

Auditing Complex Financial Instruments—Summary of Significant Comments on Consultation and IAASB Task Force Recommendations

I. Background

1. The comment period for the Consultation Paper (CP) closed on January 15, 2010. Thirty-three¹ responses were received, as follows: member bodies (12), other professional organizations (3), national auditing standard standards (3), public sector organizations (1), regulators and oversight authorities (5), firms (8), and individuals and others (1).
2. Overall, respondents were broadly supportive of the IAASB's plans to develop guidance relating to auditing complex financial instruments by revising IAPS 1012,² and supported the plans to leverage the UK Auditing Practices Board's (APB) Practice Note 23 (Revised)³ as a starting point for doing so.
3. This summary of significant comments will be discussed at the March 1-2, 2010 IAASB Consultative Advisory Group (CAG) meeting, and any comments from the Representatives will be shared during the IAASB meeting.

A. Use and Status of IAPSs

4. A number⁴ of respondents were of the view that the status and authority of IAPSs should be reassessed before finalizing revised IAPS 1012. Some suggested that their views on the form and content of a revised IAPS 1012 would likely differ if the status and authority were elevated. One respondent (CPAB) noted that it would not support any significant reduction in the guidance as a result of a change in status or authority; in their view the level of guidance provided will help practitioners in performing audits and promote greater understanding and consistency in the performance of audits in this complex area.
5. While the Consultation Paper did not explicitly acknowledge the project to consider the status and authority of IAPSs, the Task Force has considered the IAASB's discussions at its December 2009 meeting to retain the current status and authority of the IAPSs included in the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" (the Preface). Further discussion on the status and authority of the IAPSs is included in **Agenda Item 6-A**.
6. The Task Force has included language in paragraphs 2-3⁵ of the IAPS to more clearly articulate how the IAPSs are to be viewed in the context of the ISAs, in particular that (a) auditors are required to comply with all ISAs relevant to the audit; (b) reading the IAPS is not a substitute for reading the ISAs themselves; and (c) while the IAPS highlights the

¹ A list of respondents to the Consultation Paper is included at Appendix 1.

² International Auditing Practice Statement (IAPS) 1012, "Auditing Derivative Financial Instruments."

³ Practice Note (PN) 23, "Auditing Complex Financial Instruments."

⁴ ACCA, CICPA, CPAB, EYG, FEE, ICAEW, IDW, JICPA, Mazars, PWC

⁵ All paragraph references are to Agenda Item 6-C, unless otherwise noted.

requirements of certain ISAs, there may be other requirements that are relevant in the audit of financial instruments.

II. Matters for IAASB Consideration

A. Nature of Financial Instruments and Applicability of the IAPS to Audits of Entities of All Sizes

A.1 Types of Financial Instruments Addressed in the IAPS

7. Though there was broad support for using the PN as the basis for revising IAPS 1012, some respondents were of the view that more was needed in order to make the IAPS relevant. Comments from respondents reflect the challenge between providing guidance that highlights key issues relevant to auditors working with financial instruments of varying complexities, as compared to having a detailed “master class” for those who are actively engaged in the audit of such instruments or having the IAPS be more comprehensive for audits of larger financial institutions.
8. One respondent (AIA) specifically noted that “much of the content is pitched at a level that implies little or no prior knowledge or experience of the audit of financial statements. Arguably, an auditor who requires guidance at this level should consider whether it is appropriate to be auditing an entity that makes use of complex financial instruments.” One respondent (FEE) offered an alternative view – that this was necessary because of the range of users of the guidance (practitioners auditing mainly small- and medium-sized entities (SMEs) and other entities with few and often simple financial instruments to practitioners from large firms auditing listed entities, complex financial institutions, other large entities and SMEs which use extensively both simpler and complex financial instruments).
9. Respondents to the CP had mixed views as to whether the term “complex financial instruments” was sufficiently clear. Those⁶ who supported how complex financial instruments were described agreed that the PN clearly defined what is meant by the term and provides illustrative examples that will aid users in better understanding the nature of these instruments, and acknowledged that going further to define them would be difficult given the constantly evolving nature of these instruments.
10. One (BCBS) suggested a definition of complex financial instruments should be included by referring to the characteristics of such instruments, the variability associated with the cash flows of such instruments, and the complexity of fair value measurements. Another (IIF) suggested it may be more meaningful to include certain factors to be considered in an assessment of the level of complexity of a financial instrument, such as structural features, the relationship between observability of valuation inputs, pricing sources and complexity, and other risk factors. It was also suggested that the IAPS could articulate that seemingly simple financial instruments can become complex when markets become inactive.⁷

