Federation of European Accountants
Fédération des Experts comptables Européens

Mr. James Gunn
Technical Director
IAASB
545 Fifth Avenue, 14th Floor
New York, New York 10017
USA

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Ref.: AUD/PJ/HB/LA/SH

Dear Mr. Gunn,

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

FEE is pleased to provide you with its comments on the IAASB Discussion Paper: The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications.

FEE commends the IAASB for taking the initiative to initiate a thorough debate with all its stakeholders on the fundamental and significant issues regarding the audit of financial statement disclosures. The development over the years has significantly changed financial reporting and changes in reporting content and format for financial statements are likely to continue. One of the results of these changes is that the financial statements now include significantly more disclosures containing qualitative information. These changes have both intended and unintended consequences potentially impacting the readability and understandability as well as the auditability of the financial statements as a whole.

Although the current ISAs are of high quality and provide relevant and detailed guidance, it appears appropriate at this point in time to carefully consider whether they provide the auditor with the necessary framework for the audit of developments in financial reporting, especially in the area of disclosures and with the guidance needed to deal with audit issues in this area.

Our main comments on the issues raised in the Discussion Paper are summarised below:

Financial reporting matters impacting the audit

- The Discussion Paper describes clearly how financial reporting matters impact the audit. With regard to the auditability of financial statements, the main issue is whether management are able to provide sufficient evidence to support the disclosures they have included. The combination of the complexity of the matters disclosed and the application of financial reporting standards makes this increasingly difficult.
- Extensive rule-based disclosure requirements can easily result in information overload in the financial statements. There is a distinct risk that the quantity of information could

reduce the readability and the understandability of the financial statements due to a lack of consideration given to what is important to the users.

- Therefore, FEE believes that there needs to be clarity under the financial reporting framework that only those disclosures that are material and relevant to the users of financial statements are included.

Behavioural issues

- There is a tendency for preparers to include all disclosures required in the financial statements regardless of the relevance and materiality of the information. This stems from a wish to be compliant with the relevant standards as well as from a fear of the negative consequences of non compliance if criticised by regulators for immaterial omissions. It would therefore be appropriate in the application of standards to move away from a checklist-based, box-ticking approach to an approach for the financial statements that is based on judgement, keeping in mind that this is the approach that the financial reporting standards as well as the auditing standards are based on. In this regard, a behavioural change by all parties is needed.
- FEE also believes that when standard setters establish new disclosure requirements they should also assess whether management will be able to provide auditable evidence to support those disclosures.

Audit related matters

- One of the main difficulties regarding auditing disclosures is the application of the risk standards. The developments in financial reporting require management increasingly to exercise judgement in the valuation of assets as well as liabilities. These judgements are often based on assumptions regarding risk that involve significant uncertainty and lead to disclosures of estimates that are difficult to substantiate. The IAASB should consider whether ISAs give sufficient guidance in these particular areas.
- FEE concurs with the IAASB that materiality in the disclosures is a key point and especially the issue of whether there are different materiality levels for different disclosures. Given the fact that materiality is an accounting issue, it is important that the same materiality level is, in practice, perceived to be the same by all parties (standard setter, preparer, auditor and regulator) involved in the financial reporting chain. It is the preparers of financial statements that should decide which disclosures are material. Subsequently, auditors should apply a risk-based approach to determine those disclosures that are material to the financial statements as a whole and therefore need to be audited.
- Although not addressed in the Discussion Paper, there may be aspects related to the auditability of financial statement disclosures that affect the audit report and auditor's communication that could be analysed in order to assess whether further clarifications in the ISAs are needed.
- Therefore, FEE calls upon the IAAAB to consider where more guidance could be provided to assist auditors with practical aspects regarding the audit of disclosures as discussed in the responses to individual questions, especially on determination of materiality in the planning and performance of the audit and the use of professional judgement for qualitative disclosures.

FEE encourages the IAASB to take these issues forward as a matter of priority and to engage in an even closer cooperation with the IASB. Also, there would be benefit in an enhanced dialogue with regulators and enforcers of financial statements in order to mitigate the identified risks of misperceptions of the views of various stakeholders at regional as well as international level.

Our detailed comments are set out in the appendix.

