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# INTERVIEWS WITH AUDITORS OF SMALLER AND MEDIUM ENTITIES FEEDBACK STATEMENT

## Disclosure Requirements in IFRS Standards -

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### Note to TEG members

The content of the Detailed feedback is considered as background reading for the TEG preparation. The main messages are presented at the beginning of this paper.

## Objective and background

Most of the participants of the field test were large entities. In order to get specific evidence from smaller and medium sized entities, the EFRAG Secretariat had a number of interviews with auditors, to leverage from their knowledge of the readiness and resources of their clients.

The purpose of the interviews was to understand the challenges that the proposed approach raises for smaller and less resourced entities. The challenges might relate to their processes and to the audit of their disclosures.

EFRAG has developed in addition to the survey<sup>1</sup>, a conversation guideline in order to gather views from auditors of smaller and medium sized entities on the Exposure Draft *Disclosure Requirements in IFRS Standards - A Pilot Approach* (the ED; available here). This includes both the general guidance and on the proposed amendments to IFRS 13 *Fair Value Measurement* and IAS 19 *Employee Benefits*.

Smaller and medium-sized entities applying IFRS were not sufficiently represented in EFRAG's field test. Therefore, the experience and knowledge of the auditors of these companies about their resources and processes is useful to get an understanding of the implications for both topics.

Four auditors from different jurisdictions (Germany, Italy, and Norway) gave us interviews.

The following table provides an indication of the range of responses relating to the terms used throughout the summary:

Term used	Percentage of respondents
All	100%
Most	75%
Some	50%
One	25%

<sup>1</sup> The report on the result of the survey is uploaded as a separate paper to the TEG meeting 22 Dec 2021 (agenda paper 08-04).

## Main messages from the interviews

### *Overview of the feedback received on the capabilities of small (and medium sized) entities*

Most auditors were of the opinion that a more judgmental approach could be a concern for smaller preparers.

Auditors generally considered that:

- The capabilities of medium sized and smaller entities are much more restricted than the capabilities of the bigger ones.
- In addition to lacking resources (personnel and skills) and motivation, smaller entities would tend to allocate less resources to non-core business areas. Even the medium-sized, listed companies often maintained structures in their accounting department (number of staff and knowledge) that seem just sufficient or sometimes even inadequate to deal with complex accounting issues or to apply judgement specifically to the extent proposed by the new approach.
- Therefore, small and medium listed companies are often more interested in disclosing less information and being more pragmatic about the disclosures to be provided.

Most respondents clearly saw a disclosure problem around the current disclosures of smaller and medium-sized entities which often included too few (relevant) or too much (irrelevant) disclosures. They saw merits in disclosure objectives to help smaller companies to better focus on material and relevant disclosures and noted that this could also lead to a change in mindsets.

Some respondents replied that practical reasons would prevent the approach from improving the situation, such as a lack of prescribed disclosures under the new approach and too much judgement. Most respondents found a checklist approach more appealing as it would give more safety to smaller (and medium sized) entities and auditors that important information is not missing.

Some respondents opined that a staged approach (rather than a big leap into only objectives-based disclosures) would have better chances of successes for smaller (and medium sized) entities. Entities (especially smaller ones) cannot dedicate significant resources to (ad hoc) changes of the disclosures, therefore a different (entity specific) set of disclosures could only be developed over more than one reporting period.

Although the IASB does not in principle required preparers to second guess the users' needed identified in the ED, most auditors saw problems with the determination of whether users' needs would be adequately met. The reason for this is that smaller companies do usually not have much investor communication or in some jurisdictions local GAAP financial statements would be more important to investors.

Some respondents expressed the view that the materiality assessment was the main issue for small (and medium sized) entities' preparers. It was noted that that smaller (unlisted) entities often publish too much (irrelevant) information because they were not able to assess users' needs or important information as they lack understanding (also of materiality) and experience.

