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Global Mindset, Asian Insights

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Dear Mdm,

RESPONSE TO THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB) EXPOSURE DRAFT (ED) – PROPOSED CHANGES TO THE INTERNATIONAL STANDARDS ON AUDITING (ISAs) – ADDRESSING DISCLOSURES IN THE AUDIT OF FINANCIAL STATEMENTS

The Institute of Singapore Chartered Accountants (ISCA) appreciates the opportunity to comment on the above ED issued by the IAASB in May 2014.

To solicit meaningful feedback for this ED, ISCA has sought views from its members through a one-month public consultation process as well as engaging targeted stakeholders. Relevant comments have been incorporated into this response.

Promoting the quality of disclosures is a common objective of many stakeholders. International collaboration and cooperation between IAASB, International Accounting Standard Board (IASB), regulators and other key stakeholder groups has always been viewed as critical in addressing issues surrounding disclosures, for example, the issue of excessive disclosures in financial statements. Such collaborations create synergies out of the efforts of the key stakeholders to reap maximum benefits for the profession. We are heartened to note that IAASB has and will continue to closely monitor relevant developments and activities of the stakeholders. It is important that the objectives of the ED are aligned to the work of these stakeholders to the extent possible (such as IASB's project on Disclosure Initiative). Continuous monitoring of the developments would also help IAASB determine if the requirements in the auditing standards related to disclosures need to be reviewed and amended in the future to be in line with the objectives and activities of other key stakeholders. Also, we note that some of the proposed changes in the ED may run contrary to IAASB's intention to address the issue of excessive disclosures and have highlighted them in this response.

Another important point we would like to put forth is the need for a framework on the materiality concept to guide auditors in making appropriate judgments when assessing risks of material misstatements and evaluating misstatements relating to disclosures, particularly qualitative disclosures. We have also highlighted some areas where further guidance could be provided, such as the audit of disclosures in the context of group audits. Another area which calls for broad guidance is in the nature of audit procedures required to be performed to assess the operating effectiveness of non-financial systems and processes where evidence relating to disclosures may be obtained from.

In addition, we agree that timely consideration of disclosures is key to planning an effective audit and the proposed changes to the assertions would align the standards with the current practice as most audit firms in Singapore already consider disclosures at the planning stage of the audit. As such, the impact of the proposed changes to the assertions would not be felt by these firms. Furthermore, whilst auditors may consider disclosures early, in practice, they are affected by the timing of the provision of the disclosures information by management which could pose a challenge to the auditors at times.

The details to our above comments are included in our response to the specific questions in the ED as follows:

<u>Question 1</u>

Whether, in your view, the proposed changes to the ISAs are appropriate and sufficient for purposes of enhancing the focus of the auditor on disclosures and, thereby, will further support the proper application of current requirements in the ISAs?

1.1 We welcome changes that enhance the focus of the auditor on disclosures and generally, the proposed changes to the ISAs are appropriate. Notwithstanding that, we have highlighted a few areas in our response to Question 2 where further enhancements can be made.

Question 2
Are there any specific areas where, in your view, additional enhancement to either the requirements or guidance of the ISAs would be necessary for purposes of effective auditing of disclosures as part of a financial statement audit?

Framework on materiality concept

2.1 We believe that a framework on the materiality concept to provide guidance to auditors in making judgments when assessing risks of material misstatements and evaluating misstatements relating to disclosures, particularly qualitative disclosures, should be developed. While the current materiality concept is well understood and widely applied to quantitative financial information, it is practically challenging to apply the same to the increasingly voluminous and wide variety of qualitative information disclosed in the financial statements. Significant professional judgement is involved in assessing the materiality of qualitative information and guidance in this area will be useful to the auditing profession, for example, in determining whether the omission or misstatement of a qualitative disclosure warrants inclusion in the list of uncorrected misstatements or a modified audit opinion on the financial statements.

Excessive disclosures

2.2 The issue of excessive disclosures in financial statements, which increase the risk that useful or relevant information will be obscured, is a concern raised by many stakeholders including IAASB. IAASB has also acknowledged in the ED that any progress in this area to yield an effective response would require collaboration and cooperation between many stakeholders. We fully agree with this and firmly reiterate the need for IAASB's work to be co-ordinated with that of IASB as the issue of materiality for both financial reporting and auditing, needs to be addressed in tandem. IAASB should continue to follow closely relevant developments and activities of IASB, for example, its project on materiality under its Disclosure Initiative.

2.3 However, we also noted that some of the proposed changes in the ED may run contrary to IAASB's and IASB's intention to address excessive disclosures. The fear of adverse consequences (such as sanctions imposed) arising from non-compliance with the standards may drive the unintended behaviour of excessive disclosures and some of the proposals could further exacerbate this problem:

(a) Firstly, with the additional emphasis from the ED, through the proposed inclusion of paragraph A2a in ISA 450 *Evaluation of Misstatements Identified during the Audit*, to accumulate and evaluate misstatements in disclosures, auditors may be inclined to request management to include more disclosures in the financial statements, albeit unnecessary, in order to avoid the practical challenges they face in accumulating and evaluating disclosure omissions or misstatements. This may be more pronounced in instances where it is unclear whether disclosures are necessary and both auditors and management may adopt an "always disclose if unsure" or "better to disclose more than less" approach which further aggravates the problem of excessive disclosures. It is therefore important for a framework on the materiality concept, as highlighted in paragraph 2.1 above, to be in place for the auditor to consider materiality when applying professional judgement in the evaluation of whether misstatements in disclosures should be accumulated and also in the evaluation of the effect of the misstatements on the audit opinion of the financial statements.

