European Banking Authority
European System of Financial Supervision

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Dear Madam or Sir

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

The European Banking Authority (EBA), which has come into being as of 1 January 2011, welcomes the opportunity to comment on the discussion paper on the audit implications of financial reporting disclosures.

The EBA has a strong interest in promoting sound and high quality audit practices supporting high quality corporate reporting which is a crucial element of market confidence and discipline. This is particularly relevant to financial statement disclosures, which continue to increase in prominence as accounting standards develop and more judgment is introduced into accounting.

The EBA welcomes the discussion paper as it covers the main issues and provides a sound analysis of the audit of disclosures. The analysis in the discussion paper provides an opportunity for us to comment on ISA requirements and auditors' methodologies and approaches to the audit of disclosures.

International Standards on Auditing (ISAs) contain some requirements and guidance relating to the audit of disclosures. However, we believe that there could be more requirements and guidance which focus on disclosures. Specifically, most ISA requirements on auditing disclosures are combined with the requirements relating to the work on the financial statements overall. It would be beneficial, given developments in disclosures and the greater role they play in financial statements, for the requirements covering the audit of disclosures to be separately identified in ISAs.

However, we note that the issues around the audit of disclosures cannot be totally separated from broader issues with financial reporting disclosures within an accounting framework[1] such as how materiality is assessed in relation to disclosures. The EBA would therefore welcome the development of a financial reporting framework for disclosures, which could specify the

[1] Any reference to accounting standards in this letter is in respect of IFRS.

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objectives and qualities of disclosures. This could assist the auditors in their approach to the audit of disclosures as well as the expectations of stakeholders on which information they can expect to be disclosed and under what circumstances. We would encourage the IAASB to pursue this with the IASB.

The appendix to this letter includes our detailed responses to the consultation questions for regulators.

If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33 1 4292 5801) in his capacity as Chair of the EBA Standing Committee in charge of monitoring developments in the accounting and auditing area or Ms. Sucher (+44 20 7066 5644) in her capacity as Chair of the technical group that coordinated the response.

Yours sincerely

Andrea Enria
EBA Chairperson

Appendix: Responses to questions R1 – R10

R1) Have you encountered a disclosure which you believe was immaterial, and could have been removed to enhance the understandability of the financial statements? Please provide examples, your reasoning for why you believed they were immaterial in the context and why you believe they were not omitted.

We believe there may be circumstances where disclosures made may be immaterial and could be removed to enhance the understandability of the financial statements.

Immaterial (and also 'boilerplate') disclosures, which do not convey relevant information about the entity, can obscure the essential disclosures in financial statements which can undermine understandability. An example of such disclosure is the description of accounting policies that apply to certain types of transactions even though no such transaction has taken place during the reporting periods covered by the financial statements

However, the layout and presentation of disclosures is also important as essential disclosures may not be sufficiently prominent and understandable to the user.

In some circumstances we are aware that preparers may include overly detailed disclosures in the financial statements because preparers were not confident about how much detail would be required to comply with the accounting standard and/or it was easier to keep disclosures in the financial statements even though they may no longer be relevant.

We believe that development of a disclosure framework (e.g. by the IASB) could assist preparers, users and auditors in understanding the overall objectives of providing disclosures in financial statements and when omission or presentation of disclosures may lead to material misstatement for users. We would encourage the IAASB to work with the IASB on such a project.

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

ISAs already contain some provisions applying to disclosures but ISAs should contain more provisions specifically focused on disclosures.

In various ISAs current requirements on the disclosures are combined with the requirements relating to the work on the financial statements overall and they apply to "amount, classification, presentation, or disclosure". Moreover, auditors are required to perform tasks at the "assertion level for classes of transactions, account balances and disclosures" or "for each material class of transactions, account balance, and disclosure", without any specific guidance on how these tasks can be fulfilled for disclosures.

It would therefore be beneficial, given developments in disclosures and the greater role they play in financial statements, for the auditor's requirements on disclosures to be separately identified in the relevant ISAs. Any specific requirement on disclosures should be accompanied by practical guidance on concepts such as evaluating the sufficiency and appropriateness of evidence and misstatements. There is currently a need for guidance that is more

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tailored to audit of disclosures. Development of a disclosures framework could assist in framing this work.

