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Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
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Subject: International Auditing and Assurance Standards Board's (IAASB) January 2011 Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the IAASB's January 2011 Discussion Paper entitled *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications.* We support the Board's efforts to clarify the auditor's responsibilities related to auditing financial statement disclosures. Also, we support development of principle-based guidance, either as a standard or other guidance, for evaluating disclosures that builds on the existing requirements in the International Standards on Auditing (ISAs). Such guidance can improve the consistency and effectiveness of auditing disclosures. In developing such guidance, we suggest the Board consider developing or strengthening existing guidance in the following areas:

- developing uniform criteria for evaluating disclosures,
- providing additional guidance on evaluating qualitative disclosures, and
- clarifying the extent of the auditor's responsibilities for auditing disclosures.

Criteria for Evaluating Disclosures

Currently, the criteria for evaluating disclosures are presented in multiple standards and the language used in explaining the criteria has subtle differences that could result in inconsistent application. Disclosure criteria discussed in various standards and summarized in the Discussion Paper include:

- financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements. (ISA 700)
- disclosures of estimation uncertainty in the financial statements are in accordance with the requirements of the applicable financial reporting framework. (ISA 540)

- provide additional disclosures to avoid the financial statements prepared under a financial reporting framework prescribed by law or regulation from being misleading. (ISA 210)
- fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. (ISA 240)
- an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the user's understanding of the financial position, financial performance or cash flows of the entity. (ISA 450)
- evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. (ISA 330)
- when the financial statements are prepared in accordance with a fair presentation framework, the financial statements achieve fair presentation in view of the overall presentation, structure and content of the financial statements and the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation. (ISA 700)

We recommend that the Board consolidate the criteria in the various standards into uniform criteria for auditors to use in evaluating financial statement disclosures. Such uniform criteria could improve the quality and consistency of audits. Uniform criteria should also help address concerns regarding the auditability of some disclosures. Additional guidance on auditing disclosures should identify and further develop criteria for evaluating disclosures.

In developing uniform criteria, the Board should also consider standards and pronouncements developed by other professional bodies. For example, certain fair presentation frameworks contain requirements to consider disclosures beyond the specific requirements in the framework. In the United States, the U.S. Securities and Exchange Commission (SEC) has issued guidance on disclosure criteria in several of its rulings. In its final rule under Section 302 of the Sarbanes-Oxley Act, the SEC stated that, in its view, a "fair presentation" of an issuer's financial condition, results of operations, and cash flows includes disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosures necessary to provide investors with a materially accurate and complete picture of an issuers' financial condition, results of operations, and cash flows. Further, in administrative proceedings, the SEC has found that "issuers… have a paramount obligation to provide full and timely disclosure of information required by the federal securities laws. The issuer's legal obligation extends not only to accurate quantitative reporting of the required items in its financial statements, but also to other information, qualitative as well as quantitative, needed to enable investors to make informed decision." In several cases, issuers were found to have failed to adequately apprise investors of a material risk of lower earnings, failed to discuss a known trend, and failed to disclose management's consideration of issues that could result in material asset write-downs.

Guidance on Evaluating Qualitative Disclosures

We agree with the viewpoint in the Discussion Paper that the audit standards should provide additional guidance related to the auditor's evaluation of qualitative disclosures. As acknowledged in the Discussion Paper, disclosures have become more complex, which has created a greater need for the auditor to consider the qualitative aspects of disclosures. Factors that might be relevant in evaluating the qualitative disclosures include:

- the prominence of key disclosures, i.e., are they readily visible in a central part of the report, or are they obscured in a lengthy paragraph,
- the extensiveness of disclosures, i.e., do the disclosures assist the user in understanding the basis for reported amounts,
- the nature and source of the disclosures, i.e., do the disclosures distinguish between disclosures of fact based on historical information and disclosures reflecting management's intent or belief regarding future events, such as expected litigation outcomes,
- the clarity of the disclosures, i.e., are the disclosures vague, poorly worded, or confusing,
- the objectivity of the disclosures, i.e., do the disclosures reflect an unbiased and neutral position that does not distort the information,
- the completeness of the disclosures, i.e., do they omit information necessary to avoid disclosures from being misleading, and
- the fair presentation of the disclosures, i.e., are the disclosures sufficiently adequate and complete to achieve fair presentation, which may go beyond specific requirements in fair presentation financial reporting frameworks.
- the materiality of the disclosures, i.e., the amount of detail provided, the emphasis placed on the information, and how the information is aggregated.

