

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



REQUEST FOR COMMENTS

The IAASB approved this Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*, for publication in January 2011. The responses to this Discussion Paper will be considered by the IAASB in its deliberations regarding the need for additional standards or guidance on disclosures.

Respondents are asked to submit their comments **electronically** through the IAASB website (www.iaasb.org), using the “Submit a Comment” link on the Exposure Drafts and Consultation Papers page. Please note that first-time users must register to use this new feature. All comments will be considered a matter of public record and will ultimately be posted on the IAASB website.

Comments can also be faxed to the attention of the IAASB Technical Director at +1 (212) 856-9420, or mailed to:

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Comments should be submitted by **June 1, 2011**.

Copies of this exposure draft may be downloaded free of charge from the IAASB website at www.iaasb.org.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance.

The objective of the IAASB is to serve the public interest by setting high-quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The structures and processes that support the operations of the IAASB are facilitated by IFAC. The mission of IFAC is to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession’s expertise is most relevant.

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

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Preface

Over the past decade, the nature of financial reporting has evolved to meet the changing needs of users. Business and capital markets have become more challenging, with greater complexity in business models, sources of risk and uncertainty, as well as greater sophistication in how risk is managed. This evolution reflects a desire for information that is relevant to users, even if such information may be more subjective and less reliable.

Financial reporting disclosure requirements and practices have also had to respond to these changes by shifting from simply providing breakdowns of line items on the face of the financial statements to providing more detailed disclosures, including disclosures of assumptions, models, alternative measurement bases and sources of estimation uncertainty, amongst others. In some ways, disclosures have become the balancing item in the calculus of how to provide credible, decision-useful information.

In light of these trends in the role and importance of financial statement disclosures, questions have arisen about how auditors should apply auditing concepts in obtaining sufficient appropriate audit evidence about financial statement disclosures to support their opinion on the financial statements as a whole.

This Discussion Paper (DP) is designed to help the International Auditing and Assurance Standards Board (IAASB) gain a robust understanding of views and perspectives on issues relevant to auditing disclosures in a financial statement audit. It explores a number of issues regarding financial statement disclosures and includes a series of consultation questions. The IAASB is aware that challenges in approaching disclosures do not affect just auditors. Preparers, investors, lenders, creditors, regulators and other users also need to consider their approaches to disclosures. Therefore, although this DP is focused on the implications for auditors, many of the issues are equally relevant for these stakeholders.

The DP begins with a discussion of recent trends in financial reporting and their impact on financial statement disclosures. It then discusses how the International Standards on Auditing (ISAs) currently deal with disclosures. The remainder of the DP focuses on audit issues that the IAASB has identified regarding disclosures required by a financial reporting framework.

The IAASB encourages all stakeholders to respond to this DP in order to assist the IAASB's deliberations on this important topic. Specific questions have been drafted for certain stakeholder groups and are shown at the end of this DP.

I. Introduction

Background

1. Over the past decade, the nature of financial reporting has evolved to meet the changing needs of users. Business and capital markets have become more challenging, with greater complexity in business models, sources of risk and uncertainty, as well as greater sophistication in how risk is managed. The financial services sector continues to grow in significance and has created new asset classes such as securitizations. Financial reporting has had to keep up with these changes, perhaps most significantly with more widespread use of fair value accounting, which often involves more complex and judgmental measurements. This shift reflects an underlying trend toward the provision of information that is relevant to users, even if such information may be more subjective and less reliable.
2. Financial reporting disclosure requirements and practices have also had to respond to these changes by shifting from simply providing breakdowns of line items on the face of the financial statements, to providing more detailed disclosures, including disclosures of assumptions, models, alternative measurement bases and sources of estimation uncertainty, amongst others. In some ways, disclosures have become the balancing item in the calculus of how to provide credible, decision-useful information.
3. All of these trends in financial reporting pose challenges not only for preparers who have to prepare and support these new disclosures, but also for investors in trying to discern the importance of the disclosed information when making decisions based on the financial statements, for accounting standard setters in forming judgments on the disclosures that should be required, and for auditors in determining how auditing standards and underlying concepts, such as materiality, apply to their consideration of disclosures in their audits of financial statements.
4. Under ISAs, auditors are required to address disclosures in planning and performing the audit, including identifying and assessing the risks of material misstatement at the assertion level for disclosures. Further, for financial statements prepared in accordance with a fair presentation framework, auditors are required to consider the overall presentation of the financial statements and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.
5. Recently, the role of auditors in relation to disclosures has been the focus of considerable attention. One element of this appears to have arisen in the context of the recent financial turmoil, and relates to perceptions regarding the auditor's efforts in relation to disclosures. Some recent reports have suggested that auditors need to use greater professional judgment and skepticism in approaching disclosures. It has also raised questions about particular challenges in obtaining sufficient appropriate audit evidence in relation to some disclosures, and even whether all disclosures are capable of being audited.
6. Against this background, the IAASB decided to issue this DP to explore the range of views and perspectives on issues relative to disclosures and the approaches of preparers and auditors. The IAASB encourages responses from all relevant stakeholders including preparers, investors, auditors, accounting standard setters and regulators.

7. The IAASB believes it is important that participants in this discussion articulate their underlying reasoning to properly inform the IAASB's deliberations. Stakeholders are encouraged to comment on the range of issues with financial statement disclosures to ensure that others, including the IAASB, have the opportunity to engage with different perspectives. To this end, the IAASB has prepared specific questions for preparers, investors, regulators and auditors, which are on pages 36–45. Stakeholders not falling into any of these categories are invited to respond to those questions they consider most appropriate.

Scope

8. This DP explores issues regarding note disclosures required by a financial reporting framework in the audit of financial statements. This DP does not discuss issues regarding the classification and presentation of line items on the face of the financial statements. The DP also does not cover other information in documents containing or accompanying audited financial statements.
9. While ISAs are neutral in respect of financial reporting frameworks, this DP has been prepared using the disclosures required by International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) as a frame of reference, although the issues raised are also valid for other financial reporting frameworks.
10. While this DP is written primarily from the perspective of auditors, many of the matters auditors need to consider in auditing disclosures are encountered first by preparers. The ISAs do not impose responsibilities on management, but an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged their responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework including, where relevant, their fair presentation. Thus, the preparation and presentation of the disclosures in the financial statements, and support for the assertions made in them, rests in the first instance with management.
11. Further, while stakeholders may have various views on the auditability of certain disclosures, this paper is prepared on the preliminary assumption that all disclosures required by a financial reporting framework are capable of being covered by the auditor's opinion on the financial statements. However, to respond to these views, Section V examines the auditability of certain disclosures and asks for input from stakeholders.
12. The IAASB has the following projects on its current work program that respond to the complexity in disclosures generally:
- A project to revise ISA 720¹ to consider whether the ISA continues to specify appropriate responsibilities of the auditor relating to the range of other information

¹ ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

in documents containing or accompanying the audited financial statements and the auditor’s report thereon – including disclosures made by the entity in, for example, their annual report that are beyond the requirements of the financial reporting framework.

- A project to consider user perceptions about the standard auditor’s report under ISA 700² as well as considering the wider context of information about auditor reporting from other relevant sources, including auditor reporting models used in countries where the auditor’s report reflects a different form and/or content than the ISA 700 report.

Also, representatives of the IAASB meet with representatives of the IASB on a regular basis to discuss recent financial reporting and auditing developments and to provide input on each other’s work programs. This is an important opportunity for the IAASB to provide an auditing perspective to the IASB on proposed financial reporting requirements.

Small- and Medium-Sized Entities (SMEs) Perspective

13. Disclosures are likely to be more challenging to prepare and audit when the business model and transactions of the entity are complex. As such, the issues regarding the auditing of disclosures in this DP will be relevant to entities and their auditors that have complex operations or financing, regardless of their size. Although some financial reporting frameworks for SMEs have less complex disclosure requirements, even under these frameworks, auditors of SMEs are likely to encounter auditing issues, particularly in respect of obtaining evidence that the disclosures are understandable, complete and relevant to the entity.

Public Sector Perspective

14. This DP is also relevant for the public sector as many public sector regulators base their financial reporting frameworks on the International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board (IPSASB), which encourage the disclosure of additional information on key issues such as the entity’s outputs, outcomes and compliance with laws and regulations. These additional public sector disclosures may be made in or outside of the financial statements, and may be within the public sector audit mandate.

² ISA 700, *Forming an Opinion and Reporting on Financial Statements*

II. Financial Reporting Disclosure Trends

This section raises issues about:

- Financial reporting disclosure trends;
- The increasing complexity of financial reporting disclosure requirements;
- Which categories of disclosures pose particular challenges for preparers and auditors; and
- The practical difficulties in preparing disclosures.