Additionally, there are certain developments in disclosures that may not be sufficiently addressed in the ISAs either through requirements or, more likely, guidance:

- Given the move to more objective based requirements in IFRS (e.g. in IFRS 7, IAS 8) it is not clear that there is sufficient guidance in the ISAs to deal with these aspects of accounting standards;
- Guidance on the requirement to consider whether management's compliance with the specific requirements of the accounting framework provide sufficient information for the financial statements to be true and fair; and
- The discussion paper notes that often the timing, formality, focus and control over the preparation of disclosures is less than that for the primary statements. This has a consequential impact on the robustness of audit procedures that it is possible to apply. To address this, auditors should focus on their planned approach to obtaining evidence on disclosures early, and discuss this with management. We believe there may be merit in incorporating some guidance on this into the relevant ISAs on audit planning and audit engagements.

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

Throughout the audit work on disclosures, it is important that auditors challenge whether management have provided all necessary disclosures (particularly for the objective based disclosures where the individual disclosures may not be tied to specific accounting requirements, or for those where there is valuation uncertainty and disclosures may evolve) in a manner which is sufficiently balanced and understandable.

ISAs require that the extent of audit work on disclosures should be driven by an audit risk assessment (just as the primary statements are), based on the notion of a material misstatement of the financial statements as a whole, as this is the basis of the audit opinion. This audit risk assessment may need to be conducted according to a methodology developed specifically for disclosures. Based on this, a risk-based audit plan should determine the extent of evidence that the auditor needs to obtain.

We note three key issues that affect the quality of audit evidence for the examples given in paragraphs 60-70:

(1) The quality of audit evidence is often a function of the quality of the process management has undertaken to produce the information to be audited. If management do not provide a clear audit trail with support and evidence for their disclosures, the auditor has more difficulty gathering audit evidence.

(2) Many disclosures are generated from systems and processes which are not subject to the same degree of internal control as the core financial systems. This may affect the reliability of evidence obtained.

(3) The auditor may find it more challenging to assess whether they have gathered sufficient appropriate audit evidence to support those disclosures which involve a high level of management judgement. As

the level of judgment in disclosures continues to increase (e.g. disclosures addressing estimation uncertainty), the importance of auditor scepticism grows. The auditor must critically evaluate the adequacy and completeness of disclosures and management's assertions therein, and be alert to events or conditions that may contradict what management has disclosed.

Each of these issues, or a combination of them, can have an impact on the quality of the audit evidence that the auditor gathers. Two examples are as follows:

Fair value disclosures of items not measured at fair value

As far as we are aware, there is probably a tendency for less rigour to be applied to determining these fair values, as well as auditing them. In some cases the disclosed fair values are not part of the routine processes and controls as those items that are measured at fair value. The audit of these disclosures should not be more challenging than if the amounts were recognised on the balance sheet. When auditors are limited by the quality of evidence available from management, they should challenge management to improve this quality, since these disclosures are necessary to comply with the relevant accounting framework.

Fair value methods and assumptions

In principle, we believe auditors would have examined fair value methods and assumptions when performing work on the financial statement items subject to fair value measurement. Consequently, the audit of the disclosure of such information can be considered an extension of this work. However, the auditor is likely to face challenge in evaluating the extent to which management has provided the necessary detail, sufficient to allow users to understand the exposures, how they were measured, uncertainties and sensitivities.

R4) Some disclosures include the fair value of a financial statement line item measured on another basis, such as historical cost. In this circumstance, what level of effort do you expect an auditor to apply on the fair value disclosure? Should the auditor's effort be the same as if the fair value was on the face of the balance sheet?

Disclosures are an integral part of financial statements and therefore, within the context of their overall assessment of the risks of material misstatement, auditors are expected to demonstrate a level of work effort commensurate with the assessed level of risk and materiality regardless of whether information is on the face of financial statements or only disclosed in the notes.

The risk of material misstatement of some disclosures that are not linked to data in the financial statements (such as disclosures on off-balance sheet commitments) can be higher than the risk of material misstatement of disclosures that are linked to data in the financial statements (e.g. disclosures of the fair value of items carried at amortised cost). Qualitative disclosures could also carry a higher risk of misstatement, even though not readily quantifiable, than in quantitative disclosures.