⁶ ACCA, AIA, CICA, CICPA, CPAB, DTT, FACPCE, Hermes, HKICPA, ICAEW, ICPAS, NZICA, RSM, SAICA

⁷ BCBS, PWC

11. A number⁸ of respondents were of the view that including examples of more and less complex instruments was helpful to illustrate the applicability of the IAPS in a wide variety of circumstances. Respondents noted that it is difficult to get a common understanding of where the threshold between complex and non-complex financial instrument lies, and suggested the complexity of a financial instrument might also be regarded with respect to (a) the sector in which a company operates, and (b) the measurement basis. Some respondents⁹ suggested it was less important to explain how the guidance can be applied to a range of entities, and more important to explain how the guidance can be applied to more and less complex financial instruments; in their view, the level of complexity and the resulting risks of material misstatements are the drivers of the audit approach.
12. A number¹⁰ of respondents supported expanding the guidance to all financial instruments, with a few of these respondents suggesting that the proposed pronouncement cover all but the simplest financial instruments, by perhaps specifically scoping out items such as cash, trade accounts receivable, trade accounts payable, and perhaps other financial instruments that may be carried at amortized cost. These respondents believed that much of the guidance is not exclusive to complex financial instruments, and that it should seek to compare complex financial instruments to financial instruments as a whole, including derivatives. One respondent (IIF) promoted the benefit of having a single, comprehensive source of audit literature for all financial instruments including both assets and liabilities and both derivative and non-derivative instruments.
13. A number¹¹ of respondents did not believe this was necessary, for a number of reasons. Some noted the pressing need for guidance related to complex financial instruments because these represent more significant audit challenges, and auditors dealing with instruments that are simple would find relevant guidance in the ISAs themselves. Others thought that broadening the remit would be distracting and would add to the length of the document unnecessarily.
14. A few respondents¹² suggested that not referring to “complex” in the title of the IAPS and retaining the paragraphs dealing with the levels of complexity and the applicability of the guidance in a number of circumstances may assist in promoting the use of the IAPS to the broadest extent.

Task Force’s Recommendations

15. Taking account of all the comments received, the Task Force determined that the IAASB’s work to develop the IAPS would have the most benefit if the IAPS was seen to be applicable to the broadest base. While the Task Force agrees there is a need for detailed guidance on auditing complex financial instruments, it also believes that auditors dealing with all types of financial instruments could benefit from this additional guidance. Entities

⁸ ACCA, CICA, CPAB, DTT, FACPCE, FEE, Hermes, IAA, ICAEW, ICPAS, IOSCO, NZICA

⁹ BCBS, EYG, GT, IAA, IAIS, IIF, IOSCO, JAB, PWC, RSM

¹⁰ FACPCE, FEE, GT, HKICPA, IAA, ICAEW, ICPAS, IDW, IIF, JAB, KPMG, RSM, SAICA

¹¹ ACCA, AIA, APRA, AUAASB, CICA, CICPA, CPAB, DTT, EYG, Hermes, IAIS, JICPA, NZICA, RSM

¹² ACCA, IAA, RSM

and auditors may not realize the complexities involved with certain instruments, for example contracts that have embedded derivatives, or the conditions in which the instruments are held (for example, when markets become inactive). Focusing the guidance on the auditor's risk assessment and highlighting factors that may drive the complexity of financial instruments allows the IAPS to be scalable to audits of all financial instruments.

16. The Task Force recognizes, however that, by expanding the guidance to all financial instruments, the guidance may not meet the needs of those who would like for the IAPS to be a comprehensive audit guide for auditors of financial institutions dealing with very complex financial instruments.¹³ The Task Force believes that auditors dealing with large financial institutions or entities that engage in a high volume of financial instrument transactions are likely not those who most need the additional guidance that could be placed in an IAPS. Accordingly, it believes that the IAASB's efforts should be focused on developing guidance to improve practice in this area by those who may not be as familiar with the issues surrounding valuation, including suggesting that both management and auditors may need to supplement their expertise in this area.
17. The Task Force proposes the following:
 - Scoping out the simplest financial instruments, and explaining that the IAPS applies to financial instruments measured at fair value (noting that certain instruments carried at amortized cost may be required to be disclosed at fair value and are therefore covered by the IAPS in that regard).
 - Explaining factors that may influence the complexity of particular financial instruments, and the affect this complexity has on the auditor's risk assessment and audit procedures.
 - Including additional examples of financial instruments, including reference to structured products and embedded derivatives.
 - Incorporating material from extant IAPS to define certain financial instruments and highlight key terms used in practice in an Appendix.
 - Specifically acknowledging that the IAPS is designed to be applicable to both financial and non-financial institutions, and can be applied by auditors of entities of all sizes with financial instruments of varying complexities, including audits of small- and medium-sized entities.

See paragraphs 4-11 of **Agenda Item 6-C**.

18. The Task Force, however, has not reached a consensus on what the document should be titled. This is, in part, due to questions about the intended audience and what type of guidance is most needed in practice,. In addition, the Task Force has not fully benefited from the input of its experts, given the timing of the Consultation Paper. The proposed options are:
 - “Auditing Financial Instruments” (the current working title of **Agenda Item 6-C**), which, in some Task Force members' view, allows for the likelihood of the most

¹³ APRA, AIA, IIF, JICPA

readers of the document, with the content describing how the use of the material may differ depending on the circumstances;

- “Auditing Complex Financial Instruments” (the APB’s title), which, in some Task Force members’ view, is appropriate given that loan loss provisioning and impairment issues are not addressed in the document and complex financial instruments may not always be measured at fair value;
- “Auditing Financial Instruments Measured or Disclosed at Fair Value,” which, in some Task Force members’ view, is appropriate given the link to ISA 540¹⁴ and the fact that the current draft does not address financial instruments carried at amortized cost.