Increasing Length and Complexity of Financial Statement Disclosures

15. As discussed above, disclosures were once primarily related directly to further explanations of line items on the face of the financial statements. They included, for example, disclosures of accounting policies related to line items and breakdowns of those items into smaller categories for the purpose of enabling a user of the financial statements to understand the movements in balance sheet items. A significant theme of these disclosures was that the majority of them were derived from the accounting system and, as such, raised few specific audit challenges. Auditors would be able to largely address the risks of the financial statements being materially misstated due to disclosures via their audit work on the related line items. There were other types of disclosures but the predominant disclosure theme was directly related to the numbers in the financial statements.
16. As financial reporting has grown more complex, financial statements are now more likely to include a variety of disclosures in addition to the traditional disclosure items. For the purpose of this DP, the IAASB has identified the following categories of disclosures in contemporary financial statements:
 - Significant accounting policies—descriptions of the accounting policies adopted by the entity relevant to understanding the line items on the face of the financial statements and the basis of the accounting policies of the entity.
 - Components of line items—such as breakdowns of line items into smaller categories, movement analyses or other related information about a line item.
 - Factual information about the entity—such as addresses, names of group entities, composition of share capital and dividend payments.
 - Judgments and reasons—judgments made in the process of applying accounting policies and management decisions and reasons for the policies/decisions selected/made. Examples include disclosure of material uncertainties in relation to the going concern basis of accounting.
 - Assumptions/models/inputs—includes disclosures of material information relevant to the calculation of items in the financial statements, such as possible ranges of values, discount rates, effective interest rates and growth rates.

- Sources of estimation uncertainty/sensitivity analysis disclosures—these are disclosures to enable users to understand the underlying measurement variability of an item in the financial statements. An example is value at risk disclosures or other types of sensitivity analyses.
 - Descriptions of internal processes—disclosures such as risk management policies and practices. An example is the disclosure of the policies and procedures for managing financial instrument risks.
 - Disclosure of the fair value of an amount recorded on the balance sheet using a different measurement basis—such as a requirement to disclose fair values for items measured using another measurement basis such as historical cost or amortized cost, for example the requirement to disclose the fair value of reclassified financial assets.
 - Objective-based disclosure requirements—these are overarching requirements that set out the objectives of the disclosures to be provided rather than require specific disclosures. Thus, preparers are expected to provide additional disclosures when compliance with the specific disclosure requirements in a standard will be insufficient for users to be able to understand the impact of particular transactions, other events and conditions on the entity’s financial position and performance. See further discussion of this trend in paragraphs 29–33.
17. From the categories above it is clear that financial statements are now more likely to include a broad variety of disclosures, some of which may not be derived from the accounting system and may include more forward-looking information, disclosures of estimation uncertainty and models. The complexity of disclosures has also increased to deal with disclosures necessary to faithfully represent new and challenging subject areas such as financial instruments, business combinations and off-balance sheet financing.
18. As a result, the note disclosures in financial statements have increased significantly. One study of Annual Reports in the United Kingdom (U.K.) noted that they grew on average from 26 pages in 1965 to 75 pages in 2004, reflecting increases in both voluntary and mandated disclosures.³ Further, a recent Deloitte U.K. publication⁴ indicated that in 1996 the average length of a U.K. Annual Report was 44 pages, whereas in 2010 it grew to 101 pages. This increasing length and complexity of disclosures has drawn the attention of many parties in the financial reporting supply chain. For example:

Many people point to the increasing length and detail of annual reports—and the regulations that govern them—as evidence that we have a problem. Others are more worried that reports no longer reflect the reality of the underlying businesses, with key messages lost in the clutter of lengthy disclosures and regulatory jargon.⁵

³ Beattie, V. and Dhanani, A. “Investigating Presentation Change in U.K. Annual Reports.” *Journal of Business Communication*, Volume 45, 2 (April 2008), pp.181–222.

⁴ Deloitte, *Swimming in Words: Surveying Narrative Reporting in Annual Reports* (London: Deloitte, October 2010).

⁵ Financial Reporting Council, *Louder than Words* (London: FRC, June 2009), p. 2.

19. One response by accounting standard setters to the challenges with disclosures has been efforts to develop a framework for disclosures. Such a framework would assist accounting standard setters in developing consistent, logical and balanced disclosure requirements. They would also assist preparers in the judgments that need to be made in applying disclosure requirements in practice. Projects have been initiated by, for example, the European Financial Reporting Advisory Group,⁶ the Financial Accounting Standards Board (FASB)⁷ in the United States (U.S.) and the Canadian Accounting Standards Board.⁸

The Blurring of the Boundaries of Financial Reporting

20. There are discussions underway in a number of forums about the boundaries of financial reporting. Some argue that information that is relevant to investors extends beyond the traditional boundaries of financial statements, and there is, at least for some, a growing interest in the concept of integrated corporate reporting⁹ across a broader range of performance information.
21. There has already been some blurring of the boundaries of the traditional financial statements. For example, under IFRSs certain mandated disclosures can be presented outside of the financial statements in a document that is made available on the same terms as the financial statements and at the same time with cross references from the financial statements to that information.¹⁰ There are also some jurisdictions that permit cross-references of certain disclosures, such as directors' and executives' compensation disclosures, to documents outside of the financial statements. This blurring of the boundaries may be to avoid duplication of disclosures and to avoid adding to the length of financial statements when disclosures are already being made elsewhere in some cases. Accounting standard setters have also shown an interest in addressing aspects of corporate reporting beyond the traditional financial statement format, such as the management commentary.¹¹

⁶ www.efrag.org/projects/detail.asp?id=169

⁷ www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156344894

⁸ www.acsbcanada.org/projects/completed-projects/item18119.aspx

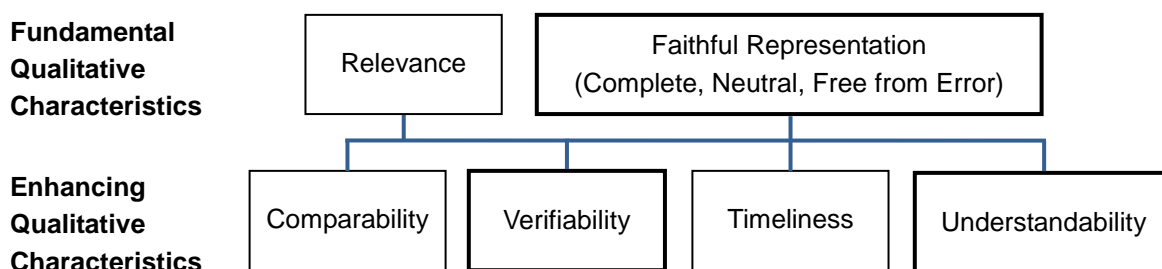
⁹ See, for example, the recent launch of the International Integrated Reporting Committee (www.integratedreporting.org/). Integrated reporting is described as “a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format—put briefly, in an “integrated” format. The intention is to help with the development of more comprehensive and comprehensible information about an organization’s total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model.”

¹⁰ IFRS 7, *Financial Instruments: Disclosures*, paragraph B6

¹¹ For example, the IFRS Practice Statement, *Management Commentary*, issued in December 2010, notes that the management commentary is a type of financial reporting, even if it is not included in the financial statements.

Developments in the Conceptual Framework of Accounting Standards

22. It has been suggested that part of the reason for the increasing length and complexity of financial statements may be that accounting standard setters have increasingly emphasized the fundamental qualitative characteristic of relevance over reliability. Indeed, the qualitative characteristic of “reliability” that used to be one of the principal qualitative characteristics of financial information in the IASB *Conceptual Framework for Financial Reporting* (the IASB Conceptual Framework) has been replaced by the characteristic of “faithful representation.” In September 2010, the IASB issued an update to the IASB Conceptual Framework that included an update on Chapter 3 *Qualitative characteristics of useful financial information*. The updated Chapter 3 includes a hierarchy of qualitative characteristics (see Figure 1 below). Reliability is no longer mentioned. It has been replaced by faithful representation, which requires three sub-characteristics: complete, neutral and free from error.¹² Verifiability, which might have been considered as similar to reliability, is identified as an enhancing characteristic. In the revised IASB Conceptual Framework, although enhancing characteristics are expected to be maximized to the extent possible, they are not sufficient on their own, in that they cannot make financial information useful that is not both relevant and a faithful representation.

Figure 1: Hierarchy of Qualitative Characteristics

23. Given the new emphasis on faithful representation some argue that, in some circumstances, the disclosures about the line item may become at least as important, if not more useful, to users as the number on the face of the financial statements. The disclosures are necessary to inform users about judgments and assumptions made in the measurement of the line item, reasons for the judgments, facts, circumstances and the measurement uncertainty related to that line item. In effect, the disclosures in these cases are being used to achieve balance between the principles of relevance and faithful representation.

24. In paragraph QC15, the IASB Conceptual Framework states:

Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For

¹² IASB, *The Conceptual Framework for Financial Reporting* (London: IASB, September 2010).

example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

25. Also important is the enhancing characteristic of verifiability, which (see paragraph QC26):

... helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

26. There are some who have expressed concern about the fact that less emphasis is being placed on reliability. For example, the Institut der Wirtschaftsprüfer (IDW) issued a concept paper in 2007 outlining further steps the IASB should take in regard to the IASB Conceptual Framework. A particular focus of the paper was the need for proper consideration of management's need to have accounting evidence to support their judgments. Amongst other matters, the paper highlights that the move away from reliability in the IASB Conceptual Framework may make it difficult for management to assemble appropriate accounting evidence and documentation:

The reliability of accounting processes and evidence, together with its verifiability, may also have a significant impact on the consistency with which IFRSs are applied at an international level.¹³

27. Two other aspects of the revised IASB Conceptual Framework may be particularly relevant when thinking about disclosures. The sub-characteristic of neutrality requires management to ensure that the financial statements are free from bias. This helps to ensure that the financial statements are a neutral depiction of the economic phenomena and are not "slanted, weighted, de-emphasized or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably."¹⁴ This may be particularly relevant when considering how qualitative disclosures are written.
28. The IASB Conceptual Framework also recognizes that financial information is enhanced if it is "understandable," which is recognized as another of the enhancing qualitative characteristics. The IASB explains:

Classifying, characterizing and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. At times, even well-informed and diligent

¹³ Institut der Wirtschaftsprüfer. *Additional Issues in Relation to a Conceptual Framework for Financial Reporting* (Düsseldorf: IDW, September 2007), paragraph 4.