Fair value disclosures may be material to users including investors and other stakeholders (e.g. regulatory authorities). If an item is determined by the auditor to be material, and it poses the same level of audit risk whether it is disclosed or recognised, then the auditor's effort should be the same.

However it is conceivable that certain disclosed amounts are determined to be less risky or less material than recognised amounts, thereby having an impact on the level of audit work performed.

R5) Does the shift in the IASB Conceptual Framework away from reliability and towards faithful representation change what you expect of preparers and auditors? Please explain your answer.

The IASB noted at the time of the change that its intention was for a clarification rather than a change of meaning to the Conceptual Framework. In our comment letter in response to the proposal[2], we observed that this change might not convey the same meaning, despite the IASB's intent.

However, following the change to the Conceptual Framework, given the IASB's intent, we would argue that preparers are still expected to produce financial statements which are complete and 'neutral' (i.e. avoiding overly prudent or aggressive estimates) and auditors are still expected to assess their completeness and neutrality. While increased judgment affects expectations on auditors, we do not believe this change to the Conceptual Framework, in itself, does.

Due to this increased use of judgement, preparers should, when appropriate, enhance those disclosures which enable users to understand the information for key areas of estimation uncertainty (inputs, assumptions and processes used, sensitivity analysis). In performing audit work on disclosures, auditors should focus on gathering enough audit evidence to challenge preparers on the inputs, assumptions and processes they used.

R6) What is your expectation regarding the need for disclosures not specifically required by the financial reporting framework, but which some users may believe are relevant to the fair presentation of the financial statements? Examples may include non-compliance with a critical law, even though there is no quantitatively material effect, or the fact that the entity does not have a material holding of a particular asset class, such as sovereign debt, which may be of particular interest in the current economic environment.

As established in the IASB Conceptual Framework ('qualitative characteristics of financial statements') an item is material, if its omission or misstatement could influence users' decision making. We believe this should be the benchmark for evaluating the relevance of additional disclosures in financial statements, which are not specifically required by the financial framework. In practice, this relates to the application of the requirement in IAS 1 (17c) "to provide additional disclosures when compliance with the specific requirements of IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance."

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[2] http://www.eba.europa.eu/getdoc/608068e6-40ec-4b0f-94f7-6d62bf9c44b6/2008-09-29Comment-Letter-ED-Phase-A-Conceptual-Fra.aspx

What is material is a dynamic concept as circumstances and users' information needs change over time. Therefore, it is reasonable to expect disclosures and audits thereof to change in response.

A minor breach of a rule may not be material (quantitatively) to an entity initially but if it has the potential to become material, is relevant to users. As well as the quantitative aspects of any breach, reputational risk aspects need to be considered, as they can also have a significant impact on the future business and therefore the enterprise's ability to continue as a going concern.

Regarding disclosures relating to the absence of material exposures, we believe that in certain circumstances this 'non-exposure' could be material to users. Specifically, disclosing that there is no material holding in assets which are considered of major importance in a given economic environment, increases transparency and is useful for decision making. It is for management to identify such items (again, in the spirit of IAS 1). The auditor's role is then to form a judgment on the extent to which the omission of the disclosure affects the overall truth and fairness of the financial statements.

R7) What do you believe represents a material misstatement of a disclosure? Please give an example of what, in your view, would constitute a material misstatement for the following categories of disclosure:

In line with IAS 1, we would regard a misstatement to be material if it could influence the economic decisions of users taken on the basis of the financial statements as a whole. We describe below some hypothetical examples of material misstatements with reference to each of the categories listed in the discussion paper. In practice, this determination would depend on the auditor's view on materiality given the prevailing facts and circumstances. Indeed, when auditing disclosures that cover key management judgements, auditors have to use their own judgment and to consider materiality from the view-point of the users to determine the appropriateness and the sufficiency of the disclosures.

Judgements and reasons/assumptions/models/inputs:

- factually incorrect information (e.g. the disclosed assumption does not reflect the actual assumption made);

- one that the auditor disagrees with (e.g. an unreasonable assumption; this would also lead to material misstatement of the relevant Financial Statement Line Item (FSLI));

- inappropriate inputs (e.g. incorrect yield curve); and

- inadequate explanations such as broad, generic comments.