Depending on the IAASB’s views, additional work may be needed to address areas not currently covered in the draft IAPS. For example, should the Board believe it is appropriate to address all instruments measured at fair value, guidance relating to loan loss provisioning and impairment would need to be incorporated.

A.2 Applicability to Audits of Entities of All Sizes

19. While most¹⁵ respondents believed the guidance explaining the applicability of the PN to audits of entities of all sizes was helpful, a number of respondents were of the view that more could be done to make the applicability to SMEs more clear, such as:
- Including considerations specific to smaller entities, or to entities with a small portfolio of complex financial instruments (ACCA, AUAASB, FEE, ICAEW)
 - Including guidance as to the types of internal controls typically in place in a large entity with high levels of trading as compared those in place in a small entity with relatively few transactions, and highlighting the need to balance the work performed over internal controls and the extent of substantive procedures (APRA, FEE, Mazars); however, the IAPS should not assume such controls are effective in larger entities (IDW, IIF)

Task Force Recommendations

20. The Task Force believes that changes to the IAPS described in Section A.1 of the document will further highlight the applicability of the guidance to auditors dealing with SMEs. Further, the IAPS now highlights that the relevance of each area of guidance may differ considerably between different entities and is dependent on the complexity of the financial instruments being audited. See paragraphs 4 and 12-13 of **Agenda Item 6-C**.
21. The Task Force did not consider it appropriate to highlight considerations specific to smaller entities because of its decision to focus the IAPS on the complexity of the instruments as the driver of the auditor’s risk assessment and audit procedures. As noted by

¹⁴ ISA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”

¹⁵ ACCA, AIA, AUAASB, CICPA, CPAB, DTT, EYG, FACPCE, FEE, GT, Hermes, HKICPA, IAA, ICAEW, ICPAS, IIF, Mazars, NZICA, PWC, RSM, SAICA

PWC, it would be inappropriate for the guidance to be interpreted to suggest that the audit effort would be proportionate with the sophistication and complexity of the entity. In their view, it is not the size of the entity that influences the type of audit procedures that are appropriate. Rather, it is the nature and characteristics of the financial instruments that the entity holds, and the related controls in place, that are relevant. The Task Force has, however, sought to explain in the IAPS that certain controls may not be in place for smaller entities and has made changes to the PN to avoid implying that controls will always be effective (or will form the majority of the auditor's procedures) in larger entities.

22. One challenge for auditors of smaller entities is that they may not have the same knowledge and experience with auditing financial instruments as auditors of entities in industries in which these sorts of instruments and related risks are core to their audits. At the same time, management of smaller entities may have less experience in managing investments in financial instruments and controlling the related risks (noted by AUAASB and PWC). Accordingly, the Task Force has made changes within the IAPS to highlight the need for both management and the auditor to ensure that they have the appropriate expertise to understand the financial instruments in which the entity and invests. See further discussion in Section II C.1 of this paper relating to management's experts and paragraphs 39-48 of Agenda Item 6-C relating to the auditor's use of specialized skills or knowledge.
23. In this regard, the Task Force was of the view that it was important to highlight early in the document considerations dealing with the purpose and risks of using financial instruments, which are now included as paragraphs 14-18 of **Agenda Item 6-C**.

Matters for IAASB Consideration

1. Does the IAASB agree with the Task Force's proposal to expand the scope of the IAPS to auditing all financial instruments, scoping out the simplest instruments?
2. Does the IAASB support the Task Force's view that it is important to highlight the relationship between the complexity of financial instruments and the extent of an entity's use of them and risks of material misstatements? Does doing so make it clearer that the IAPS is applicable to auditors dealing with SMEs and allow for wider use of the IAPS?
3. What are the IAASB's views on how the document should be titled in light of the content it contains?

B. Use of an Overview Section and References to the ISAs

B.1 Structure of the Practice Note, including the Use of an Overview

24. Respondents had mixed views as to the length and flow of the PN. Many¹⁶ respondents agreed that the PN reflects the significant areas that need to be addressed in revised IAPS 1012 and is structured in a logical order, dealing with the key aspects and procedures in the audit process.

¹⁶ ACCA, AUAASB, CICPA, CPAB, EYG, FACPCE, FEE, Hermes, IAA, ICAEW, ICPAS, IDW, PWC, RSM

25. While many¹⁷ respondents supported the use of an Overview section, others¹⁸ were of the view that it should be deleted. One respondent (GTI) noted that an Overview section could be used to highlight the main considerations which, in their view, are the need for the auditor to understand the economics of the financial instruments, why the instrument is being used by the entity, and its effects on the entity’s risk and ultimately audit risk.
26. Further to this point, a number¹⁹ of respondents thought duplication within the APB’s PN could be eliminated in part by deleting references to guidance already included in the relevant ISAs. In general, respondents were of the view that repeating requirements that applied to all audits was unnecessary.