For further information on this FEE[1] letter, please contact Hilde Blomme at +32 2 285 40 77 or via email at hilde.blomme@fee.be or Lotte Andersen at +32 2 285 40 80 or via email at lotte.andersen@fee.be from the FEE Secretariat.

Yours sincerely,

Philip Johnson
FEE President

[1] FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 500.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of such developments and, in conjunction with Member Bodies, to seek to influence the outcome;
- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.

Avenue d'Auderghem 22-28, B-1040 Brussels
Tel: +32 (0)2 285 40 85
Fax : +32 (0)2 231 11 12
secretariat@fee.be
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Appendix: Responses to Questions

Question 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.

Discussions with audit clients about materiality occur frequently in practice and causes of the considerations and discussions can be found partly in the financial reporting framework itself with regard to the definition of materiality for which disclosures should be required as well as in behavioral attitudes of all parties within the financial reporting chain.

Materiality

With regard to materiality, the main area of uncertainty arising in practice, and, in particular, in relation to qualitative disclosures, seems to be whether a materiality level is to be set when applying the financial reporting standards or whether the standard setter has already decided on the materiality of a disclosure on the basis that it has been included in the standard.

Materiality is currently defined within the financial reporting framework and regarded as an entity-specific aspect of relevance based on the nature or magnitude, or both, of items to which the information relates. Therefore, the financial reporting standard setter cannot specify a uniform threshold for materiality.

The Discussion Paper refers to different interpretations of how the concept of materiality is applied to disclosures. FEE is of the view that only material disclosures should be included in the financial statements. The other scenario, which is omitting immaterial disclosures, would in theory result in the same outcome, but is in practice likely to create more disclosures in the financial statements. FEE believes that the financial reporting conceptual framework already allows entities to include only material disclosures in the financial statements, and there may therefore be a need for the financial reporting standard setter, as well as the financial reporting enforcers to clarify this, for instance through increased consistent application of the materiality concept in the standards or by issuing additional guidance.

In the current Conceptual Framework for Financial Reporting, the characteristic of reliability has been replaced with the principle characteristic of “faithful representation”, which encompasses three other sub-characteristics (complete, neutral and free from error). FEE in its letter to the IASB expressed its concerns regarding the proposal indicating that the reliability is a term that has been used for many years and well understood by users. Therefore we are not convinced that there is a problem with the meaning of reliability that needs to be fixed or that faithful representation is a concept that will be better understood and applied.

FEE notes that the financial reporting standard setter sometimes defines very prescriptive disclosure requirements in current and proposed standards regardless of the materiality of the information to be disclosed from the perspective of a particular entity[2]. This rule-based approach can potentially result in an excessive number of disclosures that will reduce the readability and the understandability of the financial statements and also, as explained above, have a negative impact on auditability of the financial statements as a whole. Therefore, FEE believes that it is the preparer who should set the materiality level for the provision of information in the financial statements based on clear and robust principles.

On this basis, FEE wants to reiterate its support for a substantial reduction of note disclosures, leading to relevant and better information that is clearly based on information needs of users. If there is a wish to move towards integrated reporting, which is currently being extensively discussed by various stakeholders, then it seems that the best way forward is first to streamline financial reporting and to ensure that the principles of relevance and materiality of disclosures, in particular, are sufficiently clearly defined in order to allow for consistency in application by entities as well as consistency in audit and enforcement. FEE believes that this would subsequently lead to a significant reduction of unnecessary disclosures currently included in the financial statements which would lead to increased readability of the financial statements.

Considering the audit implications, it should be noted that the audit opinion expresses a view on the financial statements as a whole and not on individual disclosures. However, the perception of users may be different, as it may be conceptually difficult for a non-technical person to understand that audit relates to more than the verification and accuracy of individual transactions and disclosures, but also involves a stand back evaluation as to how the various disclosures interrelate. This could be further considered as part of the IAASB project on the auditor's report.

Also, in accordance with the audit model, some disclosures will be subject to substantive audit procedures whilst other disclosures will be subject to an assessment by the auditor of their consistency with other parts of the financial statements or the management report due to their qualitative nature. The ISAs need to allow for audit of the variety of disclosures and recognise that the audit work will be different depending on the character of the disclosure. In this context, ISA 320[3] seems to focus on materiality for quantitative disclosures, both in the definition of "*Performance Materiality*" as well as in the requirements with the references to amounts. The IAASB is encouraged to consider whether there would be a possibility to underline the differences more clearly in the determination of materiality for qualitative disclosures compared to what is already required for quantitative disclosures.