¹⁴ The IASB Conceptual Framework, paragraph QC14

users may need to seek the aid of an adviser to understand information about complex economic phenomena.¹⁵

The Prevalence of Objective-Based Disclosure Requirements

29. One of the themes of recent accounting standard-setting activities has been the increased use of objective-based disclosure requirements in addition to specific disclosure requirements. For example, paragraph 7 of IFRS 7 states:

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Further, paragraph 31 of IFRS 7 has a similar requirement in respect of the nature and extent of risks arising from financial instruments that the entity is exposed to at the end of the reporting period. Paragraph B3 of IFRS 7 gives some guidance on what level of detail to provide:

An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Similarly, paragraphs 69–71 of IASB ED/2010/6, *Revenue from Contracts with Customers*, requires:

To help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, an entity shall disclose qualitative and quantitative information about its contracts with customers and the significant judgments, and changes in judgments made in applying the [draft] IFRS to those contracts ...An entity shall consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements ...If the disclosures provided in accordance with this [draft] IFRS and other IFRSs do not meet the objective [above], *an entity shall disclose whatever additional information is necessary to meet that objective*. [Emphasis added]

30. These objective-based disclosure requirements create particular challenges for preparers. They must “stand back” from the financial statements and evaluate whether sufficient disclosures have been made. This is a highly judgmental process and it may be difficult for management to substantiate how they complied with these types of disclosure requirements.
31. Also, these disclosure requirements emphasize providing users with decision-useful information, though this may come at a cost to consistent, comparable information. An entity may reasonably decide to show a disclosure one year to comply with an objective-

¹⁵ The IASB Conceptual Framework, paragraphs QC30–32

based disclosure requirement, but may not make the same judgment in a subsequent year. This could cause challenges for users who may look to compare disclosures over time. An entity in a particular industry may also make judgments about the disclosures that are particularly relevant in the circumstances of that entity. However, this may result in entities in the same industry not including the same disclosures. While that fact in and of itself might yield useful information to users, it is at a cost of less comparability and consistency which other users—and regulators—might value more.

32. While not directly commenting on objective-based disclosure requirements, the comments of the FASB¹⁶ on the effect of moving to principles-based financial reporting are useful guidance for all stakeholders in assessing the judgment needed for these types of disclosure requirements:

Preparers and auditors would need to apply professional judgment in more circumstances, while the SEC, investors, creditors and other users of financial information must accept the consequences of applying professional judgments, including some diversity in practice.

33. A response to concerns that the emphasis on judgment comes at the cost of consistency has been calls for the development of a framework for the application of judgment. A judgment framework would be “a set of principles, guidelines or good faith thought process that enable decision-makers to consider a situation holistically and drive more consistent decision-making.”¹⁷ Such a framework could assist preparers, auditors, regulators and investors in understanding how to organize their analysis and what factors should influence judgments.¹⁸

Observations Regarding Disclosure Preparation

34. The IAASB’s outreach activities touch on many parts of the financial reporting supply chain, including preparers, regulators, auditors, investors and standard setters. Discussions with auditors and preparers have also uncovered some practical realities in relation to the preparation of the disclosures in the financial reporting process that may be relevant as issues regarding the expectations of auditors in relation to disclosures are explored.
35. Most audit firms prepare disclosure checklists or illustrative financial statements. Many preparers welcome such practice aids because they assist preparers in complying with the disclosure requirements. However, a counterargument is that the checklists and illustrative examples could be criticized for encouraging unnecessary disclosures, as preparers do not want to omit any required disclosures.
36. Further, in practice, it is common for disclosures, once added to the financial statements, to remain in the financial statements—even if management judges them to be immaterial in future years—and for there to be a reluctance to change the approach to and content of

¹⁶ Financial Accounting Standards Board. *Proposal for a Principles-Based Approach to U.S. Standard Setting* (Norwalk: FASB, October 2002).

¹⁷ Barrow, Shirley, *Judgment Sustained* (New York: Deloitte, January 2010).

¹⁸ Securities and Exchange Commission. *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (Washington: SEC, August 2008), p. 91.

a disclosure once it has been developed (for example, in response to a new accounting standard). While this may assist trend analyses by users, it can be an impediment to continuous improvement.

37. Another common observation from practice is that disclosures are often prepared late in the financial reporting process. This is because the financial statements flow from the accounting system, which is the focus of attention throughout much of the year. Disclosures are usually prepared based on a separate process, and increasingly are derived from information technology (IT) systems which are not connected to the accounting system, such as risk management systems. Further, detailed disclosures are often not required for preliminary announcements to stock exchanges, and so the pressure to prepare them early is reduced.
38. As a consequence, even where the process for preparing the financial statements themselves is well-organized and structured, the process for preparing disclosures is usually less formal and less structured. In order to meet the filing deadline within the short period of time, entities are usually rushing to finish the process, and so there is a disincentive for both preparers and auditors to make any changes to disclosures, including deletions of disclosures that might now be considered to be immaterial.¹⁹ Of course, the next year's disclosures begin again with the previous year's disclosures, meaning that any inadequate consideration of the materiality of disclosures and the understandability of the financial statements as a whole may not be reexamined in subsequent years.
39. In some circumstances, particularly in relation to SMEs, management may be relatively unfamiliar with the disclosure requirements and the auditor may provide advice on disclosure requirements.
40. A positive development has been the creation of disclosure committees at some of the larger U.S. listed entities in response to a U.S. Securities and Exchange Commission (SEC) recommendation.²⁰ The SEC adopted rules regarding disclosure controls and procedures and recommended that entities establish a disclosure committee of officers and senior management to supervise the disclosure process.
41. Another source of practical experiences is the results of interviews conducted by the U.K. Financial Reporting Council (FRC), which made the following observations²¹ regarding the reasons for including immaterial disclosures:
 - Due to time pressures, preparers simply repeat disclosures made in prior years rather than considering whether they are still material

¹⁹ One perspective on this issue comes from a recent report (FRC, *Louder than Words*). The view of the U.K. FRC was that auditing standards, by requiring communication by auditors of detected errors, including omissions of material disclosures, to management, may actually result in an increase in disclosures. This is because management finds it time-consuming to debate the materiality of disclosure omissions and so err on the side of including disclosures they consider material.

²⁰ SEC Rule 33–8124, *Certification of Disclosure in Companies' Quarterly and Annual Reports*.

²¹ FRC, *Louder than Words*, p. 42.

- Lack of confidence in making the judgment between disclosures that are material and those that are not
- Just as much work being required to conclude on materiality as to prepare the disclosure
- Desire to avoid lengthy debates with the auditors
- Following the leader: if another company makes a disclosure, it can influence others to follow
- Fear that a missing disclosure will be challenged by regulators

III. How Do ISAs Currently Deal with Disclosures?

42. ISAs are directed to an audit of financial statements and expressing an opinion on the financial statements as a whole. They recognize the role of disclosures in performing risk assessments and developing responses to assessed risks, gathering and evaluating audit evidence, forming the auditor’s opinion on the financial statements, including (where applicable) their fair presentation, and communicating with users of financial statements, management and those charged with governance. In Appendix 1 to this DP, there is a summary of the key requirements of relevant ISAs on the topic of disclosures. In addition to these key requirements, ISAs often refer to “classes of transactions, account balances and disclosures” when describing the auditor’s responsibilities in many areas, indicating that disclosures are treated in the same way as classes of transactions and account balances in the application of many auditing requirements.

43. In addition, the definition of a misstatement deals with misstatements in disclosures in the same way as misstatements in classes of transactions or account balances. A misstatement is defined as:²²

A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor’s judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

44. ISAs are predicated on a risk-based approach, where an auditor obtains an understanding of the entity and its environment and identifies and assesses the risks of material misstatement at the assertion level. Disclosures are a key part of this process. The following assertions are identified in the ISAs regarding disclosures:

- Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

²² ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(i)

- Completeness—all disclosures that should have been included in the financial statements have been included.
 - Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
 - Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.²³
45. It is worth noting that, while many of the assertions above are also relevant for classes of transactions and account balances, there are some important differences. The explanations of the assertions have been tailored to presentation and disclosure and, also, the assertion of understandability is unique to presentation and disclosure.
46. ISA 320 requires, in addition to the auditor determining the materiality for the financial statements as a whole, that if, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor is also expected to determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.²⁴ ISA 320 describes factors that may be relevant in determining if a lower level of materiality is needed for particular disclosures, such as whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).²⁵
47. The ISAs include specific requirements and guidance related to the consideration of particular disclosures in several standards including, for example, ISA 540²⁶ and ISA 550.²⁷ ISA 540 is of particular relevance because it contains specific requirements for the auditor to obtain sufficient appropriate audit evidence about the reasonableness of accounting estimates and related disclosures including evaluating the adequacy of the disclosure about estimation uncertainty. The IAASB also recently released an exposure draft of IAPS 1000²⁸ that highlights considerations in auditing the disclosures regarding complex financial instruments, amongst other matters.