Task Force Recommendations

27. In revising the PN, the Task Force has considered the length of the document. While duplicative paragraphs have been deleted and the content reordered, the Task Force has concluded that the current length is appropriate in light of the material contained within proposed IAPS 1012. One driver of the length of the document is the educational material contained within it; at the December 2009 meeting, the IAASB seemed to favor the document giving this level of detail given the target audience, and the Task Force supports this view. After the March 2010 IAASB discussions, the Task Force may continue to reorder the document and consider whether certain topics, such as valuation, could be highlighted more prominently.
28. The issue of how to refer to the ISAs was initially considered by the Task Force in the context of elevating the status and authority of the IAPSs to that of application and other explanatory material. However, given the IAASB’s views at its December 2009 meeting, the Task Force has reconsidered how best to refer to the ISAs without duplications. **Agenda Item 6-C** therefore has been revised to generalize references to the ISAs, mostly through the use of footnotes. As noted in paragraph 6 above, the IAPS now also reminds auditors of their obligation to comply with the ISAs, rather than merely consider the material contained in the IAPS.
29. In light of the comments about the overview and other suggestions for minimizing duplication within the ISAs, the Task Force has replaced the Overview with a section called “Key Considerations in Auditing Financial Instruments.” This new material incorporates areas which, in the Task Force’s view, are the most important considerations for the auditor in dealing with financial instruments. While the key considerations are not meant to be exhaustive, the Task Force is of the view that this signposting is helpful to auditors in understanding what the IAPS is meant to cover and will help to promote the use of the document by auditors dealing with financial instruments of all complexities. See paragraphs 19-24 of **Agenda Item 6-C**.

¹⁷ ACCA, AIA, APRA, CICA, CPAB, DTT, EYG, FACPCE, FEE, IAA, ICAEW, ICPAS, IOSCO, JAB, RSM, SAICA

¹⁸ AUAASB, CICPA, HKICPA, IAIS, IDW, KPMG, NZICA, SAICA

¹⁹ BCBS, CICA, EYG, FEE, IAIS, ICPAS, IDW, Mazars, NZICA, KPMG

30. The Task Force used the PN as the basis for the draft IAPS presented to the IAASB for reference at its December 2009 meeting. Subsequent to that meeting, and in light of comments received from respondents requesting additional guidance or highlighting areas of duplication, the Task Force has substantially revised the draft IAPS and, accordingly, believes it is not necessary to present a mark-up version showing changes from either the December 2009 draft or the PN included in the CP.

Matters for IAASB Consideration

4. In reviewing the draft of the IAPS included at Agenda Item 6-C, the IAASB is asked to consider whether the linkage to the ISAs is appropriate in light of the current status and authority of the IAPSs.
5. Does the IAASB agree with the matters included in the Key Considerations section and how the matters are cross-referenced to other material within the IAPS?

C. Valuation of Financial Instruments

C.1 Use of a Management's Expert, Including Broker Quotes and Pricing Services

31. The knowledge and experience of management and those charged with governance is an important element of the control environment, as is management's philosophy and operating style. The use of financial instruments without relevant expertise within the entity may result in the entity assuming significant risk, often unintentionally. When management does not have this expertise, it often engages third-party experts to provide assistance with valuation of its financial instruments. These experts may include brokers and pricing services, or may be specialists employed by the entity (for example, quantitative staff).
32. The majority²⁰ of respondents agreed that further guidance should be included to describe broker quotes and pricing services, in particular:
- More comprehensive guidance on the use of independent pricing services and valuation models, including guidance indicating how those charged with governance or management may involve the use of independent experts in providing pricing services and designing valuation models and the types of audit procedures that may be appropriate.
 - Linking to the requirements in ISA 500²¹ for the auditor to evaluate the competence, capabilities and objectivity of management's expert and the appropriateness of the expert's work as audit evidence.
 - Acknowledgement that access to management's expert's methodologies is often challenging, especially in emerging markets, and highlighting that management retains the responsibility for the assumptions and methodologies used in the valuation.

²⁰ AUAASB, BCBS, CICPA, CPAB, DTT, EYG, FACPE, FEE, GT, HKICPA, ICAEW, IDW, IIF, NZICA, PWC, RSM, SAICA

²¹ ISA 500, "Audit Evidence."