Cross-references can also become an issue for the audit as cross-references can result in reference to parts of the annual report that is not subject to audit and ISAs should be clear on how to deal with such references.

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[2]For instance, FEE believes that in the IASB ED Revenue Recognition the proposal starts with overarching disclosure objectives but these principles-based objectives appear to be inconsistently applied in the subsequent disclosure requirements. These subsequent and extensive requirements will likely be regarded as a 'minimum list' and could result in a large amount of insignificant detailed information. In general, FEE has expressed similar concerns in relation to the IASB proposal on Leases and on proposals related to financial instruments.

[3] ISA 320 Materiality in Planning and Performing an Audit

Behavioural issues

Another important factor is behavioural. In practice, auditors often discuss materiality in disclosures in the financial statements with audit clients. As a result of a perception that non-disclosures of even immaterial information will lead to a demand for restatements by regulators and a fear of the negative consequences thereof, preparers tend to include all disclosures required in the financial statements regardless of the relevance and materiality of the information disclosed.

In this context, FEE agrees that checklists, for compliance with the financial reporting standards, based on an extensive financial reporting framework, can result in too many disclosures being included, due to preparers as well as auditors using an excess of caution as to what can be considered as immaterial. The stand-back evaluation by auditors and by preparers in the final stages, is therefore important to ensure that only immaterial disclosures are being omitted.

In this context, preparers should ensure, when applying the compliance checklists, that sufficient time is devoted to preparing clear, coherent, understandable and readable disclosures in the preparatory phases. Also, the auditor should ensure in the planning and performance phases of the audit engagement that sufficient time is devoted to the audit of disclosures. The auditor should be conscious that, in addition to ensuring compliance through the use of checklists, disclosures should enhance the readability and understandability of the financial statements for the users.

Therefore, FEE believes that there is a need for behavioural changes by all parties of the financial reporting chain. FEE would encourage further engagement of the standard setter with auditors and regulators to identify inconsistent application of accounting standards caused by behavioural and interpretation issues.

Behavioural changes for auditors would relate to being more willing to challenge management in their use of excessive caution as to which disclosures are material by using their professional judgement. This should be done in a way that makes auditors acknowledge that it is generally accepted by both standard setters and regulators that financial statements only include material disclosures. This should enable the auditor to be strongly positioned in the discussions regarding materiality with the audited entity and challenge the views of the entity with regard to the level of materiality for disclosures. The audit profession is committed to make behavioural change happen in this respect. However, FEE believes that it will need to be the standard setters and the regulators that jointly initiate the change needed.

Regarding enforcement, the general perception is that the understandability or readability requirements in the financial reporting framework are not enforced in such a way that enforcers require entities to omit immaterial disclosures. Behavioural change in this regard could be done by the enforcers being more transparent on these matters, as further discussed in our response to question A14.

Question A2 How do you approach the identification and assessment of the risks of material misstatement in disclosures?

The risk of material misstatement will often be high for areas in the financial statements that contain disclosures that include significant judgement and estimation, such as financial instruments, pensions, deferred taxes, business combinations, estimates and the general provisions in IAS 1[4]. The audit procedures for these areas compared to other areas are designed to take these risks into account, as set out in the risk standards in ISAs. The IAASB should consider whether the risk-based approach, as currently defined in the risk standards, provides sufficient guidance as to the audit of qualitative information, and it is not just designed having the materiality level of quantitative information in mind.

Question A3 Are there ISA requirements that, in your experience, pose practical challenges in respect of disclosures? Please explain your answer.

More and more disclosures are not directly linked to the figures in income statement, balance sheet and other quantitative information in the financial statements and audit procedures need to be designed accordingly.

Developments in financial reporting have resulted in three types of disclosures:

1. Disclosures derived from a financial reporting and internal control system that auditors are familiar with.
2. Disclosures derived from systems within the entity that auditors are not familiar with.
3. Disclosures that are not derived from any internal system at all.