²³ ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph A111(c)

²⁴ ISA 320, *Materiality in Planning and Performing an Audit*, paragraph 10

²⁵ ISA 320, paragraph A10

²⁶ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

²⁷ ISA 550, *Related Parties*

²⁸ Proposed International Auditing Practice Statement (IAPS) 1000, *Special Considerations in Auditing Complex Financial Instruments*, available at www.ifac.org/Guidance/EXD-Details.php?EDID=0143

48. ISAs require auditors to make a number of judgments about disclosures when forming an opinion on the financial statements. These include:
- Evaluating whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework;
 - Evaluating misstatements, including misstatements of disclosures, both individually and in aggregate; and
 - Evaluating whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
49. One of the characteristics of a fair presentation framework is the requirement to add disclosures in order to give a true and fair view. A key requirement of the ISAs is that, when the financial statements are prepared in accordance with a fair presentation framework, the auditor evaluates whether the financial statements achieve fair presentation in view of the overall presentation, structure and content of the financial statements and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.
50. Disclosures are also included in ISA requirements related to communication. Financial statement disclosures are given as an example of matters the auditor may communicate with those charged with governance, particularly in regard to sensitive disclosures and the overall neutrality, consistency and clarity of disclosures. If the financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, then the auditor is required to discuss the matter with management and determine if it is necessary to modify the opinion.²⁹
51. When considering the effect of a material misstatement on the auditor's report, the auditor considers whether the effect on the financial statements is pervasive. Pervasive effects include disclosures that are, in the auditor's judgment, fundamental to users' understanding of the financial statements.³⁰ If there is a material misstatement of the financial statements that relates to the omission of information required to be disclosed, the auditor is required to discuss the omission with those charged with governance, describe in the basis for modification paragraph the nature of the omitted information and, unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

²⁹ ISA 700, paragraph 18

³⁰ ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 5(a)

IV. Audit Issues Regarding Disclosures Required by a Financial Reporting Framework

Overview

52. The auditor's consideration of an entity's financial statement disclosures in an audit of financial statements raises questions regarding:
- What constitutes sufficient appropriate audit evidence in relation to different categories of financial statement disclosures; and
 - How to apply materiality to, and evaluate misstatements in, disclosures.
- Within each of these areas there are different perspectives and issues which deserve attention from the IAASB and its stakeholders.
53. Although this DP is based on the premise that all disclosures are capable of being audited, there are perceptions that not all disclosures required by financial reporting frameworks are capable of being audited. The IAASB is aware of two perspectives on what is meant by auditability: (1) whether an auditor can apply procedures to reduce the risk of material misstatement; or (2) whether information is so imprecise that an auditor cannot increase the credibility of the information. Section V discusses the differing perspectives about the auditability of disclosures.
54. This section, however, begins by examining the auditor's opinion on the financial statements as a whole, and then deals with the key questions about what constitutes sufficient appropriate audit evidence and how to deal with materiality and misstatements in respect of disclosures.
55. It is important to recognize that the objective of the auditor is not to form an opinion on each individual disclosure in the financial statements. ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. Auditors are looking for sufficient appropriate audit evidence to enable them to draw reasonable conclusions on which to base an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.³¹ Therefore, the gathering of sufficient appropriate audit evidence on classes of transactions, account balances and disclosures is a part of this process and not an end in itself. This may introduce a different perspective on the question of what constitutes sufficient appropriate audit evidence with respect to some disclosures.
56. ISAs require auditors to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels, including for disclosures. As many disclosures relate to specific line items, consideration of the risks of material misstatement at the assertion level for disclosures may often be done at the same time as, and in conjunction with, the related line item. Furthermore, audit evidence obtained in the process of performing procedures in response to the identified assessed risks of material misstatement for the related

³¹ ISA 500, *Audit Evidence*, paragraph 4

account balances or classes of transactions may be used for auditing the related disclosures.

57. However, as noted earlier, one of the trends in financial reporting is disclosure of information that provides context to specific line items, or the financial statements more broadly, but may not be derived from the accounting system. Therefore, the identification and assessment of the risk of material misstatement for these disclosures will necessitate a separate exercise. Further, the identification and assessment of the risk of material misstatement in relation to the assertion of understandability appears to require separate consideration.
58. One challenge is that disclosures may be prepared late in the financial reporting process and may be produced using less formal procedures. This may make it difficult for auditors to perform at least some of the risk assessment procedures until closer to the end of the financial reporting process and the risk assessment process may also be less formalized.

What Does Sufficient Appropriate Audit Evidence Mean for Disclosures?

This section on sufficient appropriate audit evidence (SAAE) raises issues about:

- Appropriate support for management’s consideration of disclosures and the auditor’s ability to provide assurance depending on management’s support for their disclosure;
- SAAE for different types of disclosures; and
- The impact of the changes in the IASB Conceptual Framework, such as the inclusion of “faithful representation” instead of “reliability.”

Different Views about Sufficient Appropriate Audit Evidence

59. ISA 200 requires an auditor to obtain SAAE to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion.³² Sufficiency is a measure of the quantity of audit evidence and is affected by the auditor’s risk assessment and the quality of audit evidence.³³ Appropriateness is a measure of the quality of audit evidence and is influenced by its source and by its nature.³⁴
60. Different issues about audit evidence arise with different types of disclosures. Paragraphs 61–70 give examples of the audit evidence issues that arise with different types of disclosures – some of them directly related to a line item from the face of the financial statements and others which are not directly related to any particular line item. Several examples are provided below:
 - A note disclosure for the property, plant and equipment asset (see paragraph 61);

³² ISA 200, paragraph 17

³³ ISA 500, paragraph A4

³⁴ ISA 500, paragraph A5

- An operating segment disclosure (see paragraph 62);
 - A disclosure related to a line item that is reflected in the financial statements at fair value (see paragraph 63);
 - A disclosure of the fair value of a line item recorded on another basis, such as amortized cost (see paragraph 64);
 - A proposed disclosure of stress test information (see paragraphs 65–66);
 - Disclosures which mention an internal control, contain forward-looking information or express an intention of management (see paragraph 67); and
 - An objective-based disclosure requirement (see paragraph 70).
61. The note disclosure for the property, plant and equipment asset is largely derived from the accounting system. The evidence regarding the amounts included in the related note disclosures, such as categories of property, plant and equipment and related amortization, will often be obtained in the course of auditing the assertions for the related line item rather than as a separate evidence gathering exercise.
62. Similarly, the auditor obtains some of the evidence regarding the information in operating segment disclosures in the process of obtaining evidence on the full financial statements. Importantly, ISA 501³⁵ clarifies that the auditor is not expected to obtain the audit evidence that would be needed if expressing an opinion on each segment individually, as the auditor’s work on the segment disclosure is in the context of the financial statements as a whole. ISA 501 states in paragraph A26:
- The auditor’s responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.
63. A note disclosure supporting a line item recorded at fair value extends to describing the judgments, assumptions and model, if any, used. Therefore, the auditor seeks audit evidence about whether the disclosure is an accurate portrayal of the basis for the calculation of the fair value, recognizing that the disclosure is an integral part of the presentation of the related financial statement amount. The auditor’s focus is more on whether the disclosure conveys the appropriate information relevant to the preparation of the related financial statement amount (for example, the model used, the assumptions applied or the sensitivity analysis performed). This is not simply checking that the disclosure is an appropriate reflection of the process followed in preparing the fair value, because the reasonableness of assumptions and methods needs to be evaluated in obtaining sufficient appropriate audit evidence regarding the recognition and measurement of the related financial statement amount.
64. By contrast, a disclosure in the notes to the financial statement of a fair value of an item recorded on the face of the financial statements on a different measurement basis, such as

³⁵ ISA 501, *Audit Evidence—Specific Considerations for Selected Items*

amortized cost, raises different questions. This situation arises, for example, in accounting for certain financial assets under IFRSs. In that circumstance, a question arises as to whether the auditor seeks the same amount of evidence about the fair value amount as they would on the line item on the face of the financial statements.

65. Even more questions arise when the required disclosure provides context for, but is not derived from, the related financial statement amounts, for example, in the IASB's proposed stress test disclosure in ED/2009/12, *Financial Instruments: Amortized Cost and Impairment*. That ED provides an example of a disclosure which would not be related to any particular line item. The proposed disclosure is:
20. If an entity prepares stress testing information for internal risk management purposes it shall disclose that fact and information that enables users of financial statements to understand:
 - (a) the implications for the financial position and performance of the entity; and
 - (b) the entity's ability to withstand the stress scenario or scenarios.
66. For such a disclosure,³⁶ there are two views on what audit evidence is needed:
- (a) The first approach is that the auditor only needs to obtain evidence about whether the disclosure properly describes the process the entity followed in performing the stress test and the outcomes of that test (that is, whether it is an accurate description of the stress testing that was performed); or
 - (b) The second approach is that the auditor needs to obtain evidence as to whether the stress test was, in fact, appropriately performed (which would require suitable criteria that are available to intended users, such as direction from regulators on the parameters of the entity's stress testing, or other expectations of how such a stress test should be performed), whether the reported outcome of the test is appropriate in the entity's circumstances, and whether the disclosure properly describes the process the entity followed and its outcome.
67. Another disclosure that helps illustrate this difference is a disclosure, such as a risk disclosure required under IFRS 9,³⁷ which includes a description of an internal control. For such a disclosure, questions arise as to whether the focus of the auditor's work is on whether the description of the control is accurate or whether the auditor is expected to test that the internal control is also operating effectively. Further, some disclosures relate to explanations of management intent and, as the interpretation of the evidence for intentions is likely to be subjective and may not be verifiable using external data, it poses a question about what evidence auditors are expected to obtain. Similarly, other disclosures are forward-looking and the evidence is likely to be limited to management's own process for determining the disclosure, with limited external evidence to provide confirmation or contradiction.