Due to operational challenges and lack of resources, smaller (and medium sized) companies would try to find an efficient way to address potential changes, if the ED is finalised, by:

- not presenting fundamentally different disclosures and instead carryover most of their current disclosures with little changes; and/or
- continuing to apply a minimum disclosure requirement approach (for instance by using the list of non-mandatory disclosures in the ED or developing their own checklist based on prior period disclosures or the examples of financial statements published by large audit firms...); and/or
- benchmarking other disclosures (e.g., those from early adopters) and adjust slightly.

#### *Overview of the feedback received on the audit and enforcement consequences*

All interviewed auditors stated that the audit might become more complex as they would have to verify that material information is not missing. They commented that the discussion about disclosures and objectives would have to be conducted by more experienced audit personnel.

Some auditors assessed that it is easier to qualify an audit opinion based on a material item missing disclosure from a checklist. Under a judgmental approach, it would be more difficult to qualify an audit opinion. Some assessed that there will potentially be more discussions with regulators because it will be easier for the regulator to challenge judgement than to challenge missing disclosures based on materiality considerations only.

Some expected that the level of complexity of future audits will depend on the preparer's documentation. Some stated that the amount of discussion and the level of controversy in the discussion with the client will probably increase and all respondents noted that the audit process will therefore take more time. Most respondents thought that the audit will become more difficult due to having to audit entities' judgements.

Some pointed out that they expected more effort (and cost) from preparers in the beginning, but probably not more in the subsequent phase (when the structure of disclosures will be more static). Then, in the following years, a checklist approach would be applied.

respondent raised the concern that the effort (and costs) will increase on an ongoing basis as the audit would have to assess possible changes in the environment of the company that could require different disclosures.

#### *Overview of the feedback received for the general approach*

Some respondents were concerned about a lack of prescribed disclosures under the new approach and too much judgement. Most respondents found a checklist approach more appealing as it would provide more safety to smaller entities and auditors that important information is not missing.

One respondent stated that it would probably be better to have a different set of disclosures for smaller entities compared to bigger ones. One respondent suggested requiring more mandatory disclosures (e.g., a minimum list of mandatory disclosures).

Some respondents opined that the extension of the time horizon would be a key success factor for the implementation of the new approach. Entities (especially smaller ones) cannot dedicate significant resources to (ad hoc) changes of the disclosures. One respondent had the feeling that the preparer's willingness would be key for the implementation. Some emphasised the need for more guidance on materiality for preparers.

## *Overview of the feedback received for the specific standards*

### *Alternative fair values*

Some respondents perceived alternative fair value measurements to be useful for readers.

One respondent mentioned the reduced usefulness of sensitivity analysis in practice under the standards status quo, e.g., when key inputs and their changes are not disclosed.

One respondent did not see a risk in the audit of alternative fair value measurements as auditors themselves use a reasonable range of fair values in the audit, so the reasonable range for disclosure purposes should be within the acceptable range for audit purposes.

### *Reduced reference to fair value hierarchy levels*

One respondent agreed with the requirement for more disclosures on Level 2 depending on the scenarios. There would be no need for more information about plain derivatives contrary to fair valued investment property.

### *Overall disclosure objective for defined contribution plans*

Some stated that the disclosure objective for defined contribution plans (“... enables users of financial statements to understand the effect of defined contribution plans...”) would not be an issue in their respective jurisdictions as it would not be a topic of high measurement uncertainty and complexity.

### *Sensitivity analysis*

One respondent agreed that cash flow information would be quite useful for user (and probably more useful than a sensitivity analysis).

## Detailed feedback - Section A

### Smaller and medium sized entities – what is the impact of the new disclosure approach

#### **Question 1 – From your view, are entities able to establish a satisfactory process for implementing and applying the new approach? What are the challenges?**

One auditor noted that assessing the changes required by the new approach to disclosures would help entities to think about their current disclosures. In practice, the conclusions drawn would be quite different depending on the size of the entity.