33. Two of these respondents suggested that this material could be included as an Appendix to the document, incorporating the Glossary of Terms from extant IAPS 1012.
34. Those²² that did not support including additional material about brokers and pricing services noted that circumstances may be largely jurisdictionally driven and suggested such guidance would be better developed by national standard setters, and also noted such material would likely be duplicative of that produced by the International Accounting Standards Board (IASB)'s Expert Advisory Panel (EAP).²³

Responsibility for Management to Understand the Methods and Assumptions Used by Management's Experts

35. There are differing views among auditors and others as to whether the auditor's degree of understanding of the entity and its complex financial instruments changes depending on whether the process is done within the entity or whether one or more third-party experts are used. For example, if the management's expert is a well-known, competent and objective expert, some argue that the auditor can rely on the expert's competency and experience and may not need as thorough of an understanding of the valuation processes, assumptions and methods for a particular instrument. They likewise argue that in such cases the auditor does not need to test the assumptions and methods as thoroughly. However, others contend that reliance on the expert's competency and expertise is not sufficient to discharge the auditor's responsibility to obtain an understanding of the expert's assumptions and methods and also to evaluate the reasonableness and appropriateness of them.

Task Force Recommendations

36. The Task Force believes that the use of experts by management is one of the most significant issues in practice and, accordingly, has highlighted the matter as a key consideration. The Task Force has substantially revised the PN to incorporate additional guidance and highlight issues surrounding the use of management's experts. First, it is important that experts are engaged when management does not possess the expertise needed in dealing with financial instruments. However, doing so does not relieve management for its responsibilities for the preparation of the financial statements.
37. The IAPS now specifically notes that an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged their responsibilities for the preparation of the financial statements, including where relevant their fair presentation.²⁴ The PN has been restructured to describe "Management's Method for Valuing Its Financial Instruments" (see paragraphs 111-131), which now explains that management is responsible for obtaining evidence to support its valuations, and that using inputs from brokers and pricing services is one aspect of doing so.

²² ACCA, AIA, CICA, ICPAS

²³ EAP Report issued October 2008, "Measuring and disclosing the fair value of financial instruments in markets that are no longer active."

²⁴ ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing," paragraphs 4 and A2.

38. Following this, the IAPS further highlights the importance of management understanding the assumptions and methods on which brokers and pricing services have compiled their quotes in order to assist management in evaluating the relevance and reliability of this evidence to support management’s valuations. This is consistent with language used in ISA 540²⁵ that clearly states: “Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management’s assumptions.” Management also has a responsibility²⁶ to provide written representation whether they believe significant assumptions used in making accounting estimates are reasonable. The Task Force believes it will be very difficult for management to meet their responsibilities if they are unable to “get behind” the assumptions and methods used by brokers and pricing services to arrive at prices and valuations.
39. The auditor’s ability to comply with the requirements in ISA 540 to understand how management makes its accounting estimates, and test those estimates, is highly dependent on the evidence management has obtained to support its valuations. The use of an expert by management has implications for the auditor, which have been addressed by the IAPS, for example, on:
- The auditor’s risk assessment and planned procedures, including the possible identification of significant risks and the procedures required by the ISAs when significant risks are identified;
 - The need for the auditor to use an auditor’s expert when management has used a management’s expert;
 - The potential inability for the auditor to obtain sufficient appropriate audit evidence when management is unable to obtain an understanding of management’s expert’s method and assumptions.
40. The Task Force acknowledges that there have been difficulties in this area in practice, insofar as brokers and pricing services have been unwilling to provide this information to management and auditors often attempt to obtain it directly from brokers and pricing services. However, the Task Force believes it is necessary that the IAPS highlight the auditor’s requirements under the ISAs and the potential effects of the scope limitation when management does not have the evidence necessary to support its valuation. This matter was highlighted for the IAASB’s discussions at its December 2009 meeting, and the Board seemed to support the initial direction proposed by the Task Force. However, this continues to be a significant issue in practice - as highlighted by the expert on the Task Force, quotes from pricing services and brokers have quite often been the *only* evidence to support valuations in recent years and the difficulties for both management and the auditor to get the necessary information on how such prices were determined persist.
41. See guidance included in **Agenda Item 6-C** in paragraphs 25, 30-35, 54, 111-131, which describe management’s process, and paragraphs 149-157 and 181-189 relating to the

²⁵ ISA 540, paragraph A31.

²⁶ ISA 540, paragraph 22.

auditor's procedures on valuation. In addition, the Task Force has incorporated more general material contained in the IASB's EAP report from October 2008 as Appendix 3.

C.2 Use of Models

42. Many²⁷ respondents agreed that the guidance on the use of models was sufficient. Those that did not believe the guidance was sufficient believed more guidance could be incorporated about:
- Features of widely-used common models, how they operate, and the risks associated with them;
 - Financial instruments valued using customized approaches such as discounted cash flow analysis and option pricing models;
 - The need for the auditor to exercise professional judgment when evaluating valuations based on models, including challenging management's approach and the reasonableness of management's assumptions;
 - The need for the auditor to consider the validity of inputs to models, including internal controls over inputs and whether inputs and assumptions used in models are internally consistent and reflect management's intent and ability to undertake a particular course of action; and
 - The auditor's evaluation of an entity's existing valuation reserve methodologies (e.g., model risk reserves).