(b) Secondly, the proposed amendments to paragraph A4 of ISA 700 *Forming an Opinion and Reporting on Financial Statements,* require the auditor to consider whether the disclosures in the financial statements are adequate to assist the intended users to understand:

- the nature and extent of the entity's potential assets and liabilities arising from transactions or events that do not meet the recognition criteria established by the applicable reporting framework;
- the nature and extent of risks of material misstatement arising from transactions and events; and
- the methods used and the assumptions and judgments made, and changes to them, that affect amounts presented or otherwise disclosed, including relevant sensitivity analyses.

Similarly, auditors may request additional disclosures to be made in the financial statements, regardless of materiality considerations, to err on the side of caution rather than risk being challenged later for a lack of disclosures.

As such, there should be a greater emphasis in the standards for the auditor to consider the relevance and materiality of disclosures. Although the concept of "relevance" is mentioned in the standards such as paragraphs 13(d) and A3b of ISA 700, there should be greater linkage to the "materiality" concept to help guide the auditors to make appropriate judgements when evaluating the fair presentation of the disclosures, striking a balance between "relevant and material" and "adequate" disclosures.

Additional guidance in other areas

2.4 The ED has pointed out that with financial reporting requirements for disclosures now evolving and also that some disclosures now include information from systems and processes that are not part of the accounting system, changes are proposed to give prominence to disclosures where the information is not derived from the accounting system, and related considerations pertaining to this source of audit evidence. In this aspect, we wish to highlight two areas where enhancements can be made:

(a) Where sources of audit evidence for disclosures are from non-financial systems, there may be a concern over what can be considered as acceptable audit procedures to be performed in order to obtain evidence over the operating effectiveness of those non-financial systems. For example, an entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks. Such information are not part of the accounting system but are obtained from the entity's risk management system. This issue does not seem to have been envisaged or addressed by the proposed changes.

(b) Paragraph 30 of ISA 330, *The Auditor's Responses to Assessed Risks*, has been proposed to be amended to state that the auditor's documentation shall demonstrate that the financial statements, including disclosures, agree or reconcile with the underlying accounting records. This proposed change appears to suggest that an auditor only needs to agree or reconcile disclosures with the underlying accounting records. This would not be consistent with the fact that audit evidence for some disclosures may be derived from systems and processes that are not part of the accounting system or the underlying accounting records as mentioned in paragraph 2.4(a) above and IAASB should take this into consideration when proposing the changes.

2.5 It may be helpful to consider additional guidance to address the audit of disclosures in the context of group audits within ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, particularly for cross-border audits. For example, auditors may face challenges in the compilation of uncorrected misstatements, especially for qualitative disclosures. Hence, additional guidance could be provided to the group auditor on how to communicate the threshold for reporting of uncorrected misstatements relating to qualitative disclosures to the component auditors.

Question 3

Whether, in your view, the proposed changes to the assertions will help appropriately integrate the work on disclosures with the audit work on the underlying amounts, thereby promoting an earlier and more effective audit of disclosures?

3.1 We agree that the proposed changes to the assertions may help integrate the audit work on disclosures with the audit work on the underlying amounts. In fact, these changes are in line with the current practice of most audit firms in Singapore. For these firms, the proposed changes are already reflected in their audit methodologies and procedures, where disclosures are considered at the planning stage and the audit procedures for disclosures are performed together with those of the underlying classes of transactions and account balances, as opposed to a separate set of audit procedures solely on disclosures. Hence, at least from the perspective of auditors, they do try to address disclosures early in the audit.

3.2 However, in practice, there are challenges for auditors to address all disclosures early as the timing of audit work relating to disclosures is largely dependent on the timing of management's data gathering and preparation process. While some disclosures information obtained from the accounting system may be provided around the same time as the information on the underlying classes of transactions and account balances, there is less emphasis by management to provide disclosure information obtained from other non-accounting systems or sources. In practice, such information are often provided towards the end of the audit process. For the smaller entities which may not have the necessary resources or expertise, even disclosures information from accounting system may be provided late in the audit process.

3.3 Additionally, we welcome the inclusion of the attribute of relevance of disclosures in the proposed assertion for "Presentation", as this will encourage auditors to address the issue of irrelevant or excessive disclosures. However, we note that the proposed "Presentation" assertion only covers relevance and understandability. This appears inconsistent with ISA 700, paragraph 13(d) which requires the auditor to evaluate whether the information presented in the financial statements is relevant, reliable, comparable and understandable. The attributes of reliability and comparability appear to have been omitted. IAASB should consider what drives the attributes of disclosures and adopt the same terms consistently throughout the standards so that auditors would be focused on the right attributes to consider when addressing disclosures.

Other Comments

<u>Effective Date</u>

4.1 The ED has mentioned that the effective date for the revised standards would be 12-15 months from the issuance of the final standards. We are of the view that 12 months may not be adequate for audit firms that are members of international networks as their global audit methodologies and audit software may need to be changed for some of the proposed amendments. A period of 18 months would be a more appropriate timeframe.

Notwithstanding the above, we support the effective date to be aligned to the IAASB's Auditor Reporting project and the project to revise ISA 720, *The Auditor's Responsibilities Relating to Other Information* since there are common ISAs affected by the proposed changes under these projects.

Should you require any further clarification, please feel free to contact Mr Kang Wai Geat, Deputy Head, Technical Standards Development and Advisory, or Ms Fua Qiu Lin, Manager, Technical Standards Development and Advisory, at ISCA via email at waigeat.kang@isca.org.sg or qiulin.fua@isca.org.sg respectively.

Yours faithfully,

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