Two auditors stated that the new approach will become a problem for smaller (and medium sized) entities (even if quite large with a market capitalisation above one billion EUR) as their reporting structures are not sophisticated. One of these auditors stated that smaller (and medium sized) entities tended to disclose in more detail the accounting policies followed, and judgements made (sometimes in boilerplate manner). For the additional notes required by specific standards, entities usually comply with the minimum required.

Consequently, it will be even more difficult for much smaller (and medium sized) entities to implement the approach. The IFRS knowledge among such entities is on average less deep (in particular when unlisted). Those entities have the expectation that auditors should support clients in coping with the disclosure requirements as there is a lack of necessary processes and resources to deal with the problem on their own.

The auditors further noted that small (and medium sized) listed entities are often more interested in disclosing less information and being more pragmatic about disclosures. Even the medium listed entities maintain reporting structures that seem just sufficient or sometimes even inadequate for their size, contrary to bigger listed entities that are motivated to deliver better disclosures to attract investors.

#### **Question 2 - The proposed approach will require the company to make its own judgements as to what would be material and relevant information to users rather than just following a checklist. Is this assessment feasible?**

One auditor stated that the current disclosure checklist approach results in too much effort on both sides (preparer and auditor). If there were to be only disclosure objectives (without minimum disclosure requirements), auditors may wonder about the preparer's judgement, as currently the emphasis is on what has not been disclosed.

Three auditors were of the opinion that a more judgmental approach could be a concern for smaller preparers. One considered that smaller (and medium sized) entities in its jurisdiction would not be interested in applying judgement and considering useful disclosures, but they would rather focus only on mandatory requirements.

Two auditors stated that when entities do not have the appropriate structure and knowledge for judgement, they tend to

- review and copy the disclosures of bigger entities (e.g., in case of the implementation of new standards); or



- use old disclosure requirements to fulfil new disclosure requirements to avoid complex implementation.

From another auditor's point of view, some smaller (and medium sized) entities with appropriate personnel are able to deliver more useful disclosures than other entities. Those apply judgement to reduce lengthy, less valuable disclosures, but the level of knowledge and behaviour is diverse in the various jurisdictions. This auditor did not have a big concern that smaller (and medium sized) entities would go for a minimum checklist approach under the ED's proposals, as the entities tend to be very open for discussions with the auditor.

Finally, two auditors considered the documentation relating to the disclosures and specifically, the application of judgment by the preparers, to be very challenging.

### **Question 3 - From your perspective assessing the capabilities of small or medium sized entities:**

#### **(a) Can companies easily assess the materiality and relevance to users of information with reasonable cost and effort? Please explain.**

According to two auditors, smaller (and medium sized) listed entities should potentially know what to disclose (users' needs) but would have to consult with their users to explore the required information. Smaller entities (that can prepare IFRS financial statement in the jurisdiction even when not listed) will probably not have and will not be able to get the information. At least three of the auditors stated that the practical application will be challenging.

As a consequence, as mentioned by three auditors, smaller unlisted entities often publish too much (irrelevant) information, in particular with regard to the general disclosures on accounting policies and estimation and judgement (e.g., copying from the standard or illustrative financial statements), as the important information is not clear. Both publishing too little or too much information originates from insufficient knowledge by preparers, but in the context of audit and regulatory activity, it is preferable to publish more information rather than too little.

One auditor considered that - contrary to listed entities - it is difficult to identify the user of unlisted financial statements and such a user's needs as there is not much communication with these users. In the specific jurisdiction, investors (e.g., typically the owner) of unlisted smaller companies only focus on the annual financial statements and the cash flow perspective under local GAAP. Other users such as banks would probably not be really interested in what is disclosed under IFRS.

As a consequence, smaller entities are also less motivated to provide sophisticated entity-specific disclosures (see also question 3(b)), because the increase in quality will probably not result in advantages (e.g., no better loan conditions or easier access to financing).

Two auditors found the current assessment of materiality to be a huge problem for preparers. Auditors may be well prepared for the assessment, but there seems to be no definition for materiality from the preparer perspective. It is questionable whether preparers from smaller entities could apply the quantitative and qualitative materiality approach appropriately.