³⁶ See IASB ED/2009/12, *Financial Instruments: Amortized Cost and Impairment*.

³⁷ IFRS 9, *Financial Instruments*

68. The ISAs acknowledge circumstances when the auditor may obtain evidence by testing the process management has followed to prepare information. For example, ISA 540 identifies “testing how management made the accounting estimate and the data on which it is based”³⁸ as one of the four methods to obtain evidence in response to a risk of material misstatement in an estimate. With this method, auditors also evaluate whether the assumptions used by management are reasonable.
69. However, others are concerned that users of the financial statements may not understand that evidence obtained regarding the process of preparing the financial statement amount would be of a different nature to evidence obtained with respect to other disclosures in the financial statements. Users may not fully understand that, while some disclosures can enhance users’ understanding of the nature of inherently uncertain financial statement amounts, they cannot make that information more reliable (i.e., disclosures cannot reduce inherent measurement uncertainty), nor will auditing the disclosures reduce inherent measurement uncertainty. Also, the auditor’s responsibility under ISAs is to consider the risks of material misstatement at an assertion level, meaning that the auditor must consider all applicable assertions.
70. The final example is an objective-based disclosure requirement in which management is required to make its own judgment on how much to disclose in relation to specific financial statement items.³⁹ As the disclosure requirement is open-ended, the question arises as to what constitutes SAAE as to whether the entity has met the objective-based disclosure requirement.

The Role of Professional Skepticism

71. Closely related to the topic of sufficient appropriate audit evidence are calls for an examination of the use of professional skepticism. The U.K. Financial Services Authority (FSA) and FRC stated:
- ... we stress the importance of auditors applying a high degree of professional skepticism when examining key areas of financial accounting and disclosure which depend critically on management judgment. Both the FSA and the FRC believe auditors need to challenge management more. Arising from its more intensive approach to supervision, the FSA has questioned whether the auditor has always been sufficiently skeptical and has paid adequate attention to indicators of management bias. Although the difference between the FSA’s view, what management has done and the auditors have accepted may not be material to whether the financial statements are fairly stated overall, there are concerns that the auditor sometimes portrays a worrying lack of skepticism in relation to these key areas.
72. This may have led to the view expressed by some⁴⁰ that auditors may not be exercising sufficient judgment regarding disclosures in the financial statements. There is a perception that auditors may not sufficiently challenge management and those charged

³⁸ ISA 540, paragraph 13(b)

³⁹ See paragraphs 29–33 for an explanation of these types of requirements.

⁴⁰ See, for example, Discussion Paper 10/3, *Enhancing the Auditor’s Contribution to Prudential Regulation* (London: FSA and FRC, June 2010).

with governance about whether all necessary disclosures are included in the financial statements, particularly in respect of major transactions. Alternatively, others may have the perception that auditors focus solely on completeness (that is, use checklists) without applying judgment regarding whether all of those disclosures are necessary in the context of that specific entity.

Management's Evidence and Documentation of Disclosures

73. The ISAs are premised on management assuming responsibility for (a) the preparation and fair presentation of the financial statements;⁴¹ and, (b) while not explicitly stated in the ISAs, having a sufficient basis to support their disclosures (in effect, evidence).⁴² Some suggest that management may not always have sufficient support for all disclosures in all circumstances due to the nature of some disclosure requirements, which may make it difficult for the auditor to obtain SAAE.
74. This leads to the question of what is adequate support for management's disclosures, particularly for the newer and more subjective categories of disclosures. This question was addressed by IDW in a report⁴³ in 2007 which noted:

When management seeks to support the arguments in its decision-making process to recognize, measure, classify, present or disclose (or not to do so) certain circumstances or events relating to the entity in a certain way, it uses information (evidence) to support the assertions embodied in its arguments. The existence of circumstances or the occurrence of events in relation to an entity generally leave behind evidence about these. Furthermore, the formulation of arguments in the decision-making process about the recognition, measurement, classification, presentation and disclosure of such events and circumstances also represent evidence supporting the arguments in that decision-making process.

75. Part of the debate about what is SAAE depends on what is seen to be adequate support for management's disclosures in the evolving areas of disclosures.

The Auditor's Work Effort

76. The auditor's work effort with respect to some disclosures is relatively straightforward. Many disclosures are derived from the accounting system and are likely to be audited as a part of auditing the items on the face of the financial statements. However, the work effort in respect of some disclosures is less clear.
77. Despite the ISAs treating the risks of material misstatement at the assertion level for disclosures equivalently to risks of material misstatement at the assertion level for classes of transactions and account balances, some parties have expressed the perception that

⁴¹ ISA 200, paragraph A2

⁴² The IDW paper on the conceptual framework (IDW, *Additional Issues in Relation to a Conceptual Framework for Financial Reporting*, paragraph 39) notes "It is management's responsibility to gather evidence to support its accounting decision-making process ...Without such evidence, management is not in a position to justify its decision on accounting treatment, and management would therefore be unable to meet its stewardship responsibilities."

⁴³ IDW, *Additional Issues in Relation to a Conceptual Framework for Financial Reporting*, paragraph 38.

auditors may not pay the same amount of attention to disclosures as they do to amounts on the face of the financial statements. Indeed, accounting standard setters have debated requiring some such disclosures to be placed on the face of the financial statements themselves to ensure the appropriate audit rigor is applied. However, it is not clear whether these perceptions relate to work effort, materiality, sufficiency and appropriateness of audit evidence, evaluation of misstatements or some other matter.

78. Others would argue, however, that auditors are applying a risk-based approach and, as a result, may judge some disclosures as more or less significant than others. This means that auditors may vary their work effort in response to the assessed risks of material misstatement of the disclosure. As such, disclosures with a lower assessed risk may have fewer and less persuasive audit procedures applied. Of course, a disclosure which has been assessed as significant should have more audit procedures applied. The auditor's assessment of risk for an entity will change from engagement to engagement so the audit procedures will vary as well.

How Materiality Is Applied to Disclosures, and How Misstatements Are Evaluated

This section raises issues about:

- The application of materiality to disclosures;
- What constitutes a misstatement in the context of different types of disclosures;
- How auditors evaluate qualitative and quantitative misstatements in forming an opinion; and
- The challenges in judging fair presentation.

Materiality for Disclosures

79. Materiality is a pervasive concept in auditing, including in respect of disclosures. ISA 320 contains several requirements and application material relevant to disclosures.

Are All Disclosures Material?

80. One view is that accounting standard setters have applied a materiality “filter” in setting the accounting requirements and have judged them to be “material” if the related line item is “material.” As such, the holders of this view would argue that all disclosures required by a financial reporting framework are material. Under this view of materiality, an auditor considers whether all disclosures required by the financial reporting framework are included if the related financial statement item is material. A useful example is the disclosure related to share-based payments—these may be extensive even if the particular share-based payment is quite quantitatively small. This prompts the question of whether the preparer and the auditor are able to further filter out the least important disclosures in the context of the entity to enhance the readability of the financial statements, even if they are ostensibly required by the financial reporting framework.
81. It is important to note that the IASB also makes the point that specific disclosure requirements need not be complied with if the information is not material. In addition,

some disclosures may be useful to investors even if they are not quantitatively material to the entity. 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. Another example may be an entity's non-compliance with a particularly critical law or regulation, such as competition law, even if the resulting fine is immaterial.

82. However, a recent report⁴⁴ included comment on the perception that preparers and auditors have had challenges in applying the materiality concept to disclosures and that this may have increased the volume of disclosures. This is because both preparers and auditors desire to have the financial statements include all required disclosures. One of the effects the report cites is that management may believe that it is easier to include the requested disclosure rather than try to prove to the auditor that the disclosure is immaterial. However, it is acknowledged that voluminous disclosures can arise for other reasons, for example, because of the nature and complexity of an entity's operations. Further, lengthy and complex disclosures may be necessary in many instances to fully inform users of financial statements of the key aspects of the entity's financial position, performance and cash flows.
83. There is a view that completeness of disclosures is a key issue for SMEs, although it also affects other entities. This is because auditors are concerned about the difficulties preparers may have in explaining why a specific disclosure requirement does not appear in the financial statements, and the difficulty in agreeing materiality judgments in this respect with a regulator after the fact.
84. Another materiality issue concerns how to apply materiality and performance materiality to quantitative disclosures of financial instruments, in particular. For example, disclosure of the nominal contract amounts of derivatives or maximum credit risk for a bank is likely to be a number larger than the gross assets of the bank. If the auditor uses the same performance materiality for these disclosures as that used for account balances, then it could be argued that the auditor would need to perform extensive audit procedures as a result. Some believe that this has the effect of reducing the risk of material misstatement of the underlying information to a lower level than would be normally required in a reasonable assurance engagement.
85. In contrast, applying materiality to qualitative disclosures poses very different challenges. Materiality for qualitative disclosures is based on the guiding principle that "misstatements, including omissions, are considered to be 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."⁴⁵ A key consideration is likely to be finding a balance between competing demands such as understandability of disclosures, excessively lengthy financial statements, consistency and comparability. Auditors need to consider whether the assertion of "understandability" has been met in respect of these disclosures, which is a

⁴⁴ FRC, *Louder than Words*, p. 45.

⁴⁵ ISA 320, paragraph 2. See also paragraph QC11 of the IASB Conceptual Framework, which states "Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity."

subjective judgment, leading to disagreements with management that may be difficult to resolve. Preparers and auditors also need to weigh the competing demands for consistent and comparable information, including whether materiality is applied to determine only misstatements, or also to remove disclosures that are immaterial.