In accordance with the developments in financial reporting, more disclosures of categories 2 and 3 are being included in the financial statements, and especially the third category poses more and more audit risk and challenges with regard to obtaining sufficient audit evidence. The IAASB should ensure that the risk[5] ISAs correspond with this development in financial reporting.

The IAASB should have specific focus on whether the risk ISAs properly address the considerations that are specific for qualitative disclosures such as judgments and assumptions for estimation uncertainties and sensitivity analysts made by management which, as discussed in our response to Question A1, differs in practice from those of quantitative disclosures.

As an outcome, this may also be a reporting issue, which should be addressed in ISAs dealing with the content of the audit report or in the requirements on communication with those charged with governance, as some communication may be more relevant as part of the private reporting than the public reporting in the audit report. The question is when an omitted disclosure will lead to a modified opinion, or even what the consequences for the audit report will be when not just one specific disclosure is omitted, but the structure of the financial statements as a whole compromises the readability and thus the true and fair view of the financial statements.

[4] IAS 1 Presentation of Financial Statements
[5] ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and ISA 450 Evaluation of Misstatements Identified in the Audit

In this regard, the requirement in ISA 705 for the auditor to include any omitted disclosures (material or immaterial) in all cases in the audit report, is impractical and inappropriate in cases where this is not required by local law or regulations or where the omission itself is not material. Also, it can lead to the perception of the auditor assuming management's responsibilities for the content of the financial statements. In addition, this requirement is counterproductive to a desirable reduction of disclosures in the financial statements. It would be more appropriate to require that the auditor points out the ramifications for the audit report, if the disclosure is not included. Therefore, FEE recommends that this particular point is addressed as part of the current IAASB project on auditor's report.

Question 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 unauditable? 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.

Situations where management has some evidence for a specific disclosure but where the auditor can have difficulties in finding sufficient and appropriate third party audit evidence do occur regularly in practice. In this context, it is evident that as the financial reporting framework as well as the application of it becomes more complex, so do the audit procedures and so does the ability to obtain sufficient audit evidence.

The difficulties in obtaining sufficient and appropriate audit evidence are most frequent in relation to qualitative disclosures and the increasing requirements in financial reporting for management's use of judgement where it can be difficult to find sufficient and appropriate evidence for the judgements made. In such situations, the audit evidence obtained will be the arguments used by management in their decision-making process, which can be considered as sufficient, given the circumstances in the particular situation, as also referred to in paragraph 74 of the Discussion Paper. FEE supports the requirements in the Fourth and Seventh Directives to keep accounting records, which we would understand to also include retaining evidence supporting the judgments made by management regarding all disclosures in the financial statements. As qualitative disclosures are becoming more and more prevalent within the financial reporting framework, the audit procedures will also need to develop to accommodate for this evolving nature of financial reporting and recognise, in particular, that audit today is more focused on assessment of what is reasonable and sufficient, judging the judgement of management, and not just on accuracy of the information. FEE believes that there may be room for the IAASB to add guidance to assist auditors in this area.

The most prominent example is in relation to the significant amount of qualitative disclosures required for financial instruments in IFRS 7 where it can be difficult to find sufficient audit evidence even when management provides a relevant description of the qualitative disclosures as required.

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In practice, there are situations where management may take a more aggressive view on accounting matters which may challenge the boundaries of the financial reporting framework, for instance in relation to impairment and valuations of level 3 financial instruments. In such cases, the IAASB is encouraged to consider whether it could be beneficial if the auditor could have some appropriate tools to critically assess the reasonableness of the judgments made by management.

In this context, it may be particularly relevant to identify whether ISAs are sufficiently clear on the consequences for the audit procedures in case management cannot provide sufficient and appropriate evidence for a specific disclosure required in the financial reporting framework. It seems in such situations that the auditor has the following options:

- To accept the lack of evidence and rely on management's judgement given the materiality of the disclosure.
- To include an emphasis of matter paragraph or a modification in the audit report.