Sources of estimation uncertainty/sensitivity analysis disclosures:

- factually or mathematically incorrect;

- incomplete – e.g. missing 'sources', sensitivity omits a key variable;

- inadequate explanation of identified 'sources' of uncertainty; and

- sensitivity analysis was not based on a reasonably possible change.

Descriptions of internal processes:

- factual misrepresentation of the process.

Disclosure of fair value information for a line item recorded on the balance sheet using a different measurement basis:

- same principles as misstatement for FSLIs (this answer is independent of the level of audit 'rigour' that should be applied).

Objective-based disclosure requirements:

- does not fulfil objective (e.g. effects of major transaction on accounts are not adequately explained). For instance, IFRS 7 requires disclosures sufficient to allow users to evaluate the significance of risks from the usage of financial instruments. The specific requirements address this, but it is entirely conceivable for the specific requirements to be met without meeting the overall objective. For example, if liquidity risk is the biggest risk facing the entity, and IFRS7 disclosures focus on market risk disclosures, and provide minimal but compliant liquidity risk disclosure obscured by surrounding information, then it would not meet the objective.

R8) Some disclosures are relevant to an understanding of the entity but are not related to any specific line item in the financial statements. Below are two examples of these types of disclosure:

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?

We believe the auditor should evaluate whether the information is correctly described, comprehensive and reflective of what management actually has in place. Auditors should look to available evidence obtained during the audit and from their cumulative audit knowledge and experience.

We do not believe the auditor needs to test that the controls are effective in addressing risks, for the purposes of performing audit procedures on the disclosure, unless management is making the assertion that the controls provide a specific level of confidence in the disclosure. However, where there is evidence that the controls are not operating effectively the auditor should challenge management on the disclosures, if necessary.

b) The IASB has proposed disclosures regarding stress tests. What work would you expect an auditor to do in relation to the proposed stress test disclosures? What do you believe would constitute a misstatement of a stress test disclosure?

While there are currently no such disclosure requirements in IFRS and the IASB has abaondoned this propsal in its current projects for now, we recognise that these types of disclosures may become more prominent in the future.

There are two broad components to auditing these types of disclosures:

i. the process and mechanics/calculations for preparing the disclosure; and

ii. the reasonableness of the assumptions/scenarios used.

The former should be reasonably straightforward and the auditor should be able to gather evidence to validate the process. The latter is far more complicated, because the reasonableness of the assumptions/scenarios used, is more a matter of opinion. The auditor could utilise the evidence provided by management on what it believes are appropriate assumptions/scenarios. When there is independent evidence (e.g. direction from regulators on the inputs for the stress testing and /or historical evidence on how the stress tests were performed), this can support the auditor's assessment in this area.

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

As disclosures are an integrated part of financial statements, the audit opinion covers both information on the face of financial statements and disclosures. We therefore believe there should be a presumption that all disclosures can be subject to some form of audit procedures, in the context of the audit of the financial statements as a whole. This is the case even if they are very subjective, forward looking, or reliant on management's intent. That is why, even when facing such disclosures, auditors should devote enough effort, time and resources to obtaining sufficient and appropriate evidence for all material disclosures.

Disclosures are not audited separately and what constitutes sufficient, appropriate audit evidence varies according to the item subject to audit, including the extent to which the item is inherently subjective (e.g. information based on management's intent or certain fair value estimates).

R10) What criteria do you believe should be used to assess an auditor's judgement in respect of the fair presentation of the financial statements as a whole?

As noted above, we believe that management needs to go beyond mere compliance with specific disclosure requirements to consider whether they are presenting a true and fair view overall. The concept of "true and fair" is dynamic as it evolves in response to changes in accounting and business practice and the circumstances facing the entity.

This is supported by requirements in ISA 700 in the definition of "fair presentation framework" and the auditor's responsibilities in assessing compliance with this.

The basis of this assessment must come from the auditor's understanding of the entity, its business and environment, and risk assessment based on this. This will enable the auditor to form a view of which elements are material and warrant special audit attention, including those related to disclosures.

As banking supervisors, we are aware that in some jurisdictions regular dialogues between auditors, banking regulators and industry bodies take place addressing key issues which will help to identify possible disclosures needed to satisfy the true and fair criteria.