Task Force Recommendations

43. The Task Force has considered the requests for more detailed guidance on the use of models. In general, additional guidance has been included about actions of the auditor in evaluating models, including considering the validity of the model, and the professional judgment involved in doing so. Guidance included about the need for the auditor to evaluate whether the assumptions used by management are reasonable also applies to the consideration of inputs to models used by the entity. Further guidance has also been included to explain why valuation adjustments to model outputs may occur, based on guidance in the IASB's EAP report. See paragraphs 124-125, 130, and 151-157 of **Agenda Item 6-C**.
44. The Task Force does not believe it is practicable to attempt to develop guidance explaining commonly used models, given the rapidly changing environment and the judgment involved by management in selecting a model, or to specify procedures that auditors would undertake for specific models.

C.3 Linkage to the Fair Value Hierarchy Explained in Accounting Standards, Including Reference to Inactive Markets

45. A few respondents were of the view that more should be explained in the IAPS about the

²⁷ ACCA, AIA, CICA, DTT, EYG, FACPCE, GT, Hermes, ICPAS, IDW, NZICA, SAICA

levels of the fair value hierarchy and the difficulty that unobservable inputs pose, in particular when markets are inactive.²⁸ Some suggested that the IASB’s EAP document provided useful guidance that could be incorporated into the IAPS.

46. The Task Force was of the view that accounting for fair value measurement under U.S. GAAP and IFRS is becoming more similar, and these frameworks will be applicable for most financial instruments. Accordingly, reference has been added within the IAPS to the fundamental concepts of the fair value hierarchy, including the use of 3 levels to describe inputs and disclosure requirements related to these levels. The Task Force is of the view that, while this may be seen as less framework-neutral than what is typically done in an IAASB pronouncement, highlighting how the accounting requirements may be viewed in the context of auditing challenges is appropriate. See guidance included in paragraphs 106-110 of **Agenda Item 6-C**.
47. Guidance to explain what is meant by “inactive markets” and how management and auditors may need to respond to inactive markets, including changing approaches to valuations and obtaining multiple sources of evidence to corroborate management’s valuation, have also been incorporated into the IAPS. See guidance included in paragraphs 126-130 of **Agenda Item 6-C**.

Matters for IAASB Consideration

6. Does the IAASB agree with the Task Force’s assessment of the responsibilities of both management and auditors with regard to understanding how brokers and pricing services arrive at pricing information used as inputs to valuations, including the matters explained in paragraph 40?
7. If so, does the IAASB believe additional guidance may need to be provided about the consequences of the inability of the auditor to obtain sufficient appropriate evidence in these circumstances (i.e., that this would lead to a scope limitation)?
8. Does the IAASB agree with the material included in the IAPS dealing with models?
9. Does the IAASB agree with the Task Force’s decision to include reference to the fair value hierarchy as explained in IFRS and US GAAP? Is the guidance included about unobservable inputs useful, in particular the description of the challenges facing management when markets become inactive?

D. Presentation and Disclosure

D.1 Sufficiency of Guidance on Disclosures Included in the PN

48. Nearly all²⁹ respondents believed the guidance included about disclosures was useful. One respondent (FEE) noted that disclosures are mainly driven by the relevant accounting

²⁸ APRA, BCBS, CICPA, IIF, KPMG

²⁹ ACCA, AIA, APRA, AUAASB, CICA, CPAB, DTT, EYG, FACPCE, FEE, IAA, ICAEW, ICPAS, IDW, IIF, Mazars, RSM

framework and was of the view that the guidance should be framework neutral. A few³⁰ respondents did not find it useful as some of the guidance merely seemed to repeat the accounting requirements. A number of respondents suggested improvements that could be made to the guidance, including:

- Providing more guidance on auditing qualitative and quantitative disclosures of, for example, operational risk, and emphasizing the need for the auditor to apply professional judgment to determine whether qualitative disclosures comply with the requirements of the applicable financial reporting framework;
 - Testing management’s sensitivity analysis and value-at-risk disclosures; and
 - Highlighting the need for the auditor to keep in mind the information value of the disclosures when auditing them, to ensure they are understandable to readers of the financial statements and are also comprehensive, meaningful, consistent and comparable.
49. A few³¹ respondents supported including more guidance on information systems that are not otherwise used to generate financial statements. One respondent (AUAASB), supported by another (IAA), suggested that it would be useful to incorporate such guidance into the section of the IAPS dealing with evaluating the control environment and internal control, because auditors should obtain this information during the course of the audit to determine the nature and extent of procedures required on this information. A few respondents believed controls should be implemented to ensure that financial instruments can be classified to the appropriate fair value hierarchy to meet the IFRS 7³² disclosure requirements.