Especially with regard to qualitative disclosures, it may be relevant to analyse whether more guidance is needed, for instance with reference to:

- Work in accordance with ISA 200[6] when considering disclosures.
- Identifying, assessing (and determine how to address) the risks of material misstatement in the disclosures, in particular with regard to qualitative disclosures in accordance with ISA 315[7].
- Whether ISA 320 sufficiently addresses qualitative disclosures and the difference in the assessment of materiality between quantitative and qualitative disclosures.
- Ensure that ISA 450[8] is sufficiently clear on the differences in audit procedures between quantitative and qualitative disclosures.
- Although the definitions of "appropriate" and "sufficient" audit evidence in ISA 500[9] appear to remain appropriate, considerations of relevance and reliability of information, sufficiency of information (precision/detail) for audit purposes, consistency of evidence from one source with evidence obtained from another, "building up" sufficient appropriate audit evidence from different procedures e.g. inspection, confirmation, re-performance, analytical, etc. could be relevant.

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

In some cases, the more qualitative in nature a disclosure is, the more difficult it will be to assess what is to be considered as "sufficient" and "appropriate" with regard to evidence. It may be beneficial to review the ISAs to see, if the guidance material corresponds with this, as with the

[6] ISA 200 Overall Objectives of the independent Auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement
[7] ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment
[8] ISA 450 Evaluations of Misstatements Identified During the Audit
[9] ISA 500 Audit Evidence, especially paragraphs 6-11

developments in financial reporting requiring more qualitative disclosures, there may not have been given due consideration to this particular point when the standards were developed.

The specific examples of disclosures are discussed below.

Disclosures on Property, plant and equipment – paragraph 61

In general, there are not many difficulties in gathering audit evidence for property, plant and equipment, and the data is normally gathered from the accounting records.

With a few exceptions, the auditor would generally not gather audit evidence to express a "true and fair" opinion on particular categories of the line item property, plant and equipment. The usual procedures for this would be inspection of land registry records, physical observation of major plant items, confirmation of supplier balances, etc.

Operating segment disclosures – paragraph 62

Sufficient appropriate audit evidence will in this case be primarily driven by the auditor's assessment of the company's internal reporting system. Therefore, questions posed to the entity would include:

a. Compliance with disclosure requirements in IFRS 8[10].
b. Does it make sense?
c. Explain any significant divergence in allocation from comparable companies and/or industry norm.

Disclosures on fair value line items – paragraph 63

Fair value leads to more judgement to be used by management as well as by the auditors when no market prices are available and more disclosures are required and needed to explain fair value. This results in the paradox of adding more disclosures which has the consequence that the readability and information value decreases. Instead of adding more disclosures, preparers as well as standard setters should ask themselves whether all disclosures are relevant or whether they can be replaced by other, more simple disclosures.

In Europe, some regulators have recently suggested that auditors should challenge more the management assumptions for fair value and to a greater extent use their professional scepticism in this regard. Also, some regulators have suggested that auditors could be involved more, such as through additional reporting responsibilities. Going forward, there may therefore be a need to look more closely into this particular issue, especially with regard to professional scepticism and a framework for extended reporting responsibilities by the auditor for fair value disclosures.

An initial sufficient appropriate audit evidence assessment of "fair value disclosure" would be its consistency with the company's business model.

[10] IFRS 8 Operating Segments

Disclosures on another basis than fair value – paragraph 64

The requirements in ISAs would entail that the audit evidence needed is the same, regardless of whether it is a line item or a note disclosure. However, the risk-based approach can lead to a different application, as auditors have the perception that users, and as a result, preparers, have less focus on disclosures in the notes than on the face of the financial statements. Furthermore, there is also a perception that a quantitative fair value figure that is not used for measurement purposes but rather as a supplementary disclosure for information only (e.g. an asset measurement based on cost with fair value being disclosed as a supplement) is regarded as less relevant to the users.

In order to resolve these issues, the IAASB is encouraged to further analyse whether this perception by auditors of the information needs of users is in fact appropriate. Also, the IAASB should consider, whether, in their view, there is a need for more clarification with regard to the extent of audit evidence needed for information disclosed on the face of the financial statements and in the notes, given the indication above on how the ISA requirements are currently applied in practice.

Stress test disclosures – paragraph 65-66

It should be noted that the IASB may not carry the proposed requirement on stress tests forward in the final standard. However, stress tests are receiving high focus in Europe at the moment from the prudential supervisors, which makes the debate in relation to stress tests very relevant.

