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Mr. James Gunn  
Technical Director  
International Audit and Assurance Standards Board  
545 Fifth Avenue, 14th Floor  
New York, NY 10017

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

Dear Mr. Gunn:

The American Institute of Certified Public Accountants (AICPA) is pleased to comment on the International Auditing and Assurance Standards Board's (IAASB) Disclosure Paper: *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*.

**General Comments**

We welcome the IAASB's initiative in undertaking this project. New accounting standards have resulted in a rapid expansion of disclosures in terms of volume and the subjectivity and complexity of those disclosures. In addition, information that previously was disclosed outside of financial statements, or not at all, is now required to be disclosed in the financial statements and covered by the auditor's reports. This information includes nonfinancial information or forward looking information that is disclosed because it now more directly enters into the application of accounting principles.

In particular, the increased use of assumptions or projections of highly volatile future events in making fair value estimates has increased the inherent imprecision of financial statements, thereby increasing the need for additional, more complex, disclosures to explain these assumptions and projections. One aspect of this change is that new accounting standards now include both specified disclosures that must be made when applicable and general requirements for any additional disclosures required for fair presentation. Although the notion of a fair presentation objective for disclosures is not new, the nature of current accounting principles has placed additional emphasis on the application of professional judgment in evaluating disclosures. Professional judgments can and do vary, creating inconsistencies in financial reporting. We support the development of a framework of professional judgment currently being considered.

We believe that there are instances in which audit work related to disclosures is performed separately from the audit of the financial statement amounts, often at the conclusion of the audit work. Further, these audit procedures consist of completing checklists by less experienced staff with review by more experienced audit personnel. Although checklists are an important aid to ensuring the completeness of required disclosures, they may not be as effective in evaluating the fairness of disclosures. We believe that consideration of the fairness of disclosures should be an integral component of the audit work performed in connection with the elements of the financial statements. Additional application guidance to help change auditor behavior in that respect would be helpful.

Finally, we recommend that the characteristics of audits of smaller entities be taken into consideration while the IAASB deliberates this project. In audits of smaller entities, auditors may be more involved in advising entities in writing disclosures. We are mindful that the level of auditor involvement has professional ethical considerations which we believe can be addressed in the standards by adding additional guidance to caution the auditor about the limits of his or her involvement in these situations.

### **Request for Specific Comments**

Our responses are limited to the consultation questions for auditors and are presented following each consultation 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.

**Response:** Auditors frequently have discussions with entities about whether some of the disclosures presented in financial statements are immaterial and can be omitted. However, many entities are hesitant to remove previously presented disclosures because the removal of the disclosures may raise additional questions or inquiries, in particular from regulators. There is little incentive for management to omit disclosures previously included in the financial statements. Rather than deleting immaterial disclosures, entities often find it easier to retain disclosures, even when immaterial, rather than to respond to regulatory inquiries. In addition, we note that the principles of fair presentation, as currently practiced, do not provide a useful basis for identifying and eliminating excessive disclosure.

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

**Response:** The risk assessment standards require the identification and assessment of the risks of material misstatement at the assertion level. These assertions include presentation and disclosure assertions. The most important aspect of assessing the risks related to disclosures is the assessment of the entity's controls over these disclosures. As discussed in current auditing standards, the auditor's evaluation of disclosure risk includes an assessment of the inherent risks that disclosures may be incomplete or inaccurate and the controls in place to address those risks. However, there are factors such as 1) auditor behavior, 2) use of senior staff or experienced staff, and 3) entity's controls over disclosures that might need additional application guidance to help practitioners more effectively implement the standards.

Auditors have indicated that they often (especially small and medium practitioners) view the audit work on disclosures as a discreet area apart from the audit work required on the financial statement amounts. As a result, the audit work related to disclosures is often left to the end of the engagement and may not be integrated with the identification and assessment of risks to the same extent as is the audit work related to financial statement amounts. Also, the linkage of the identification and the assessment of risks to the audit procedures related to disclosures may not be formally documented. We believe that additional application guidance might be helpful in emphasizing the importance of assessing the risks of material misstatement in disclosures and integrating the audit work related to disclosures as part of the overall audit and help drive a change in the auditor behavior.

