



Australian Government

Auditing and Assurance Standards Board

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1 June 2011

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

Dear James,

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

The Australian Auditing and Assurance Standards Board (AUASB) is pleased to have the opportunity to comment on the IAASB Discussion Paper on *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*. The AUASB is responsible for the formulation and issuance of Australian Auditing and Assurance Standards, and has no regulatory enforcement responsibilities or powers.

Overall, the AUASB supports the issues raised in the discussion paper as valuable to the future development of Auditing Standards. The AUASB believes that such material will be of benefit to all users and auditors of financial reports.

The AUASB has structured its response to the issues raised in two parts for the IAASB's consideration. The AUASB has included general comments only on the principles discussed in the Discussion Paper at **Attachment 1** to this letter. This is given the AUASB has no basis to comment on questions related to the regulatory enforcement of its Auditing Standards, nor on the financial reporting framework set out in Accounting Standards.

AUASB Australian constituent comments received in respect of questions that relate to practitioners have been collated by the AUASB and are attached as **Attachment 2** to this letter. Submissions were received by the AUASB from an open invitation posted on the AUASB website with an accompanying notification sent to AUASB website subscribers. The AUASB also recently hosted a "roundtable" discussion with approximately 20 constituents representing:

- Practitioners – small, medium and large-sized firms;
- The Australian professional accounting bodies; and
- Other relevant user groups.

Should you have any queries regarding this submission, please do not hesitate to contact either myself on +61 3 8080 7440 or email rmifsud@auasb.gov.au or Susan Fraser, Senior Project Manager on +61 3 8080 7437 or email sfraser@auasb.gov.au.

Yours sincerely,

Richard Mifsud
Executive Director

Attachments

**AUASB'S GENERAL COMMENTS ON THE IAASB DISCUSSION PAPER
THE EVOLVING NATURE OF FINANCIAL REPORTING: DISCLOSURE
AND ITS AUDIT IMPLICATIONS**

The evolution in the nature of financial reporting in recent times has led to a significant shift in financial statement note disclosures from those that simply support particular financial statement line items (quantitative disclosures); to note disclosures that describe detailed more qualitative aspects of the line items (quantitative disclosures).

The AUASB agrees with the Discussion Paper's premise that all financial statement note disclosures, regardless of their form, are capable of being audited. This is especially important within the Australian regulatory environment, where Auditing Standards issued by the AUASB (which conform to the ISAs) are legally enforceable under the Australian *Corporations Act 2001*. The notion of certain note disclosures within the financial statements being "not auditable" by auditors raises the prospect of auditors qualifying their opinions (on the basis of being unable to obtain sufficient appropriate audit evidence to support the disclosure), or at worst, not being able to form an opinion on the overall financial statements.

AUASB recommendations

1. The Discussion paper focuses on the auditability of note disclosures in financial statements required by the financial reporting framework, but does not cover other financial and/or non-financial information disclosed in documents containing or accompanying audited financial statements. Examples include management commentary within the annual report, director's report contents, alternative profit style disclosures (not in accordance with Accounting Standards) and transaction documents. This is also a significant area of issue for auditors and therefore is recommended to be considered as part of the Discussion Paper process.
2. Qualitative note disclosures requirements have grown substantially in number as more and more financial reporting frameworks throughout the world require entities to provide detailed explanations of the entity's historical and prospective financial circumstances. Although the ISAs (and in Australia, ASAs) contain requirements and guidance on how to evaluate qualitative note disclosures, it is not extensive, and the AUASB therefore recommends further guidance be developed and issued in this area.

The AUASB believes such additional guidance should assist auditors in how to address all aspects of the evaluation of qualitative note disclosures – including assessing their nature and risk, setting materiality (using measures other than traditional monetary levels), work effort required (audit procedures), type and level of sufficient appropriate evidence required, and evaluating identified misstatements. The benefit of this additional guidance is that it encourages consistency in how all auditors approach auditing qualitative note disclosures.