Task Force Recommendation

50. The Task Force believes that the changes to the PN that it had presented to the IAASB at its December 2009 meeting largely addressed the concerns raised by respondents. The Task Force specifically considered how it could make clear the auditor’s responsibilities to ensure the disclosures are fairly presented, including whether they are understandable to readers of the financial statements and are also comprehensive, meaningful, consistent and comparable (see paragraphs 166-169 of **Agenda Item 6-C**), however, it notes that this concern is broader than just disclosures of financial instruments and may need to be addressed in more detail by the IAASB in a separate project.
51. The Task Force, however, did not believe it was appropriate to provide examples of auditing procedures that could be undertaken and sources of audit evidence that could be obtained to assess the transparency and reasonableness of disclosures. Rather, it modified the IAPS to explain that evaluating the reasonableness and adequacy of disclosures in the financial statements relating to financial instruments involves essentially the same types of considerations applied when auditing financial instruments recognized in the financial

³⁰ GTI, NZICA, PWC

³¹ ICAEW, FEE, GTI, IAA, ICAEW

³² IFRS 7, “Financial Instruments: Disclosures.”

statements. A linkage to the requirements in ISA 540 relating to disclosures of estimation uncertainty has now been made.

52. With regard to sensitivity analysis, although the Task Force acknowledges that auditing sensitivity analysis and value-at-risk disclosures is an important issue, the Task Force was of the view that this was outside the scope of the project. Broad guidance on the issues, including highlighting that the applicability of guidance on evaluating assumptions used by management to the auditor's procedures to evaluate disclosures of sensitivity analyses, is included in paragraphs 177 and 180 of **Agenda Item 6-C**.³³
53. Material has also been incorporated from recent publications from the Basel Committee on Banking Supervision, Institute of International Finance, and the UK Financial Services Authority, as cited by respondents. See paragraphs 132-136 and 165-177 of **Agenda Item 6-C**.
54. At the December 2009 meeting, the IAASB asked the Task Force to consider how the auditor's responsibilities might differ based on the placement of disclosures. For example, IFRS 7 allows for certain disclosures about the nature and extent of risks relating to the use of financial instruments to be placed outside of the financial statements and cross-referred to the financial statements. The Task Force did not come to a consensus in this area. Some Task Force members are of the view that any disclosures required by the applicable financial reporting framework are covered by the auditor's opinion regardless of placement, and therefore subject to audit procedures. Other Task Force members believe that disclosures outside of the audited financial statements would not be audited, and would only be considered by the auditor in accordance with ISA 720.³⁴
55. Given this difference in opinion, the Task Force members were of the view that this circumstance should not be addressed in the IAPS. The Task Force also recommends that this matter be discussed with the IASB liaison representative, as it is not ideal for the financial reporting framework to allow for a selection of presentation if the intent is that these disclosures are part of the financial statements and therefore subject to audit.

Matters for IAASB Consideration

10. Does the IAASB agree with the guidance included on disclosures?
11. What are the IAASB's views on the auditor's responsibilities with regard to disclosures required by the applicable financial reporting framework that are positioned outside of the financial statements?

E. Requests for Additional Guidance

56. The Task Force is of the view that respondents' requests for additional guidance can be characterized in three main areas:

³³ See also guidance on management's use of sensitivity analysis, contained in paragraphs 75, 79, 128, 131, 151, 155, 172 and 175.

³⁴ ISA 720, "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements.

- (i) Guidance to further address the risks arising from the use of complex financial instruments and the effect on audit procedures;
 - (ii) Guidance related to other requirements in the Clarified ISAs; and
 - (iii) Guidance to address other types of instruments and provide illustrative examples and suggestions as to what types of audit procedures would be expected in relation to particular instruments.
57. Where possible, the Task Force took on requests for additional guidance from respondents in relation to the first two categories above. In determining whether such guidance was necessary, the Task Force considered whether the guidance would be broadly applicable to most users of the IAPS and the extent to which such guidance was already addressed in the IAPS. Requests in the third category were in general not incorporated into the ISA, in part because of the need for the IAPS to remain principles-based and the complexity associated with prescribing specific procedures relating to particular financial instruments. Given the need for the auditor to apply professional judgment in the circumstances of the audit, the Task Force did not consider it appropriate to list specific procedures to be followed.

E.1 Types of Risks Associated with Financial Instruments

58. The PN included a description of types of risks commonly associated with financial instruments. Respondents suggested a number of additional risks to be included, and some suggested that particular risks could be recharacterized or described differently. The Task Force believes that included material about the types of risks is meaningful in some respects, however it was of the view that, with the modifications proposed by respondents, this guidance overwhelmed the IAPS. The material has been moved to Appendix 2 for illustrative purposes.
59. Additional material has been incorporated within the IAPS, for example in paragraph 91 of **Agenda Item 6-C**, to highlight matters that may affect the auditor’s assessment of the risks of material misstatement. This material, however, is linked to the business risks associated with financial instruments, and some members of the Task Force are of the view that it may not be clear how these in turn affect the audit.

E.2 Going Concern

60. The PN alluded to the possibility that the use of financial instruments may affect an entity’s assessment of its ability to continue as a going concern. However, some respondents³⁵ were of the view that going concern should be more explicitly mentioned in IAPS 1012.
61. One respondent (BCBS) noted: “The recent crisis has shown that the completeness, accuracy and valuation of complex financial instruments can impact management’s use of the going concern assumption. Given this can be a significant risk for those entities which are substantially engaged in trading complex financial instruments, we believe that the CP should emphasize the relationship between the audit of complex financial instruments and the going concern assumption when systemic issues arise (e.g., when markets are

³⁵ BCBS, EYG, FEE, ICAEW, Mazars

dislocated or are illiquid.”