Additionally, auditors note that the audit work on disclosures is performed by different members of the engagement team who have varying degrees of experience. We believe that the identification and the assessment of risks with respect to disclosures require considerable professional judgment, especially those disclosures dealing with complex and subjective disclosures. We believe that additional application guidance to stress the importance of the use of experienced auditors in auditing such disclosures would be helpful.

Finally, we believe that the auditor's consideration of the entity's controls over disclosures is an important aspect in auditing the entity's disclosures. Management's competencies are an important consideration in the evaluation of risk and the understanding of internal control. For example, if the auditor finds that the entity's controls over disclosures are inadequate (for example, management lacks the requisite accounting skills to write a disclosure), the auditor's procedures on disclosures might be more extensive, including assisting in the development of the disclosures. Additional application guidance to address the auditor's consideration of the entity's controls over disclosures might be helpful.

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

**Response:** We have identified the following ISA requirements that we believe pose practical challenges.

- Professional Judgment—The ISAs require that the auditor exercise professional judgment, which we believe in the current practice environment, is a challenge. Competent, reasonable people may reach different judgments. Of particular concern is that well-reasoned and documented conclusions may be second guessed in hindsight, particularly by the legal process, regulators, or oversight inspections. In addition, we believe that the application of professional judgment, absent a well-defined framework for its application, may have the unintended consequence of promoting inconsistencies in the application of accounting standards, including the related disclosures.
- Materiality—ISA 320, *Materiality in Planning and Performing the Audit*, requires the auditor to determine materiality for the financial statements as a whole. The application of this requirement to financial statement amounts ordinarily is not a practice issue; however, the determination of a materiality level(s) to disclosures is more challenging. This is especially true, in situations where the auditor needs to evaluate the qualitative aspects of a disclosure, for example the sufficiency and completeness of the disclosures.

- Auditing Accounting Estimates—ISA 540, *Auditing Accounting Estimates, Including Fair Value Estimates and Related Disclosures*, addresses the auditor’s responsibilities regarding accounting estimates, including fair value estimates and related disclosures. We believe that the audit procedures involving fair value measurement, in particular, the measurement of accounting estimates derived from highly volatile assumptions and projections are a practice issue.

**A4:** [a] 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? [b] If management’s consideration of a disclosure can be appropriately supported by evidence and documentation, are there factors that could nevertheless make a disclosure unaudit-able? [c] If management has not provided evidence and documentation in support of a disclosure, do you believe you are able nevertheless to obtain SAAE [sufficient appropriate audit evidence] on the disclosure? Please explain your answer.

**Response:**

- a) Situations in which auditors experienced difficulty in obtaining sufficient appropriate audit evidence even though management believes it has supporting evidence are as follows:
- Fair Value—Auditors sometimes experience difficulties in obtaining sufficient appropriate audit evidence in auditing accounting estimates with unobservable inputs that involve subjective judgments about methods and assumptions (Level 3 fair value estimates).
  - Business Combinations—Auditors (in particular, small and medium practitioners) sometimes experience difficulties auditing business combinations. For example, smaller entities may enter into an acquisition transaction but management has little or no experience in the application of the relevant accounting standards or provides insufficient audit evidence to support the allocation of the purchase price to the assets and liabilities acquired.
  - Going Concern—Auditors sometimes experience difficulties obtaining sufficient appropriate audit evidence in auditing management plans and factors to mitigate going concern.
- b) Examples of management’s consideration of a disclosure that can be appropriately supported by evidence and documentation, but where there are factors that could nevertheless make a disclosure unaudit-able are as follows:
- Investments accounted under the equity method.
  - Quarterly disclosures.
  - Requirements imposed by legal framework.
- c) Yes. For example, in a legal matter, management might not have adequate audit evidence; however, the auditor might nevertheless obtain sufficient appropriate audit evidence in part by seeking a legal letter from external counsel. Similarly, management might not have sufficient evidence to support a fair value accounting estimate for a security with no trade quotes; however, the auditor may overcome the lack of evidence in part by obtaining an appraisal from a third-party.