It should be noted that the AUASB considers the nature and extent of principles and procedures on auditing quantitative note disclosures within the ISAs (and ASAs) are appropriate, and, therefore does not see the need for further developments in this area at this time.

**AUASB'S AUSTRALIAN CONSTITUENT COMMENTS ON IAASB
DISCUSSION PAPER**

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

The following responses to particular questions have been formulated based on written submissions and comments received from Australian constituents at the AUASB's Roundtable Discussion. Given a majority of the attendees were audit practitioners, the questions selected for discussion were on the basis of their audit practitioner focus.

Section III – How Do ISAs Currently Deal with Disclosures?

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

Response:

No, Australian constituents were generally of the view that the ISAs do not presently provide sufficient requirements and guidance in respect of particular note disclosures. In particular, constituents believed that there is insufficient guidance on the following:

- *Performing a risk assessment for each note disclosure based on certain factors – including materiality, nature, impact on the financial statements as a whole, and users' perceived importance.*
- *What constitutes a material misstatement in the notes for both quantitative and qualitative based notes.*
- *How to apply professional judgement to determine the nature and extent of work required on qualitative note disclosures, taking into account their nature, whether they are directly (or indirectly) related to material financial statement line items, materiality thresholds, and issues on which users are perceived to focus.*
- *What constitutes sufficient appropriate audit evidence in relation to the different categories of financial statement disclosures (particularly judgements and reasons, assumptions/models/inputs, estimation uncertainty, descriptions of internal processes, and objective-based disclosures) that relate to sensitive and/or complex note disclosures. Examples include going concern, fair market value disclosures that involve the estimation of future conditions, estimation uncertainty, remuneration report, equity-accounted investments, management assumptions, bank lending qualitative disclosures, and forward-looking management statements.*
- *Applying the concept and measures of materiality to qualitative disclosures and the evaluation of misstatements.*

Section IV– Audit Issues Regarding Disclosures Required by a Financial Reporting Framework

Section IV discusses the implications of disclosures required by accounting standards. In particular, it explores the challenges in providing evidence to support some disclosures (paragraphs 59–78) and discusses the assessment of materiality and misstatements (paragraphs 79–101).

- 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 unauditible? 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.**

Response:

Yes, Australian constituents have experienced difficulty in obtaining sufficient appropriate audit evidence on note disclosures. Examples include:

- *estimation uncertainty (fair market value disclosures);*
- *going concern;*
- *remuneration report;*
- *equity-accounted investments; and*
- *“qualitative” notes such as management assumptions and estimates, financial instruments disclosures (for example credit risk, foreign exchange risk; bank lending disclosures), and forward-looking management statements.*

Constituents generally did not believe, despite the difficulties, that there are any current disclosures considered unauditible. It is the auditor’s responsibility to obtain sufficient appropriate audit evidence to enable them to form an opinion on the financial statements as a whole (including all note disclosures). What form that evidence takes is up to the auditor’s professional judgement in the engagement circumstances, bearing in mind the requirements in the Auditing Standards on the sufficiency (quantity) and appropriateness (quality) of evidence. For example, an auditor may rely on management’s acceptance of the written engagement letter and signed management representation letter to obtain evidence about complex areas such as the basis of significant accounting estimates.

If management is unable to provide evidence and documentation in support of a disclosure, the auditor may still be able to obtain sufficient appropriate audit evidence, depending on the type and nature of the note disclosure, however, it is acknowledged this could be difficult.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor then considers the note disclosure in terms of its materiality, and evaluates its misstatement potential in terms of the overall financial statements.

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

Response:

Australian constituents noted that the key issues with gathering audit evidence are the timeliness of the note disclosures being made available to auditors, the extent to which they are “boilerplate”, and the number of sensitive and/or qualitative note disclosures.

Timeliness of Note Disclosures being provided

Constituents commented that it is often the case that entities prepare and finalise note disclosures late in the reporting process, making it harder for the auditor to obtain sufficient and appropriate evidence within the required reporting time frame. This issue is exacerbated if the information within the note disclosure is sourced from a non-financial system used by management to record and report non-financial information (for example the risk management system).

