient appropriate audit evidence.

We would therefore encourage the IAASB to consider the need for more specific guidance in this area, that has the appropriate level of authority, and we would urge the IAASB to ensure this action is taken forward in developing project plans as part of its Work Program for 2015–2016. For example, this may be possible in relation to issues concerning models for estimates if the IAASB decides to consider the need for changes to ISA 540 as part of the proposed project on Special Audit Considerations Relevant to Financial Institutions.

Materiality

In anticipation of the changes to the IASB's Conceptual Framework, some stakeholders have expressed the view that the description of materiality in ISA 320 paragraph 4 should be aligned with the Conceptual Framework or at least enhanced in a manner that will help auditors in their application of the concept of materiality to qualitative disclosures. One particular example cited is that the description could make explicit reference to the role of stewardship when referring to the economic decisions of users, as investor appraisals of management's stewardship help them to assess prospects for their investments. We do not suggest a full scale revision of ISA 320 paragraph 4 at this time. Instead, we encourage the IAASB to continue their close collaboration with the IASB in respect of the IASB's proposals to address materiality requirements as part of their Disclosures Initiative and the forthcoming revision of the Conceptual Framework and to consider changes to the ISAs in due course.

Yours sincerely

Nick

Nick Land
Director of the FRC and Chairman of the FRC's Audit & Assurance Council

Enquires in relation to this letter should be directed to Marek Grabowski, Director of Audit Policy

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APPENDIX 1

We have included our comments by paragraph or general point. Within our recommendations for editorial changes, additions are noted in "underline" and deletions in "strike-through."

Paragraph	Text
ISA 300.A12b	Proposed ISA 300.A12b makes reference to the potential involvement of an auditor's expert. For completeness we suggest this is extended to considerations where component auditor/management is involved in a group audit situation as follows: A12b Consideration of disclosures early in the audit assists the auditor in giving appropriate attention to and planning adequate time for…Early consideration may also help the auditor to determine the effects on the audit of:… • Matters relating to disclosures that the auditor may wish to discuss with the component auditor or component management in a group audit.
ISA 330.30	We suggest that the documentation requirement in ISA 330.30 should be consistent with the enhanced requirement in ISA 330.20: 30. The auditor's documentation shall demonstrate that the financial statements, including disclosures, agree or reconcile with the underlying accounting records, and information from systems or processes that are not part of the general ledger system.
Phrase "financial statements including disclosures"	It is not always clear why the IAASB have included the phrase "financial statements including disclosures" in some instances and not in others. For example, 315.A80 as compared to 315.A89 or 315.10. In addition "including disclosures" has been put in brackets in one instance (315.A119). As the IAASB finalise the proposed amendments, we suggest that a consistency check should be performed to ensure the two phrases are applied appropriately.
Obscure information and obscure significant information	ISA 450.A17a uses the word significant in relation to obscured information as follows: "obscure significant information". Whereas, ISA 240.A11 does not include the word "significant ("obscure information"). As the phrase "significant information" is not particularly prevalent in the ISAs, we suggest that the word "significant" is removed from ISA 450.A17a.
Audit Reporting Requirements	Notwithstanding our support for the IAASB's conclusion that the requirements in the current ISAs do adequately address disclosures in principle, there may be benefit in enhancing the requirement in paragraph 700.13 further by elevating certain aspects of the application material as follows: 700.13 In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:… (a) The financial statements appropriately disclose the significant accounting policies selected and applied, including consideration of the relevance of the accounting policies to the entity and the clarity

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Paragraph	Text
	with which they have been presened;

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