Auditing the quality aspects of disclosures poses serious challenges for auditors due to the increasing length and complexity of those disclosures. Additional guidance on identifying and assessing qualitative disclosures would greatly assist auditors and also help improve the quality and consistency of auditing disclosures.

Responsibilities for Auditing Disclosures

Concerns expressed in the Discussion Paper about inconsistent interpretation of auditing standards related to auditing financial statement disclosures highlight the need for additional guidance clarifying the nature and extent of auditor responsibilities for auditing disclosures.

Under the ISA 330 "The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, **including the related disclosures** *(bolding added for emphasis)*, is in accordance with the applicable financial reporting framework." (*Adequacy of Presentation and Disclosure*, paragraph 24). Also, under ISA 700 "The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of: (a) The overall presentation, structure and content of the financial statements; and (b) Whether the financial statements, **including the related notes** *(bolding added for emphasis)*, represent the underlying transactions and events in a manner that achieves fair presentation (*Forming an Opinion on the Financial Statements*, paragraph 14). Based on these and other standards, we believe that the auditor has the same responsibility to consider both disclosures and financial statements in forming an opinion on the financial statements taken as a whole. Also, with respect to a fair presentation framework, we believe that the auditor has a responsibility to evaluate the adequacy and completeness of disclosures necessary to achieve fair presentation, which may go beyond specific requirements in fair presentation financial reporting frameworks. Both preparers and auditors of financial statements need to "stand back" and ask themselves whether the financial statements contain all the information needed to achieve fair presentation.

Guidance clarifying the nature and extent of auditor responsibilities for auditing disclosures, including evaluating the fair presentation, should include the following considerations:

- identifying and assessing the risk of material misstatement in disclosures. For some disclosures, this may be done at the same time, and in conjunction with, related line items, while for others it will require separate procedures.
- assessing as appropriate the effectiveness of management disclosure controls. Disclosure controls are discussed in SEC rules, which require registered investment companies to maintain and regularly evaluate "disclosure controls and procedures." Under the rules, disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed is accumulated and communicated to company management, including the CEO and CFO, as appropriate to permit timely decisions regarding the required disclosure.
- designing and performing audit procedures that are appropriate in the circumstances to obtain sufficient appropriate evidence, as discussed in ISA 500, Audit Evidence. In general, we believe that the auditor should, at a minimum, obtain evidence about whether management had a reasonable basis for the information presented in disclosures, as well as a basis for determining what information should be disclosed. With respect to qualitative disclosures, such evidence generally would relate to whether the disclosure adequately describes the basis for information disclosed and the assumptions and other considerations used. For a disclosure related to the description of an internal control, such evidence would relate to whether the control is implemented, designed, and operating effectively.

Further audit guidance might also discuss the auditor's option to include, as matters of emphasis or other matters, information in the auditor's report that highlights key points in disclosures. For example, GAO has included a discussion of estimation uncertainty (based on management's disclosures) in audit reports for several entities where resolution of such uncertainties could result in materially different amounts from the estimates in the financial statements.

Financial reporting requirements will continue to pose challenges for preparers and auditors. As noted in the Discussion Paper, although it is ultimately management‘s responsibility to provide appropriate disclosures for their entity, it is the auditor‘s responsibility to question management when it believes the disclosures are inappropriate. Since the challenges to preparers and auditors are interconnected, the Board might explore opportunities to collaborate with the International Accounting Standards Board (IASB) and other bodies that establish financial reporting standards on these issues.

By incorporating these suggestions for improving the evaluation of disclosures, the International Auditing and Assurance Standards Board will help improve consistency in the considerations of the adequacy and accuracy of disclosures and assist auditors as they consider the effectiveness of the controls that management uses to ensure the validity of their disclosures.

We thank you for considering our comments on these important issues and we would be pleased to clarify our response to the Discussion Paper or contribute to the development of any new guidance on auditing disclosures.

Sincerely yours,

James R. Dalkin
Director
Financial Management and Assurance