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

**Response:** Paragraphs 60–70 provide examples that range along the spectrum of complexity of disclosures. The nature, timing, and extent of the audit evidence that the auditor requires to obtain a reasonable level of assurance regarding disclosures is dependent on the subjectivity and complexity of the disclosures. We believe the key issues in the auditor’s assessment of the sufficiency and appropriateness of the audit evidence necessary to audit the disclosure are:

- The requirements of the applicable accounting framework. The degree to which the accounting and related disclosures are dependent on the outcome of future events and the predictability of those events directly affects the precision of the related estimates. The outcome of future events cannot be “audited” to the same degree of certainty as the effects of events that have occurred.
- The business model of the entity. For example, some entities (for example, hazardous waste remediators) are involved in activities that involve much higher levels of adverse legal or regulatory effects than others.
- The controls used by the entity to identify and develop disclosures necessary for fair presentation, in particular, controls that enable the entity to identify matters requiring disclosure.
- The auditor’s assessment of disclosure misstatement risk, based on a consideration of the factors cited above and the audit procedures that can be applied to reduce that risk to an appropriate level. On one end of the spectrum, the audit procedures on property, plant, and equipment are normally straight-forward. While on the other side of the spectrum, the audit of an objective-based disclosure wherein the auditor may only be able to rely on management’s representation, is considerably more challenging for the auditor.

**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?

**Response:** We believe that the level of effort required to audit the fair value of a financial statement item is the same as the effort required to audit a fair value disclosure, all other conditions being the same.

**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.

**Response:** We acknowledge that management is responsible for the fair presentation of the financial statements, which includes presenting all disclosures required by the applicable financial reporting framework. Generally, auditors do not discourage management from including disclosures that management might want to disclose voluntarily. However, to properly address such voluntary disclosures, the auditor needs to obtain a thorough understanding of such disclosures and carefully consider the qualitative aspects of the disclosures. Auditors may also consider the user’s (including potential investors) perspective.

**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?

**Response:** In applying the concept of materiality to disclosures, we believe that the most important consideration for the auditor is what the users of the financial statements consider to be important. Therefore, it is important that an auditor performing audit procedures be mindful of the financial statement users. For example, reading the financial analysts reports may aid the auditor in identifying factors that may influence equity investors.

We understand the notion of the “filter” which is referred to in paragraph 80. However, in practice, management is reluctant, in subsequent periods, to delete formerly material disclosures that have become immaterial. As mentioned above, management often believes that it is easier to retain a disclosure rather than go through the process of explaining why a particular disclosure was deleted.

With regards to quantitative disclosures for example, nominal contract amounts referred to in paragraph 84, we believe that additional application guidance might be helpful so that the auditor could have a better understanding of how to address such disclosures. For example, in auditing notional contract amounts, auditors might consider (i) the effect on the recorded balances if the notional amounts are misstated or (ii) determine the amount of the misstatement that might influence the users of the financial statements.

**A9:** What do you believe represents a material misstatement of a disclosure? Please give an example of what, in your view, would constitute a material misstatement for the following categories of disclosure: Judgments and reasons; Assumptions/models/inputs; Sources of estimation uncertainty/sensitivity analysis disclosures; Descriptions of internal processes; Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis; and Objective-based disclosure requirements.

**Response:** We believe that it is critical that, as in the past, the propriety of disclosures be assessed by auditors in the context of the financial statements as a whole and not as individual amounts, descriptions, or representations. This is consistent with the fact that materiality is ultimately determined by considering whether the correction of a misstatement would alter the decision of a reasonable user of the financial statements.

We believe that misstatements of disclosures should be analyzed in terms of the following types:

- Omissions of material disclosures required either by the applicable financial reporting framework or to achieve fair presentation where a fair presentation framework is being used. Examples include:
  - Failure to disclose facts indicating that the entity’s historical performance is likely to be adversely affected in the future.
  - Failure to disclose situations in which the assumptions about future events used in significant estimates are highly volatile and the reasons for that volatility.
  - Matters related to contingent liabilities that would improve a user’s assessment of the likelihood of an adverse outcome.
- Factual errors in disclosures presented (either amounts, descriptions, or facts)
  - Quantitative errors in amounts presented.