Boilerplate disclosures

Constituents felt that management of some entities rely too much on published example financial statements to provide boilerplate note disclosure format and content, with auditors expected to advise necessary changes/additions to suit the entity’s particular circumstances. Other entities simply roll forward last year’s financial statement note disclosures, without considering current year implications. Management is also reluctant to remove unnecessary, out-dated, or irrelevant note disclosures because it is seen as easier to retain them rather than justify their removal. Rather than simply obtaining audit evidence to support the note disclosures, the auditor spends valuable audit time and resources “getting the note disclosures correct”. Management has advised auditors the reasons they follow this approach are that they believe the rate of change in the disclosure requirements of Accounting Standards are too difficult to keep up with, it is not a business imperative given the time and effort involved, and limited audience of people reviewing the financial statements. Hence management rely on the auditor (being technically proficient) to advise of required note disclosure additions/changes, including suggested wording.

Number of sensitive and/or qualitative notes

Constituents noted that the extent of work required on certain “sensitive” note disclosures (for example going concern, remuneration, auditor remuneration, related parties, contingent liabilities, credit risk, segment reporting, and commercially sensitive disclosures from a market or competitor perspective) and/or qualitative note disclosures are dependent on the auditor’s professional judgement, as there is no defined process for auditors to consistently follow. Each entity also has differing note disclosures required for their particular circumstances.

Constituents believe that more guidance is required on this process, particularly on what factors should be taken into account by the auditor when assessing the extent of audit work required for each type of note disclosure (that is how to apply materiality to note disclosures, how to conduct a risk assessment specifically for note disclosures).

Auditors pay more attention to quantitative note disclosures that are directly related to material financial statement line items (material) and “sensitive” note disclosures, with less attention given to note disclosures not directly related (immaterial) to financial statement line items.

Qualitative note disclosures (for example accounting policy and procedures, forward-looking statements, and credit worthiness policies) are assessed based on their nature (for example if they are “sensitive”) and potential impact on users of the financial statements.

Auditors obtain evidence to support material note disclosures, while immaterial note disclosures may have some audit work performed on them (for example, read for internal consistency between financial statement dollar values to the related note). Auditors ordinarily recommend to management that minor errors within the note disclosures be corrected to ensure the professionalism of the financial report (for example, prepayments in the financial statements are \$100, while the corresponding note disclosure has \$102).

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.**

Response:

Australian constituents believed that a material misstatement of a disclosure is a misstatement that individually or in the aggregate is reasonably expected to influence the economic decisions of users of the financial report. This may be due to the dollar size of the misstatement, its nature, the cause of the misstatement (for example error or fraud), its impact on other note disclosures or financial statement line items, or particular entity circumstances.

It was also noted that many auditors request immaterial note disclosure misstatements to be corrected by the entity before the financial statements are finalised, as these types of misstatements are deemed unprofessional to be overlooked in financial statements upon which the auditor opines. For example, if there is an inconsistency between the note

balance and the financial statement line item.

Constituents provided the following examples of material misstatements for the following categories of disclosure:

- *Judgements and reasons: erroneous going concern or related parties disclosure*
- *Assumptions/models/inputs: discount rates that are not supportable*
- *Sources of estimation uncertainty/sensitivity analysis disclosures: false or incomplete information on credit risk related disclosures*
- *Descriptions of internal processes: false or incomplete disclosure of financial instruments or credit risk policies*
- *Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis: inconsistent valuation techniques for property, plant and equipment*
- *Objective-based disclosure requirements: omitting disclosures on liquidity risk or segment reporting that the auditor deems relevant to the entity's circumstances; or incomplete auditor remuneration disclosures*

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?

Response:

Evaluation of Misstatements

Australian constituents noted that the evaluation of qualitative and quantitative misstatements is a very difficult area, as significant professional judgement is involved in the evaluation process. Adequate disclosures are therefore required to enable the intended users to understand the effects of material transactions and events on the information in the financial statements. Even if some misstatements are not evaluated as being material, they will still be requested by the auditor due to their nature (for example typographical errors). Constituents recommended some guidance be developed to assist auditors in consistently applying principles for the evaluation of note disclosures.