86. A further challenge in this area is how to deal with immaterial disclosures. IFRS 7, for example, suggests that an entity can decide how much detail to provide, how much emphasis it places on that information and how it aggregates information to display the overall picture. IFRS 7 goes on to note the need to strike a balance between overburdening financial statements with excessive detail that may not assist users and obscuring important information as a result of too much aggregation. This requires entities and auditors to exercise judgment in determining how much disclosure to provide and how it should be presented. Regulators also play a role in how such requirements should be interpreted. If entities determine that, in their particular circumstances, certain of the disclosures are not relevant, or that a higher level of aggregation is sufficient, the comparability and consistency between entities that regulators value may be lost. Some regulators have also made the point that, if an entity fails to include a disclosure, a user cannot tell if the failure to include that disclosure is attributable to a valid judgment, or an omission due to fraud or error.
87. This has resulted in disagreements where entities have tried to remove what they believed was excessively detailed information that got in the way of the users being able to understand the story of the entity's financial position, performance and cash flows but others disagreed and argued for more consistent disclosure with previous periods.

Types of Misstatements of Disclosures

88. Misstatements in respect of disclosures can be as important to users as misstatements of items on the face of the financial statements. For example, in the recent financial turmoil users placed heavy emphasis on the maturity analysis of liabilities to ascertain the difficulty the entity may have in rolling over debt facilities. A misstatement in this disclosure could affect users' decisions to hold debt or equity in that entity, extend finance or take another economic action.
89. Misstatements of disclosures may be different than misstatements on the face of the financial statements. They vary from those that are easy to detect and discuss with management through to those that are highly subjective. For example:
- A line item, such as property, plant and equipment may not have part or all of the required disclosures.
 - A disclosure may contain a factual mistake, such as an incorrect number, or may disclose an assumption or accounting policy that was not the one used.
 - A disclosure may be biased, such that the disclosure does not reflect a neutral perspective.
 - A disclosure may be poorly worded or confusing, such that the auditor is concerned about the understandability and fair presentation of the financial statements as a whole.

- Key information may be disclosed, but its order in the entity's overall disclosures may obfuscate its importance to a proper understanding of the entity's financial position, financial performance or cash flows.

Evaluating Misstatements of Disclosures

90. Under ISA 450,⁴⁶ the evaluation of misstatements of disclosures is governed by the same requirements and guidance that applies to classes of transactions and account balances. Questions have been raised by some about how misstatements in disclosures are taken into account when evaluating whether the financial statements are free from material misstatement, and whether such misstatements are given the same weighting compared with misstatements related to account balances and classes of transactions.
91. Determining whether a misstatement in a disclosure is material is relatively easy to determine for some disclosures, as they are directly derived for a line item on the face of the financial statements which provides a suitable reference point. For example, an error in disclosing the correct discount rate used can be evaluated by determining the effect the misstated discount rate would have on the line item. Equally, where a disclosure contains the fair value of a line item shown on the face of the financial statements on an amortized cost basis, the auditor can recalculate key ratios using the fair value.
92. However, it is not entirely clear how misstatements in relation to some disclosures should be evaluated, particularly when they relate to more qualitative or subjective judgments. For example, at what point does a narrative description become so biased that it would affect a decision of a user based on the financial statements as a whole?
93. In addition, for quantitative misstatements of account balances and classes of transactions, the auditor considers whether a misstatement individually, or in aggregate with other misstatements, materially misstates the financial statements. The effect of aggregation can be determined by analyzing the effect that all identified misstatements would have on, for example, net assets, profit before taxes, or other important ratios. It is less clear, however, whether misstatements in disclosures can be accumulated in the same way that other misstatements are, and whether this might differ for the different types of disclosures. For these types of disclosures, it may be easier to consider the effect of the misstatements on the fair presentation of the financial statements as a whole.
94. Usually, in accordance with ISA 450, misstatements are evaluated by considering the size and nature of the misstatements and the circumstances of their occurrence together with the effect of uncorrected misstatements from prior periods.⁴⁷ This is often focused on determining if the misstatements affect key ratios, earnings targets or contractual covenants. However, in the case of qualitative misstatements, this is not an appropriate focus as they have no effect on ratios, targets or covenants. ISAs provide some further guidance and suggest the circumstances that may affect the consideration of a misstatement, including misstatements of disclosures. However, the important test of

⁴⁶ ISA 450, *Evaluation of Misstatements Identified during the Audit*

⁴⁷ See Appendix 1 for a further summary of how ISAs treat disclosure misstatements.

reviewing ratios, targets and covenants is still not relevant and these other considerations may not be sufficient to give the auditor a sound basis to evaluate qualitative misstatements. There may be advantage in developing further guidance on the types of factors that auditors might take into account when evaluating qualitative disclosures, and determining the impact of an omission or other misstatement of that disclosure. This is not uniquely an “audit issue,” as such guidance would also have relevance to preparers in providing a frame of reference on how to prepare disclosures. Accounting standard setters working on disclosure frameworks will be grappling with similar issues.

The Meaning of “True and Fair” or “Presents Fairly” in the Context of Disclosures

95. Another aspect of the identification of possible misstatements that may be particularly relevant is whether the financial statements achieve fair presentation, particularly in judging possible omissions. Many financial reporting frameworks feature a requirement for financial statements to be “true and fair” or “present fairly.”⁴⁸ The concept of “presents fairly” implies a need for the financial statements to do more than just comply with a checklist of accounting requirements and disclosures, but rather aim for overall transparency of the financial position, performance and cash flows of the entity. ISA 200 defines a fair presentation framework to be one that:

... requires compliance with the requirements of the framework and: (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

96. In essence, the concerns about applying the concept of fair presentation to the consideration of disclosures show two different perspectives: those that believe that “presents fairly” means compliance with the financial reporting framework and those that believe that fair presentation is an overarching concept that goes beyond compliance with the financial reporting framework.
97. The second perspective has been expressed by some regulators such as the U.K. FSA and FRC, for example:

In some areas, the accounting standards may not specify disclosures and in such circumstances the auditor needs to evaluate whether additional disclosures may be necessary to give a true and fair view. This means it is necessary for the auditor to challenge management’s accounting estimates and the appropriateness of their disclosures.⁴⁹

We suspect some firms may believe it is rarely necessary to provide disclosures that go beyond the specific detailed disclosure requirements.⁵⁰

⁴⁸ From here on, the term “presents fairly” will be used to cover both “true and fair” and “presents fairly.”

⁴⁹ FSA and FRC, Discussion Paper 10/3, *Enhancing the Auditor’s Contribution to Prudential Regulation*, paragraph 3.13.

⁵⁰ FSA and FRC Discussion Paper 10/3, *Enhancing the Auditor’s Contribution to Prudential Regulation*, paragraph 3.23.

Although it is ultimately management's responsibility to provide appropriate disclosures for their entity, it is the auditor's responsibility to challenge management when it believes the disclosures are inappropriate. Therefore, the preparers and auditors of financial statements need to 'stand back' and ask themselves whether the financial statements contain all the information needed. Only if management and auditors play their role to the full can we be confident about the quality of the disclosures provided.⁵¹

98. A further aspect of "presents fairly" is about the broader issues of understandability, prominence and presentation of key disclosures in the context of the financial statements as a whole. Some would like auditors to give greater focus to the understandability of the financial statements which may include the extent to which they "tell the story" of the entity's financial position, performance and cash flows.
99. One possible factor in assessing "presents fairly" is the prominence of key disclosures. It may be argued by some that key disclosures should be easy to find and early in the notes to the financial statements, rather than towards the back of the financial statements. To a degree, this may be already happening in practice as often happens, for example, with going concern disclosures that are usually given prominence at the start of the notes to the financial statements.
100. Paragraph 13(e) of ISA 700 states that "the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements." Also, ISA 450, paragraph A16 states:

The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement ...Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity.

101. A key question to be explored is whether expectations in this regard can be reasonably met, recognizing that the adequacy of the disclosures is likely to be judged in hindsight once events have unfolded.

⁵¹ FSA and FRC, Discussion Paper 10/3, *Enhancing the Auditor's Contribution to Prudential Regulation*, paragraph 3.25.

V. Questions about Auditability

This section raises issues about:

- The implications of the IASB’s concept of “verifiability” on the auditability of disclosures; and
- Whether there are disclosures that cannot be audited.

102. The IAASB is aware of two perspectives on what is meant by auditability. The first perspective is that information may be unauditible if there are no procedures that an auditor can reasonably apply to reduce the risk of material misstatement. This might be because the criteria are inadequate, the supporting evidence is lacking or some other reason.
103. The second perspective is that information is unauditible where the information is so imprecise that an auditor cannot increase the credibility of the information. For example, a required disclosure may relate to a purely subjective judgment such that the auditor has no criteria to challenge management’s judgment.
104. The IASB’s concept of verifiability was discussed earlier in this paper, and it is useful to contrast this with auditability. The IASB Conceptual Framework describes the relationship between verifiability and disclosures in the following manner:⁵²
- It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, it would normally be necessary to disclose the underlying assumptions, the methods of compiling the information and other factors and circumstances that support the information.
105. Therefore, it is clear that information which may not be “verifiable” should have increased disclosures, that is, that disclosures are an output of the process. This can be contrasted with both of the perspectives on “auditability” which are concerned with the auditability of the disclosure itself.
106. Central to the question of auditability of disclosures is the question of management’s supporting evidence for their disclosures. If management has appropriate supporting evidence for their judgments and decisions, then it is likely that the disclosure should be capable of being audited. As such, a key question in relation to auditability of disclosures is the extent to which management has documented appropriate supporting evidence. It is clear that the extent of available evidence for both management and auditors may vary depending on the category of disclosure.
107. A further challenge with respect to auditability is the question of whether the audit process can reduce measurement uncertainty of an inherently uncertain financial statement amount. Under IFRSs, disclosures are often more extensive when measurement uncertainty is high, and it is difficult to see how the audit process could lead to the reduction of measurement uncertainty.