Two auditors questioned whether banks (as a very specific user for SMEs IFRS reports) have the capability to interpret IFRS financial statements in a meaningful way.

**(b) Do those entities have sufficient resources (number of staff and skill set) and appropriate reporting structures to implement the new approach? Please explain.**

Three auditors pointed out the differences among preparers but admitted that problems are often similar. The responsible department lacks resources in terms of the number of people and the skillset. Moreover, the development of good disclosures is an additional effort, and the related benefits are not often clear (see question 3(a)).

Four auditors assessed that there is an attitude and a behavioural problem, because the preparation of financial statement is a mandatory exercise (resulting from the listing or other regulation, or from contractual obligation) and not the entity's main focus. In addition, such entities lack adequate personnel (skilled and experienced) so preparing disclosures will either lead to disclosing too less or too much (irrelevant) information, in particular with regard to the general disclosures on estimation and judgement. If less experienced personnel prepare the notes, they probably produce too many disclosures to avoid extensive discussion with the auditors.

Furthermore, one auditor pointed out that under XBRL, entity-specific format will have to be customized, which will require time and other resources, and this could also prevent SMEs from changing their disclosures more frequently.

**(c) The exercise of judgement requires a high level of involvement of management when preparing the Financial Statements. Are companies ready to exercise the intended level of judgement? Please explain.**

Not directly addressed to some extent covered by question 1 and 2.

**(d) Considering the above, do you expect disclosures to be significantly different from current disclosures under the new approach? Please explain.**

Two auditors stated that disclosures will not necessarily be different as preparers probably will not see a huge difference between the old and the new disclosures. From a practical viewpoint, if auditors allow them, smaller (and medium sized) entities will probably just carryover old disclosures with minor changes.

**Question 4 - What are the most important restrictions that would hinder smaller entities to implement the new approach (personnel, technical/IT system, procedural, understanding, other)?**

One auditor commented that all of the above points mentioned are relevant. Two auditors agreed but found that IT systems of medium sized entities should be capable of delivering the required information.

Two auditors also added that entities – resulting from their limited resources - will not be able to change their disclosures from one year to another as such thing would need to evolve over time.

**Question 5 - Do you think that the new approach will increase or decrease the quality of disclosures and that the increased quality will outweigh any additional costs (if any)?**

Disclosures will probably stay the same (see question 3(d)).

One of the auditors did not expect that in the respective jurisdiction that smaller (and medium sized) entities would only apply the mandated disclosures. However, two auditors thought that smaller (and medium sized) entities would only disclose mandatory requirements.

**Question 6 - Do you think that smaller entities would perceive the new disclosure approach as a higher or lower hurdle for applying IFRS?**

One auditor stated that the notes in general are a hurdle to overcome when applying IFRS.

The same auditor noted that the new approach is not necessarily a higher or lower hurdle. Big entities will work on their disclosures as they have the capabilities to improve their notes and smaller (and medium sized) entities will consider the mandatory disclosures (minimum requirements) or their old disclosures (for those entities that try to avoid problems the auditor).

One auditor stated that it would depend on the understanding of the new approach by small (and medium sized) entities and the matter of judgment. It will probably not be a barrier, but it will also not make the application of IFRS easier.

**Detailed feedback - Audit and enforcement**

**Question 7 - Do you consider the new approach will change the strategy/process for the audit of the notes and disclosures considerably? If so, what will be the major advantages or disadvantages of such a new process look like? What are the biggest problems for the audit resulting from the implementation of the new disclosure approach?**

Auditors mentioned the need for differentiation between the initial and subsequent phases. After the initial phase when the disclosures would change, the notes will become more static and thus the audit will become more akin to a checklist. During the subsequent phase, disclosures will only change when material different (new) transactions arise, similar to the current audit approach.

Nevertheless, the audit might become more complex as the auditor has to cover more topics to ensure the completeness of the disclosures.