Disclosures in this category may therefore be regulated by law, standard setters and/or securities regulators and as discussed in paragraph 65 of the Discussion Paper, the fair value disclosure may not be related to a balance sheet item.

Due to the character of stress tests, greater emphasis would be placed on professional scepticism and this will push the procedures performed towards the second scenario in paragraph 66 of the Discussion Paper, where the auditor needs to obtain evidence as to whether the stress test was properly performed and not be limited to just assessing the description prepared by management, given that stress testing will be particularly relevant to financial institutions with the results having "*implications for the financial position and (future) performance*" the auditor would appear to need evidence the stress test was "*appropriately performed*".

Disclosures on internal control and management intentions – paragraph 67

The forward looking information referred to in paragraph 67 of the Discussion Paper can only be assessed by reference to "*management's own process*". The disclosures should incorporate appropriate "health warnings" on this "futurology" which are already addressed in the guidance in ISA 540[11] as referred to in paragraph 68 of the Discussion Paper.

Corporate governance codes, "best practice" and demands of various categories of users, all lead to more principle-based qualitative disclosures. The nature of such disclosures and their

[11] ISA 540 Accounting Estimates

usefulness are wholly dependent on judgement by management applied (to the extent possible) on a consistent basis from reporting period to reporting period. The auditor can obtain an understanding of that process of "walk through" with management the actual steps taken leading to a particular disclosure. However, the comfort acquired is probably (at best) "*not inconsistent with*…".

<u>Objective-based disclosures – paragraph 70</u>

In Europe, auditors do not form an opinion on the effectiveness of risk management, but merely on the description of it as included in the financial statements, for instance related to financial instruments. The assessment made is therefore whether the description is appropriate. ISAs seem to correspond appropriately to these requirements on a description of risk management.

Although not discussed in the Discussion Paper, consequences for the audit report and generally auditor's communication could be relevant to consider. There may be merit in considering whether auditors currently have the appropriate tools to communicate that financial statements are no longer just an issue of compliance with the individual requirements of a framework, but also whether the information provided by the entity makes sense and is understandable by the users. Auditors could communicate more to those charged with governance about the relevance of disclosures. There could also be a need to consider, without increasing the use of disclaimers, whether this increased use of judgement by the auditor is appropriately conveyed to the users of the financial statements. These considerations could be addressed in the current IAASB project on auditor's report.

Question 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?

In practice, users as well as other stakeholders in the financial reporting chain seem to have more focus on the face of the financial statements than on disclosures in the notes, as also discussed under question A5 above. This differentiated focus reflects on the preparers and also on the auditors to some extent.

However, the approach in the audit should be that the work effort for disclosures being directly linked to a line item on the face of the financial statements should be at the same level as the line item itself.

For disclosures that are not directly linked to a line item, the materiality level will depend on the characteristics of the disclosure itself. As mentioned above, the IAASB is encouraged to consider, if the ISAs appropriately respond to this, as it seems that there is an expectation gap between auditors and users in this regard that it could be reduced, if more clarity is provided.

Question 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.

In general, there is a need to reduce the complexity in financial reporting and to make the current application of the standards less complex. For this reason, financial reporting should be better adapted to the economic substance of transactions and the business model should be a key consideration for deciding on what information needs to be disclosed, still with the overall objective that the financial statements as a whole should give a true and fair view of the business of the entity. For all of these reasons, financial reporting needs to remain principle based.

The financial statements are currently most relevant to the investors, capital providers and other stakeholders who are identified as the primary users of financial information. Focusing on the information needs of investors should generally meet most of the information need of a wider range of users including regulators.

Users in general need to be aware that an excess in the quantity of information, resulting from an attempt to respond to the needs of multiple stakeholders, would reduce the readability of the financial statements and therefore impair their quality. Thus, financial reporting used for other purposes such as to meet the information needs of other users are likely to result in an additional burden on the already voluminous corporate reporting. This would be counterproductive to provide relevant information to the primary users.

Duplication in regulatory requirements should also be avoided and the information in the annual reports should be strictly limited to information which might affect the decision making of users to avoid information overload and not using the objectives of prudential supervision as a key driver for disclosures.