⁵² The IASB Conceptual Framework, paragraph QC28

108. As mentioned earlier, this DP is based on the premise that all disclosures are auditable, and the main question is what constitutes sufficient appropriate audit evidence. However, there are perceptions that not all disclosures required by financial reporting frameworks may be auditable. In particular, these concerns relate to two areas: can users rely on these disclosures in the same manner as for line items on the face of the financial statements and what does “audited” mean when dealing with subjective statements such as descriptions or sensitivity analyses?
109. Some believe that some categories of disclosures are so difficult to audit that there may be an expectation gap between what the auditor can actually achieve, what users of financial statements believe auditors do in a financial statement audit, and, as noted earlier in the paper, the description in the auditor’s report. For these people, it is more appropriate that some disclosures are excluded from the scope of the auditor’s opinion.
110. Others have a different view, pointing out that auditors have managed to find agreement on consistent and appropriate ways of auditing challenging subject matters previously. For example, prior to the full integration of fair value information in financial reporting, some argued that fair values were not capable of being audited, particularly those fair values that were based on unobservable inputs. The holders of this view believe that auditing should continue to evolve with the financial reporting framework by finding agreement on the composition of SAAE in respect of these types of disclosures.
111. These conflicting perceptions may be the reasons for different regulatory approaches that have been taken to certain disclosures in some jurisdictions. For example, pro forma disclosures on business combinations are scoped out of the audit mandate in Japan, because, although they are presented in the notes of the financial statements, they present events that have not occurred and it is thought that sufficient appropriate audit evidence cannot be obtained. In other jurisdictions, such information⁵³ is considered to be within the scope of the financial statement audit. In those jurisdictions, it is argued that, although the pro forma information on business combinations is of a different nature than other information in the financial statements, it is compiled from historical information and the fact that it is “pro forma” information on business combinations and the basis for its compilation can be fully described in the note. Other examples of disclosures that some argue are not capable of being “audited” are models such as value at risk and disclosures of judgments. In the U.S., for example, it is preferred that such forward-looking statements are placed outside of the financial statements, where they can then be subject to “safe harbor” provisions. The IASB Basis for Conclusions on IFRS 7 acknowledges that there was significant concern expressed by respondents about the difficulties and costs in auditing the risk disclosures required by that standard.⁵⁴ The IASB noted:

Respondents raised concerns that the disclosures of sensitivity analysis in particular should not be part of the financial statements. Respondents stated that sensitivity analysis cannot be prepared with the degree of reliability expected of information in the financial statements, and that the subjectivity in the sensitivity analysis and the hypothetical

⁵³ IFRS 3, *Business Combinations*, paragraph B64(q)(ii)

⁵⁴ IFRS 7, *Basis for Conclusions*, paragraph BC43

alternative values could undermine the credibility of the fair values recognized in the financial statements.⁵⁵

112. As discussed above, the recent publication of the IASB Conceptual Framework includes “verifiability” as one of the enhancing qualitative characteristics of financial information. Verifiability “means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.”⁵⁶ This enhancing characteristic acknowledges⁵⁷ that some explanations and forward-looking financial information may not be verifiable, and, therefore, further disclosure of the assumptions, methods of compiling the information and other facts and circumstances would be needed to help users decide if they wish to use the information. Thus, it is the complete story told by the line item and related disclosure that is being audited, including the portrayal of the inherent measurement uncertainty. Clarity on the auditor’s focus and basis for judging what constitutes SAAE in this context would, perhaps, help reconcile the two views.
113. The IAASB notes that “verifiability” is not necessarily the same as auditability, yet the recognition that not all disclosures are verifiable creates uncertainty about what auditors are presently doing with such disclosures and the appropriate response to unverifiable information.
114. In addition, the IAASB notes that, similar to the discussion regarding the auditability, there is also an attention to the enforceability of accounting standards. For instance, in February 2010, staff of the U.S. SEC published the *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers*, which notes that:

... the staff will analyze factors that may influence the auditability and enforceability of financial statements prepared under IFRS. Like the relationship between verifiability and auditability, enforceability is not necessarily the same as auditability, yet some view that there is a link between the two concepts, as auditors may be required to explain to regulators and oversight bodies at times of inspection.

⁵⁵ IFRS 7, Basis for Conclusions, paragraph BC44

⁵⁶ The IASB Conceptual Framework, paragraph QC26

⁵⁷ The IASB Conceptual Framework, paragraph QC28

VI. Consultation Questions

The IAASB believes it is important that participants in this discussion articulate their underlying reasoning to enable the IAASB's further work in this area. Obtaining different stakeholders' views on the range of issues about financial statement disclosures will be invaluable and will assist in ensuring that the IAASB, and other stakeholders, have the opportunity to engage with different perspectives. To this end, the IAASB has prepared specific questions for preparers; investors, lenders and other creditors; regulators and auditors. The IAASB also values responses from other stakeholders not falling into any of these categories, including accounting standard setters, and invites them to respond to those questions they consider most appropriate.

Pages 36–45 contain consultations questions for:

- Preparers (pages 36–37);
- Investors, lenders and other creditors (pages 38–39);
- Regulators (pages 40–42); and
- Auditors (pages 43–45).

Respondents are invited to also respond to questions from other stakeholders' list of questions if they wish to provide their perspective.

The IAASB welcomes responses even if they address only some of the listed questions.

Consultation Questions for Preparers

The following questions are designed to solicit perspectives from preparers of financial statements on the challenges faced when preparing disclosures.

Preparers are asked to comment on the following questions, and are invited to raise any other issues relating to disclosures that should be brought to the IAASB's attention.

Section II—Financial Reporting Disclosure Trends

Section II of the discussion paper explores the recent trends in financial reporting disclosures, and the practical experiences of preparers and auditors.

- P1) What have been the most significant challenges you have experienced in preparing disclosures?
- P2) Have you included a disclosure in your financial statements to comply with a specific disclosure requirement, even though you believed the disclosure was immaterial? What factors led you to this decision? What practical difficulties exist when deciding to omit a disclosure that you consider to be immaterial?

Please provide any other relevant comments that you wish to make on Section II.

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).

- P3) Have you experienced requests from auditors for evidence to support your disclosures that you find difficult to satisfy? If so, please explain the context.
- P4) 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 evidence or support do you believe you need to have as a basis for the assertions you make in the financial statements on such disclosures?
 - (b) The IASB has proposed disclosures regarding stress tests (see paragraphs 65–66). In preparing financial statements, what, in your view, would be sufficient evidence for you to support your stress test disclosure? What do you believe would constitute a misstatement of a stress test disclosure?

P5) 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 disclosures:

- 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.

Please provide any other relevant comments that you wish to make on Section IV.

Consultation Questions for Investors, Lenders and Other Creditors

The following questions are designed to solicit perspectives from investors, lenders and other creditors on the challenges faced when considering disclosures.

Investors, lenders and other creditors are asked to comment on the following questions, and are invited to raise any other issues relating to disclosures that should be brought to the IAASB's attention.

Section II—Financial Reporting Disclosure Trends

Section II of the discussion paper explores the recent trends in financial reporting disclosures, and the practical experiences of preparers and auditors.

- I1) In general, do you believe that the reliability of disclosures is at the same level as that of the line items on the face of the financial statements? Do you believe that different types of disclosures in audited financial statements can or should have different levels of reliability? Please explain your answer.
- I2) In the particular circumstance when a financial statement line item is measured on one basis, such as amortized cost, but the disclosure includes the fair value of the line item, should the auditor's effort on the fair value disclosure be the same as if the fair value was on the face of the financial statements? Please explain your answer.
- I3) 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 and your reasoning for why you believed they were immaterial in the context.
- I4) Do you believe that consistency in disclosures is important (either over time for the same entity, or between entities in the same industry), even if achieving this aim may result in extensive disclosures that may not, in the context of a particular entity, be material to that entity in the current period?

Please provide any other relevant comments that you wish to make on Section II.

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).

- I5) 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.

- I6) 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 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?
- I7) 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 disclosures:
- 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.
- I8) If there were certain disclosures that were determined to be incapable of being audited, would you want them to be included in the financial statements and labeled “unaudited” or would you prefer that they be placed outside of the audited financial statements?

Please provide any other relevant comments that you wish to make on Section IV.

Consultation Questions for Regulators, Including Audit Oversight Bodies

The following questions are designed to solicit perspectives from regulators on the challenges faced when considering disclosures.

Regulators are asked to comment on the following questions, and are invited to raise any other issues relating to disclosures that should be brought to the IAASB's attention.

Section II—Financial Reporting Disclosure Trends

Section II of the discussion paper explores the recent trends in financial reporting disclosures, and the practical experiences of preparers and auditors.

- 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.

Please provide any other relevant comments that you wish to make on Section II.

Section III—How Do ISAs Currently Deal with Disclosures?