Moreover, one auditor highlighted that – even if the biggest part of the efforts would take place in the first year – the costs in subsequent years would also change with changes in the business environment as well as changes in the business model. This would have to be assessed in the subsequent years.

A second problem will be that smaller (and medium sized) entities expect support regarding possible changes in the notes to the extent permissible (year-to-year changes). The smaller the entity the more “support” is expected (e.g., the new disclosure requirements under IFRS 16).

Auditors will need to use more experienced people to discuss the disclosures. It will be difficult to assess judgment, if the small (and medium sized) entities' documentation is not sufficient.

**Question 8 - How will the proposed new disclosure approach affect the audit regarding the**

**(a) level of dialogue with clients and users?**

Four auditors thought that the level of dialogue with the client could potentially increase, and the dialogue will need to be held by more experienced personnel, except where entities continue with the existing disclosures (with only slight changes).

Two auditors assessed that the level of controversy in discussions with clients will probably increase.

**(b) use of external experts?**

No comments made.

**(c) timing of the audit (has it to start earlier/later, do you need longer or shorter?)**

Four auditors mentioned that the audit might potentially need more time as a result of longer discussions.

One auditor said that even if the business model had not changed the auditor would still need to assess whether the environment has changed. This may then require different disclosures and result in longer audits.

**(d) XBRL audit?**

One auditor noted that while of limited practical relevance in certain jurisdictions, XBRL may differ from entity to entity.

**(e) audit documentation?**

Three auditors specifically highlighted that the documentation would become more difficult due to the higher level of judgement required. It might be less complex in cases that entities carry over their old disclosures, then the documentation might be the same.

**(f) audit costs?**

Two auditors specifically pointed out that the audit costs will increase in the beginning. Costs will probably not increase – be relatively stable - in the subsequent phase. One auditor also saw an ongoing increase in efforts (and cost).

**Question 9 - Do you expect increased efforts (more questions on disclosures and more intensive discussions) to explain the smaller entities' disclosures in enforcement procedures (e.g., to demonstrate completeness and usefulness of the information given)? Could this potentially lead to more negative findings?**

An auditor stated that to qualify an audit opinion based on a missing material disclosure from a checklist would be easier as it is obvious that something is missing. If the disclosures are judgmental, it would be difficult to qualify an audit opinion.

One auditor noted that auditors need to apply judgement in case of sensitive information, but there is not much discussion in this regard currently, so such discussions (also about sensitive information) would not be expected in the future. The auditor also thought that it will be easier for local regulators to challenge judgement exercised, so there will be more discussion, but not necessarily more negative findings.

Two auditors commented that discussion could be minimised if a proper process for judgement were to be in place, where entities show a reasonable effort in reaching a conclusion. Where this is not the case, more discussions with regulators may arise. This differs to a checklist approach as then the discussion with the regulator is mostly about the materiality of omitted disclosures.

## **Detailed feedback - Section B**

### **View on the general principles of the new disclosure approach**

#### **Question 10 - Do you agree with the IASB's assessment that there is a gap between the disclosures presented under current standards and disclosure of information that would be useful for users?**

One auditor stated that smaller (and medium sized) entities' preparers often disclose too much information or too little information, therefore the usefulness of disclosures is a problem.

Another auditor commented that the disclosure problem discussion has a long history, so there are problems with disclosures and their usefulness. The IASB's initiative makes a lot of sense.

#### **Question 11 - Do you consider that an objective-based approach as proposed by IASB is better than the current approach (e.g., prescribing detailed information requirements) and could overcome the "disclosure problem"?**

Two auditors remarked that applying disclosure objectives could help smaller (and medium sized) entities to get a better sense for disclosures. One of them stated that this could also cause a change in the preparer's mindset, especially (non-regulated) smaller unlisted entities could more vigorously focus on important information.

Two auditors replied that from an intellectual perspective, the approach suggested by the IASB mirrors exactly how entities should prepare their disclosures; but for practical reasons it does not seem to improve the current situation. Under the new approach only a few disclosures are prescribed, and significant judgement will be required to determine what to disclose.