Constituents evaluated both qualitative and quantitative misstatements in accordance with the requirements and guidance in ISA 450 Evaluating Misstatements Identified during the Audit. In terms of evaluating whether the misstatements were material to the financial statements, constituents followed Auditing Standard ISA 320 Materiality in Planning and Performing an Audit – with disclosures being material if they individually, or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of financial statements. Evaluating individual quantitative misstatements is seen as a relatively straightforward process compared to qualitative

misstatements, as there are defined dollar value materiality levels against which such misstatements can be compared. Misstatements are also evaluated in aggregate with other accumulated misstatements to ensure that overall materiality is not affected. Note disclosures (regardless of whether they are quantitative or qualitative) that do not relate directly to a financial statement line item, and which are classified as “sensitive” notes are also evaluated for possible misstatements.

Accumulating Misstatements

Constituents noted it is very difficult to accumulate misstatements of qualitative and/ or judgemental note disclosures along with quantitative misstatements, because by their nature, they cannot be evaluated on the same basis (i.e. pre-set dollar materiality levels) and require the auditor to use considerable professional judgement and skill to appropriately evaluate their potential impact on the financial statements.

Prior Year Misstatements

Constituents felt that prior year’s disclosure misstatements might affect the evaluation of current year’s financial statements in two ways. Firstly, such misstatements help the auditor to identify particular note disclosures that require particular attention in the current year, and secondly, if it was an identified but uncorrected misstatement in the prior year, that the same misstatement does not occur in the current year.

Section V–Questions about Auditability

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

Response:

Australian constituents felt that while there are some note disclosures that are difficult to audit (i.e. obtain sufficient appropriate evidence to support), all note disclosure must be “auditable” if they are required to be included in the financial statements by the applicable financial reporting framework.

Constituents noted that “difficult to audit” note disclosures tend to have the following characteristics:

- *They are “sensitive” note disclosures to the entity (see examples noted in A5 response);*
- *They involve significant management judgements or assumptions made by the entity (for example going concern, segment information, estimation uncertainty; fair value, credit worthiness policy);*
- *They involve significant estimation uncertainty (for example property, plant and equipment impairment testing); and/or*
- *They contain subjective forward-looking statements (for example entity prospects, going concern).*

Many of these characteristics are found in “qualitative” note disclosures, as they are not dollar based, but are also found in “quantitative” note disclosures not directly related to a financial statement line item.

For a note disclosure to be un-auditable, constituents were of the view that this means the auditor is not able to obtain sufficient appropriate audit evidence to reduce risk, to an acceptably low level, that the note is not materially misstated. That is not to say that the auditor is unable to obtain some evidence, but that such evidence is judged not sufficient and appropriate to form a conclusion on the disclosure being materially correct.

As all information in a financial statement is required to be assessed by the auditor in forming an opinion on the financial statements as a whole, the inability of an auditor to obtain evidence supporting a particular disclosure could result in the qualification of the audit opinion. This could occur if the disclosure is deemed by the auditor to materially affect the financial statements as a whole (for example, so-called “sensitive” notes related to remuneration, contingent liabilities, credit risk, estimation uncertainty, fair value, segment reporting, and going concern).

It was also noted that the entity’s management does not tend to argue with auditors on note disclosures other than in respect of sensitive disclosures – so that if the auditor recommends a note disclosure change, it is usually made by management without any issues. This is perceived to be due to management not being as concerned with the note disclosures as the financial statements.

Constituents also believed that there is merit in IAASB and IASB working more closely to ensure that before an Accounting Standard requires the inclusion of a particular disclosure in an entity’s financial report that such disclosure is first evaluated for its “auditability”, and where they are considered difficult to audit, guidance is provided to auditors. Furthermore, they were of the view that there are some note disclosures, such as forward-looking statements and credit worthiness policies, required by Accounting Standards that should not be included in a financial report (for example the content of U.S Comfort Letters where auditors only audit items which are contained in the financial report and nothing else).