Section III describes the key requirements and guidance for auditors in dealing with disclosures.

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

Please provide any other relevant comments that you wish to make on Section III.

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).

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

- 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.
- 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?

Please provide any other relevant comments that you wish to make on Section IV.

Section V—Questions about Auditability

Section V considers auditability of disclosures, and the implications of the IASB's concept of "verifiability" on the auditability of disclosures.

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

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?

Please provide any other relevant comments that you wish to make on Section V.

Consultation Questions for Auditors

The following questions are designed to solicit perspectives from auditors on the challenges faced when considering disclosures.

Auditors are asked to comment on the following questions, and are invited to raise any other issues relating to disclosures that should be brought to the IAASB's attention.

Section II—Financial Reporting Disclosure Trends

Section II of the discussion paper explores the recent trends in financial reporting disclosures, and the practical experiences of preparers and auditors.

- A1) Have you had discussions with entities about whether some of their required disclosures might be considered immaterial? What factors did you take into account? Please explain what difficulties (if any) you have experienced.

Please provide any other relevant comments that you wish to make on Section II.

Section III—How Do ISAs Currently Deal with Disclosures?

Section III describes the key requirements and guidance for auditors in dealing with disclosures.

- A2) How do you approach the identification and assessment of the risks of material misstatement in disclosures?
- A3) Are there ISA requirements that, in your experience, pose practical challenges in respect of disclosures? Please explain your answer.

Please provide any other relevant comments that you wish to make on Section III.

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 unauditably? 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.
- A5) What do you believe are the key issues with gathering audit evidence for the examples given in paragraphs 60–70?
- A6) 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

believe should be applied to the fair value disclosure? Should your effort be the same as if the fair value was on the face of the financial statements?

- A7) 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.
- A8) In light of the discussion in paragraphs 79–87, what do you believe is the appropriate way of applying materiality to disclosures? Do you believe there is sufficient guidance in the ISAs?
- 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.
- A10) 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 to do in relation to the proposed stress test disclosures? What do you believe would constitute a misstatement of a stress test disclosure?

- 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?

Please provide any other relevant comments that you wish to make on Section IV.

Section V—Questions about Auditability

Section V considers auditability of disclosures, and the implications of the IASB's concept of "verifiability" on the auditability of disclosures.

- A12) What are the characteristics of disclosures that, in your view, would not be auditable?
- A13) 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?
- A14) Some believe that the manner in which a financial reporting regulator enforces financial reporting requirements may influence how auditors approach their audits, including how they may approach disclosures. What is your view?

Please provide any other relevant comments that you wish to make on Section V.

Pertinent IAASB Requirements and Guidance on Disclosures

This Appendix is a brief summary of the pertinent ISA requirements and guidance that are relevant to this DP. It does not include all requirements and guidance on the topic of disclosures, nor is reading this Appendix a substitute for reading the ISAs.

ISA Requirements and Guidance

ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

1. ISA 200 includes the definition of a fair presentation framework, which acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework (see paragraph 13(a)(i)).
2. ISA 200 also includes the definitions of:
 - Misstatement, which puts the misstatement of a disclosure on equal footing with the misstatement of an amount, classification, or presentation (see paragraph 13(i)); and
 - Inherent and control risks, which put the risk/susceptibility of misstatement of an assertion about a disclosure on equal footing with the risk/susceptibility of misstatement of an assertion about a class of transaction or account balance (see paragraph 13(n)). It does this also in discussing inherent risk in paragraph A38.

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

3. Paragraph 25 places the same obligation on an auditor to identify the risk of material misstatement in disclosures as with classes of transactions and account balances:

The auditor shall identify and assess the risks of material misstatement at:

 - (a) the financial statement level; and (Ref: Para. A105–A108)
 - (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A109–A113)

to provide a basis for designing and performing further audit procedures.
4. Paragraph A111 deals with the use of assertions and notes that assertions cover the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Paragraph A111 offers a way of categorizing assertions and includes:
 - (c) Assertions about presentation and disclosure:
 - (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
 - (ii) Completeness—all disclosures that should have been included in the financial statements have been included.

- (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
- (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

ISA 320, Materiality in Planning and Performing an Audit

5. Paragraph A10 gives the following examples of factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements:
 - Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
 - The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
 - Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

ISA 450, Evaluation of Misstatements Identified during the Audit

6. Paragraph A1 specifies an omission of an amount or disclosure as one of four circumstances that may result in misstatements.
7. Paragraph A15 notes that determining whether a classification misstatement is material involves the evaluation of qualitative considerations.
8. Paragraph A16 includes, as one example of circumstances that may affect the evaluation of a misstatement, the extent to which it is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity.

ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

9. As its name implies, disclosures are treated quite explicitly throughout this ISA. This is demonstrated by the objective (see paragraph 6), which is to obtain sufficient appropriate audit evidence about whether:
 - (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and
 - (b) related disclosures in the financial statements are adequate, in the context of the applicable financial reporting framework.

10. As well as being integrated into other sections, there are two requirements specifically aimed at disclosures:
 19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.
 20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

ISA 550, Related Parties

11. ISA 550 features many requirements and application material paragraphs regarding disclosures. For example, the objectives⁵⁸ include:

The objectives of the auditor are...

- (b) where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.
12. Further, the standard establishes requirements and provides guidance for the audit of related party disclosures such as:
 - Paragraph 23 – “... the auditor shall ... inspect the underlying contracts or agreements, if any, and evaluate whether ... the transactions have been appropriately accounted for and disclosed in accordance ... with the applicable financial reporting framework.”
 - Paragraph A47 – “Evaluating the related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity’s related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if: (a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or (b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.”
13. The ISA also includes a specific requirement in paragraph 24 for the auditor to obtain sufficient appropriate audit evidence about any assertion made by management in the financial statements to the fact that a related party transaction was conducted on terms equivalent to those prevailing in an arm’s length transaction. The related application material discusses the type of support management may have for the assertion, the types of procedures that might be performed, and the practical difficulties that may limit the auditor’s ability to obtain sufficient appropriate audit evidence.

⁵⁸ See also paragraph 25.

ISA 700, Forming an Opinion and Reporting on Financial Statements

14. ISA 700 includes the same definition of a fair presentation framework as does ISA 200. As noted above, a fair presentation framework under this definition acknowledges explicitly or implicitly that it may be necessary for management to provide disclosures beyond those specifically required by the framework (see paragraph 7). This is picked up in paragraphs 13(e) and 14, which build upon paragraph 24 of ISA 330,⁵⁹ and require the auditor to evaluate whether the financial statements provide adequate disclosures (see paragraph 13(e)) and to consider the overall presentation and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation (see paragraph 14).
15. ISA 700 also includes material regarding disclosures for special cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation without additional disclosure, and even then may not achieve fair presentation (see paragraphs 7, 18 and A11).
16. Paragraph 31 requires the auditor's report to state that an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.

ISA 705, Modifications to the Opinion in the Independent Auditor's Report

17. In setting requirements for the form and content of the auditor's report when the opinion is modified, ISA 705 reminds the auditor that, according to ISA 450, a material misstatement of the financial statements may arise in relation to the appropriateness or adequacy of disclosures (see paragraph A3(c)), and provides the following guidance about situations in which the inappropriateness or inadequacy of disclosures may result in a material misstatement (see paragraph A7):
 - (a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
 - (b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
 - (c) The financial statements do not provide the disclosures necessary to achieve fair presentation.
18. Paragraph 19(c) requires the auditor's report to include the omitted disclosures unless prohibited by law or regulation, and provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

⁵⁹ ISA 330, *The Auditor's Responses to Assessed Risks*

Proposed Guidance contained in Proposed IAPS 1000, *Special Considerations in Auditing Complex Financial Instruments*

Proposed IAPS 1000 was issued for comment in October 2010, with comments requested by February 11, 2011. Even though the proposed IAPS has not been issued, it is illustrative of how disclosures may be approached by an auditor in the context of complex financial instruments.

The IAASB is proposing changes to the *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services* (the Preface) at the same time as proposed IAPS 1000. It is proposed that the Preface state at paragraph 23:

International Auditing Practice Statements (IAPs) are issued to provide ~~interpretive guidance and~~ practical assistance to ~~auditors~~ professional accountants in implementing ISAs and to promote good practice. IAPs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with the requirements of all ISAs relevant to the audit. Auditors should determine whether any IAPS is relevant to the circumstances of the audit and, if so, obtain an understanding of its content.

19. Proposed IAPS 1000 notes that financial instrument disclosures are intended to enable users of the financial statements to make meaningful assessments of the effects of the entity's financial instrument activities, including the risks and uncertainties associated with these complex financial instruments. Accordingly, disclosures are of equal importance to the amounts recorded in the financial statements relating to financial instrument activities (see paragraph 105).
20. Guidance is given on the following areas (see paragraph 107):
 - The financial risks and exposures inherent in complex financial instruments cannot always be effectively captured in a balance sheet and profit and loss account.
 - The information required to enable the auditor to conclude about whether the disclosures in the financial statements are in accordance with the requirements of the applicable financial reporting framework may come from systems outside traditional financial reporting systems, such as risk data.
 - Consideration as to whether the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved and, accordingly, the financial statements may not achieve fair presentation.
 - Whether the disclosures are complete and understandable, for example, all relevant information may be included in the financial statements (or accompanying reports) but it may be insufficiently drawn together to enable users of the financial statements to obtain an understanding of the position or there may not be enough qualitative disclosure to give context to the amounts recorded in the financial statements.

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