- Inaccurate statements or representations (for example, management's statement that related party transactions are at arms-length when, in fact, they are not).

We also believe that, where a number of immaterial omissions in disclosure combine to obscure material management bias towards a particular accounting result, this cumulative effect would be material.

**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?

**Response:** We believe that the answer depends on the form of the disclosure. If the disclosure is segregated and labeled unaudited, there would be very little work performed by the auditor. Similarly, if the disclosure is presented as an assertion by management, there would be very little work performed by the auditor also. But, if it is not segregated and therefore, covered by the opinion, sufficient appropriate audit evidence might be obtained by (i) performing risk assessment procedures to gain an understanding of the disclosures, including inspecting or observing relevant documents, (ii) gaining an understanding of entity's controls over the disclosures, and (iii) testing controls, as appropriate. We believe that an inaccurate description by management of the internal process that might influence the users of the financial statements would constitute a misstatement of the 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?

**Response:** If adopted, we believe that the auditor would be guided by the standard's stated objectives and by the actual requirements for the stress tests as mandated by the applicable regulators. Assuming that the disclosure is part of the financial statements as a whole, appropriate audit procedures that the auditor might perform include 1) obtaining an understanding of the suitable criteria 2) performing audit procedures to test whether the disclosure is in conformity with those criteria, and 3) evaluating whether the disclosure is fairly presented.

**A11:** How do you evaluate both qualitative and quantitative misstatements in forming an opinion on the financial statements as a whole? Is it possible to accumulate misstatements of disclosures, particularly when they relate to qualitative or judgmental disclosures? How do prior year's disclosure misstatements affect the evaluation of the current year's financial statements?

**Response:** In practice, auditors generally do not accumulate misstatements in disclosures in the same manner as quantitative errors in recorded financial statement balances or amounts. Misstatements in disclosures tend to be evaluated individually and are more likely to be corrected when identified. However, if an auditor identifies a trend (for example, a management bias), the auditor might step back and make an overall

assessment of the effects of errors in disclosures. Misstatements in disclosures are often documented in engagement checklists, engagement memoranda, or other engagement documentation. Misstatements in prior year disclosures would be evaluated to identify areas of higher disclosure risk in the current year and for correction if the prior year statements are presented.

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

**Response:** We believe that a disclosure would be unauditabile when sufficient evidence is not reasonably available to support the disclosure and that disclosure would be material to financial statements (and therefore, would result in a scope limitation in the auditor's report).

**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?

**Response:** We believe the following criteria would be appropriate in assessing the auditor's judgment with respect to the fair presentation of the financial statements:

- Due care and professional skepticism were exercised at the time the judgments were made, based on all relevant information reasonably available at that time.
- The auditor complied with an appropriate set of high quality standards (that is, auditing, quality control, ethics, and education).
- Facts, assumptions, alternative views, and conclusions were appropriately documented.
- Adequate consideration of materiality.

**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?

**Response:** The manner in which regulators enforce requirements deeply influences the way auditors conduct their audits and, by extension, how entities make financial statement disclosures. An audit of financial statements, in particular of subjective, highly complex disclosures requires the use of professional judgment. We believe that the application of professional judgment by auditors is influenced by both their knowledge of prior regulatory actions in similar situations and by a concern that their judgments will be second guessed in connection with reviews of filings of financial statements, inspections of audits, or in connection with enforcement actions or litigation. We also believe that this concern over regulatory actions is often reinforced by the expressed views of counsel to the preparer of the financial statements.

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Thank you for the opportunity to comment on this exposure draft. If you have any questions regarding the comments in this letter, please contact Mr. Hiram Hasty at +1-212-596-6011, [hhasty@aicpa.org](mailto:hhasty@aicpa.org).

Respectfully submitted,

/s/ Darrel R. Schubert

Chair, Auditing Standards Board