62. The Task Force believes there may be some merit in reminding auditors of their responsibilities under ISA 570,³⁶ however, it recognizes the need to caution that the use of financial instruments is only one factor considered in the entity’s going concern assessment and the auditor’s evaluation of the use of that assessment. Paragraph 56 of **Agenda Item 6-C** notes that the auditor’s understanding of the entity and its environment may assist the auditor in identifying areas where special audit consideration may be necessary, for example regarding the appropriateness of management’s use of the going concern assumption. Guidance has also been included in paragraphs 190-192 of **Agenda Item 6-C**.

E.3 Other Changes Made to the PN

63. Changes from the PN have been made throughout **Agenda Item 6-C**, however, the above are the areas on which the Task Force is seeking specific feedback. The IAASB, however, is welcome to raise comment on any matters noted in connection with the first read of the IAPS. Significant changes were made in the following two areas:

Risks Arising from the Use of Complex Financial Instruments and the Effect on Audit Procedures

- Emphasis on the need for management to be aware of, and consider, changes in the financial reporting framework and material developed by others, such as regulators
- Highlighting the use of risk management functions, clearinghouses, and sensitivity analysis
- Further guidance on incentive compensation schemes, including the need to understand local regulatory positions and the linkage with indicators of management bias

Other Requirements in the Clarified ISAs

- Guidance on high estimation uncertainty and significant risks of material misstatement, to further link to ISA 540, as well as ISA 315³⁷ and ISA 330³⁸
- Expanded guidance on professional judgment and materiality
- Guidance on involving those with specialized skills and knowledge in the audit
- Further guidance to support ISA requirements, for example in the areas of going concern, documentation, forming an opinion and Emphasis of Matter paragraphs
- The need for early communications with those charged with governance for any significant difficulties relating to the auditor’s work on complex financial instruments

³⁶ ISA 570, “Going Concern.”

³⁷ ISA 315, “Identifying and Assessing the Risks Material Misstatement through Understanding the Entity and Its Environment.”

³⁸ ISA 330, “The Auditor’s Responses to Assessed Risks.”

Matters for IAASB Consideration

12. Does the IAASB agree with retaining the material in Appendix 2?
13. Is the IAPS clear as to how the business risks of using financial instruments may affect the auditor's risk of material misstatement?
14. Does the IAASB agree with the inclusion of material relating to going concern?

Appendix 1

List of Respondents to the Consultation Paper

| Member Bodies – 12 | |
|-------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|
| ACCA | The Association of Chartered Certified Accountants |
| CICPA | Chinese Institute of Certified Public Accountants |
| CIPFA | Chartered Institute of Public Finance and Accountancy |
| FACPCE | Federación Argentina de Consejos Profesionales de Ciencias Económicas |
| FEE | Federation des Experts Comptables Europeens |
| HKICPA | Hong Kong Institute of Certified Public Accountants |
| IDW | Institut der Wirtschaftsprufer |
| ICPAS | Institute of Certified Public Accountants of Singapore |
| ICAEW | The Institute of Chartered Accountants in England and Wales |
| JAB | Joint Accounting Bodies – CPA Australia, Institute of Chartered Accountants in Australia, and the National Institute of Accountants in Australia |
| JICPA | The Japanese Institute of Certified Public Accountants |
| SAICA | The South African Institute of Chartered Accountants |
| | |
| Other Professional Organizations – 3 | |
| AIA | The Association of International Accountants |
| IIF | Institute of International Finance |
| IAA | International Actuarial Association |
| | |
| National Auditing Standard Setters – 3 | |
| Au AASB | Australian Government, Auditing and Assurance Standards Board |
| CICA | The Canadian Institute of Chartered Accountants |
| NZICA | New Zealand Institute of Chartered Accountants |
| | |
| Public Sector Organizations – 1 | |
| WFE | World Federation of Exchanges |
| | |
| Regulators and Oversight Authorities – 5 | |
| APRA | Australian Prudential Regulation Authority |
| BCBS | Basel Committee on Banking Supervision |
| CPAB | Canadian Public Accountability Board |
| IAIS | International Association of Insurance Supervisors |
| IOSCO | International Organization of Securities Commissions |
| | |
| Firms – 8 | |
| DTT | Deloitte Touche Tohmatsu |

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| | |
|-----------------------------------|--------------------------------|
| EYG | Ernst & Young Global |
| GT | Grant Thornton International |
| Hermes | Hermes Management Pensions Ltd |
| KPMG | KMPG |
| Mazars & Guerard | Mazars and Guérard |
| PWC | PricewaterhouseCoopers |
| RSM | RSM International Limited |
| | |
| Individuals and Others – 1 | |
| Joseph Maresca | Joseph Maresca |