In this context, auditor's reporting should also be considered, as omission of such disclosures would lead to considerations of whether or not a qualification should be included in the audit report.

In addition, it could be more carefully considered whether the financial statements are the most appropriate vehicle for all information required by primary as well as secondary users or whether other documents would better serve these needs. Examples of such other documents which are already produced today are analysts' briefings, press releases, reports to prudential supervisors and environmental reporting which to some extent include audited information and where the auditor already today has been requested to provide some level of assurance. When further developing an approach to disclosures included in financial statements, it should therefore be carefully considered that financial statements are to contain the core information and not necessarily meet the information needs of all potential users.

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Question 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?

FEE concurs with the view that a disclosure may often be material if it relates to a material line item, but this will depend on the nature and extent of the disclosure. However, an increasing number of disclosures are more than merely breakdowns of line items and the materiality level for such disclosures needs therefore to be decided based on other criteria.

It is evident that not all disclosures are material in all cases. Some disclosures are clearly immaterial, possibly by themselves and clearly in the context of understanding the particular financial statements as a whole and the specific entity's business model. It would be the preparer of the financial statements that is best placed to assess the materiality level of the needed disclosures, given that it will be the preparer who has all available information to make the most informed decision. Also, the preparer should be best placed to discuss the materiality level with its auditor, and therefore, should have the appropriate evidence at hand to defend the view taken with regard to the materiality level applied for the disclosures.

However, FEE concurs with the view that the risk of inclusion of immaterial disclosures is increased by the use of comprehensive software packages and group-wide preparation checklists and formats, used by preparers as well as by auditors. All parties could engage more in streamlining the preparation process of the financial statements and the disclosures to avoid this counterproductive information overload.

In this context, the materiality assessments required in ISA 450[12] could be expanded to also address situations where disclosures have no quantitative element, which does not seem to be sufficiently addressed in the current version of the standard.

Question 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.**

For all categories above, a material misstatement is one that is misleading through omission or through the provision of incorrect information of a character that would have changed the decision of the user had it been correctly included.

[12] ISA 450 Evaluation of Misstatements Identified During the Audit

Also, it is apparent that a material misstatement is more difficult to assess for the categories mentioned above than for quantitative information, although such an assessment will need to be done and is done in practice.

With regard to the specific categories, a material misstatement of a disclosure could be:

- Judgements and reasons:
  - Biased information or information that is contradictory with other financial information.
- Assumptions/models/inputs:
  - Inputs that are contradictory with market data (if available), models where the validation results/back testing results of former periods are deviating materially.
  - If own audit models are used to compare the results and the results are deviating materially from the models used by the entity.
  - As result of inadequacies found in the process of using the models (e.g. only front office information used instead of risk management and/or back office information in the case of financial instruments).
  - If assumptions are not reasonable material misstatements can arise.
- Sources of estimation uncertainty/sensitivity analysis disclosures:
  - If assumptions are not reasonable and/or there are inadequacies in the process, material misstatements can arise.
- Descriptions of internal processes:
  - Unreasonable deviations from the actual situation.
- Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis:
  - Deviations above a certain percentage.
- Objective-based disclosure requirements:
  - Deviations from reasonable assumptions and inadequacies in the process of establishing objective-based disclosures.
  - Lacking relevant disclosures.

Question 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?

From an audit perspective, the audit of these matters is not too complicated as the auditor would assess a description of the control system, test relevant controls and look at the reporting system similar to other areas, and it is a matter of assessing the risk of material misstatement, as discussed in our response to question A9 above. The tests, the underlying documentation and getting sufficient evidence may be complicated but the audit work is based on the risk-based approach would be the same as for other areas.

Question 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?

As more and more qualitative disclosures are to be included in the financial statements, the accumulation of qualitative misstatements is also becoming more important. Intuitively, it is not possible to accumulate qualitative misstatements in the same way that quantitative misstatements are accumulated. However, to some extent, qualitative misstatements will also be accumulated using professional judgement on their individual and collective significance with regard to the quality of the descriptions provided by management using the risk-based approach as set out in the risk standards. Such accumulations are already done in practice as part of the audit, but more guidance on how to accumulate qualitative misstatements would facilitate more consistent assessments in this area.