Three auditors pointed out that a checklist approach gives more safety to smaller (and medium sized) entities and auditors that important information is not missing.

#### **Question 12 - If you agree to the existence of a 'disclosure problem', can you imagine**

##### **(a) other ways (different from the proposed new approach) or**

One auditor noted that it is difficult to require the same checklist for listed and unlisted entities. This is true for the audit of smaller entities compared to listed entities in certain countries as well. One proposal would be less disclosures for small entities and a more sophisticated set for bigger entities, but this would also result in complexities.

Another auditor said it is extremely difficult to find a solution for the problem, but maybe the preparer's way of thinking could be changed through the use of objectives (by inserting those in the current requirements).

**(b) changes to the proposed ED to overcome the disclosure problem?**

One auditor suggested that there should be more mandatory disclosure requirements.

**Question 13 - Your thoughts on the approach's possible key success factors (e.g., full objective approach or approach with minimum requirements or a mixed approach; active involvement of users and creditors; clear understanding of materiality)?**

One auditor mentioned that both approaches (prescribed disclosures and the objective-based approach) could work and lead to better information, if the preparer spends more effort on considering, developing and preparing disclosures.

Two auditors stated that a change will only be possible and successful if the entities can expend their efforts for a longer time period. No entity will be able to change their disclosures in one period. They cannot dedicate sufficient resources to the (ad hoc) change of disclosures. New or different disclosures evolve over time.

Two auditors noted that the IASB should give more guidance on materiality to make it easier for preparers to understand which disclosure requirements were important. If preparers would understand what is important (material), they could probably prepare more useful disclosures.

**Remarks on IFRS 13 and IAS 19**

**Question 14 - How will the number of disclosures change under the new approach compared to the status quo?**

Three auditors explained that small (and medium sized) entities, which are not very sophisticated, would probably keep the old disclosures (carryover of disclosures) with only few adjustments in agreement with their auditor.

One auditor thought that SMEs would apply a minimum disclosure requirement approach (so in effect reduce disclosures), so they would probably only disclose what is mandatory.

**Question 15 - IFRS 13: Will the disclosure of alternative fair values result in better information than using sensitivities and will this also be accompanied by a reasonable cost/benefits trade-off?**

Two auditors perceived alternative fair value measurements to be useful for readers. One of the auditors stated that preparers would probably not favour it as it would involve more effort.

One auditor mentioned that sometimes a sensitivity analysis may not be useful in practice, especially when there is no mention of the key inputs and their changes, but it would be easier for entities to prepare a sensitivity analysis.

Another auditor expressed the view that a range of fair values can be difficult to audit for some clients. However, auditors use a reasonable range of fair values from an audit perspective (fair value point estimate is audited by using the auditor's reasonable range), so the reasonable range for disclosure purposes should be within the acceptable range of the auditor.

**Question 16 - IFRS 13: The amendment puts less emphasis on level specific disclosures, so will SMEs make more disclosures for instruments categorised as Level 2?**

One auditor agreed to require more disclosures for Level 2, but it would depend on the scenarios. Vanilla derivatives would not require more information; unlike investment property at fair value where more measurement uncertainties could exist.

**Question 17 - IAS 19: The ED only requires an overall disclosure objective for defined contribution plans. Do you think that this is sufficient information to cover the main risks related to this pension plans? Please also consider hybrid pension plans when responding.**

An auditor stated that specific schemes would exist in different territories, that were reported to external parties (banks, government). However, as there is not much measurement uncertainty for defined contribution schemes, the overall disclosure objective would be sufficient.

Another auditor stated that in their jurisdiction, “other long term employee benefit plans” are not really material.

**Question 18 - IAS 19: Do you think that a sensitivity analysis (as required today) is useful and justifies the accompanying costs?**

An auditor agreed that cash flow information would be quite useful for users (and probably more so than a sensitivity analysis).