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

Disclosures that are not auditable are generally disclosures where there are no suitable criteria to support a risk-based approach or that relate to specific future assumptions, such as disclosures where management expresses an intention to carry out specific future actions. Also, disclosures on assumptions and estimation uncertainty cause difficulties, as discussed in our responses to questions A5 and A9 above. The audit evidence for such disclosures will be more difficult to obtain, the more judgment that is used by management, as also highlighted in the paper from the IDW, and also referred to in the Discussion Paper.

It is however, important for users of financial statements that they can rely on the fact that the financial statements are actually audited where they are subject to an audit requirement. If subject to audit, the financial statements as a whole are audited which entails that disclosures that are not auditable, should not be part of audited financial statements. The conflict then arises when or if the financial reporting framework sets disclosure or other requirements that are effectively unauditable. Auditability should therefore be carefully considered by the financial reporting standard setters when developing standards. The IAASB could also consider whether such situations have any consequences for the audit report and whether the ISAs appropriately address this issue.

The relevant ISAs in this context would be ISA 560[13] and ISA 570[14] where more guidance may be appropriate at some point in the future, given the discussions that have arisen in Europe on going

[13] ISA 560 Subsequent events
[14] ISA 570 Going concern

concern assumptions and forward looking information as a result of the European Commission Green Paper on Audit Policy.

Question 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?

FEE would like to suggest that as a matter of principle, accounting standard setters should develop general criteria in the framework for the consideration of the fair presentation requirement by preparers and thus auditors.

Reference is made to our response to question A11 above as the question will be, whether the auditor has made an appropriate assessment of the risk of material misstatement.

In general, assessment of the auditor’s judgement is part of the task of supervision of the auditor which is done by audit oversight bodies. It will therefore be for the audit oversight bodies to define the criteria that are to be used for this assessment. With regard to internal quality control within an audit firm, ISQC 1 defines the necessary principles for the quality control in general, which seem sufficient.

However, there may be merit in further development of the particular issue of auditor’s judgement in respect of the fair presentation of the financial statements as a whole in ISAs, especially with regard to consequences for the audit report in situations, where the structure of the financial statements compromises the readability of the financial statements.

Question 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?

As mentioned in our response to question A8, FEE agrees that the perception of the views of the financial reporting enforcer influences the preparation of the financial statements by the preparers and influences to some extent the views of the auditors as to what is to be considered as material.

FEE believes that there is a significant amount of potential for a much closer cooperation between financial reporting enforcers, preparers and auditors with regard to these matters and would in this connection encourage the financial reporting enforcers to be more transparent in the results of the work done and the conclusions made with regard to the application of the financial reporting standards. Such enhanced transparency would be an important contribution to reducing the risks of misperceptions of the views of the financial reporting enforcers which as discussed in our responses to other questions as well as in the Discussion Paper itself, lead to inclusion of more disclosures than necessarily needed in the financial statements and therefore could contribute to reducing the information overload in financial statements to the benefits of all users.

This increased transparency about financial reporting enforcement has already been initiated within Europe by the European Securities and Markets Authority (ESMA) with the publications by its predecessor Committee of European Securities Regulators (CESR) of concrete financial reporting enforcement decisions made on a regular basis as well as its first Activity Report on IFRS Enforcement in September 2010[15]. Additional initiatives by the enforcers in line with these, and/or by other means than post-enforcement reports should be encouraged as there is still room for improvement with regard to transparency and engagement in cooperation with other stakeholders within the financial reporting chain. This applies for Europe as well as outside Europe. As the financial reporting standards are applied worldwide, further enhancement of this transparency of the enforcement activities could be done through closer cooperation between the enforcement bodies around the world, which could be done through the International Organisation of Securities Commissions (IOSCO) encouraging regional cooperation as well as transparency in enforcement activities at international level. This would, as mentioned, be beneficial to all stakeholders within the financial reporting chain, including preparers and auditors.

[15] The latest publication of CESR's enforcement decisions, 10th Extract from the EECS's Database on Enforcement, March 2011 http://www.esma.europa.eu/popup2.php?id=7230
CESR Activity Report on IFRS enforcement 2009, September 2010 http://www.esma.europa.eu/popup2.php?id=7230