



International Federation of Accountants

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Agenda Item

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Committee: IAASB

Meeting Location: Lisbon

Meeting Date: June 15-18, 2009

Complex Financial Instruments—IAASB Project Proposal

Objective of Agenda Item

1. To approve a project proposal addressing complex financial instruments.

Matters to Note

2. IAPS 1012¹ has not been updated since it was issued in 2001. Since then, the landscape in which audits of derivative financial instruments are conducted has changed, as have the ISAs themselves.
3. At its March 2009 meeting, the IAASB agreed in principle with the recommendation of the Fair Value Auditing Guidance Task Force that the IAASB consider a project to revise IAPS 1012. Such an initiative would be consistent with the IAASB's plans described in its *Strategy and Work Program, 2009-2011*, to develop guidance on the subject of auditing fair values.
4. In considering this recommendation, the IAASB Steering Committee supported a substantive revision of the IAPS to address broader issues to improve practice in auditing complex financial instruments. It noted that the UK Auditing Practices Board (APB) is currently working on a project to revise its Practice Note 23² and that, based on preliminary understanding of the direction proposed by the APB and the responses they have received to date, this work could be leveraged by the IAASB to revise its IAPS. At a minimum the work of the APB could assist in aligning the guidance in the IAPS with the redrafted audit risk standards, linking it more closely to the requirements in ISA 540,³ and expanding the scope to cover complex financial instruments.
5. Nevertheless, the Steering Committee also noted that there is a need for guidance in the marketplace in the immediate term pending the development of a revised IAPS following due process. In particular, it noted that the IAASB should consider what could be done to raise awareness around the challenges faced in auditing complex financial instruments and encourage best practice for the 2010 audit season.
6. To address this issue, as well as to inform the longer-term revision of IAPS 1012, the attached

¹ International Auditing Practice Statement (IAPS) 1012, *Auditing Derivative Financial Instruments*.

² Practice Note 23, *Auditing Derivative Financial Instruments*, issued in April 2002 and based on IAPS 1012.

³ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

project proposal therefore also includes plans for a “briefing paper”-type publication to be developed and issued by mid-October 2009. The aims of this paper would be:

- (a) To highlight a number of practical considerations that are currently posing challenges in audits of complex financial instruments; and,
 - (b) In the context of the APB’s proposed revised Practice Note⁴ and other relevant national developments as appropriate, to obtain input on whether such guidance could usefully be incorporated in a revised IAPS 1012 and on areas where additional guidance should be developed.
7. The attached project proposal has also been drafted on the basis that the final output of the project will be a revised IAPS. The IAASB has on its agenda an initiative to review the appropriateness of the content of IAPSs and determine whether they should be withdrawn or revised; and to review the authority of IAPSs⁵ and any other implementation guidance that the IAASB may develop. These discussions are slated for the IAASB’s December 2009 meeting. For this reason the project proposal makes clear that the final output of this project is subject to decisions arising from those discussions.
8. Mr. Fogarty has been invited to chair the task force for this project (subject to IAASB approval of the project proposal), the preliminary composition of which has been considered by the Steering Committee.

Action Requested

9. The IAASB is asked to consider and approve the attached project proposal.

⁴ The APB’s Working Group currently plans to make further revisions based on the comments received on exposure, and would seek to have a draft revised document available in September 2009. The ability to meet the proposed timetable of October 2009 for the IAASB “briefing paper,” as envisioned, will be contingent upon the APB’s progress on its document as well as IAASB’s deliberations in September 2009 on the content of the “briefing paper.”

⁵ The amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* explains that IAPSs are issued to provide interpretive guidance and practical assistance to professional accountants in implementing ISAs and to promote good practice.

It further states that professional accountants should be aware of and consider Practice Statements applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Practice Statement should be prepared to explain how:

- (a) The requirements in the ISAs; or
- (b) The basic principles and essential procedures in the IAASB’s other Engagement Standard(s), addressed by the Practice Statement, have been compiled with.

ATTACHMENT

**COMPLEX FINANCIAL INSTRUMENTS—IAASB PROJECT
PROPOSAL**

I. Subject

1. The development of guidance for auditors dealing with complex financial instruments. This project will include:
 - (a) The development of a Briefing Paper⁶ to raise awareness and highlight a number of practical considerations that are currently posing challenges in audits of complex financial instruments; as well as
 - (b) The revision of IAPS 1012⁷ to bring it in line with the clarified ISAs and, as appropriate, to further expand it for additional guidance for auditors when applying ISAs in the context of complex financial instruments.

II. Background and Relevant Developments

A. The Clarified ISAs

2. IAPS 1012 provides guidance to the auditor in planning and performing auditing procedures for financial statement assertions related to derivative financial instruments, focusing on auditing derivatives held by end users, including banks and other financial sector entities. It was issued in March 2001 and since then has not been updated.
3. The IAPS refers to ISAs that were in effect at the time of its publication, a number of which have been withdrawn with the issuance of new or revised standards⁸ or substantially revised, such as ISA 540.⁹

B. Relevant Developments

4. Since the IAPS was issued, fair value accounting has become more prevalent and the use of financial instruments has broadened significantly from derivatives to more complex financial instruments. The current economic environment has evidenced that there are areas in the accounting standards that may need to be clarified, and auditors have encountered issues in practice when auditing fair value accounting estimates.
5. Input to the IAASB's Fair Value Auditing Guidance (FVAG) task force from key stakeholders (for example, regulators and standard-setters) indicated that further detailed guidance and a revision of IAPS 1012 are necessary. The IAASB CAG supported this view, noting that some auditors use the IAPS as the primary guidance on which to base their audits of derivative

⁶ The title "Briefing Paper" is used for purposes of this project proposal. Consideration will be given to whether another more suitable label for the document would be appropriate.

⁷ International Auditing Practice Statement (IAPS) 1012, *Auditing Derivative Financial Instruments*.

⁸ For example, ISA 310, *Knowledge of Business*, and ISA 400, *Risk Assessments and Internal Control*.

⁹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

financial instruments and therefore it is in the public interest that such guidance be current and comprehensive.

6. Current difficult financial market conditions give rise to particular considerations in relation to valuations and to financial statement disclosures about risks and uncertainties pertaining to complex financial instruments. While the IAASB's Staff Audit Practice Alert, *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*, highlighted a number of these considerations, it may be appropriate to incorporate guidance of this type in an IAASB pronouncement.
7. National and international groups that acknowledge a need for additional guidance relating to fair values include, to date:
 - The UK Auditing Practices Board's update of Practice Note 23,¹⁰ which widens the scope to cover other complex financial instruments.
 - The Basel Committee on Banking Supervision's request that the IAASB get involved in their discussions with the IASB on the issue of provisioning in the context of IAS 39.
 - The US Public Company Accounting Oversight Board's Staff Audit Practice Alert No. 4,¹¹ to inform auditors about potential implications of three FASB Staff Positions issued in April 2009.
8. In addition, a number of initiatives relating to accounting for fair value are underway, including:
 - The International Accounting Standards Board's projects related to fair value, including the development of an International Financial Reporting Standard on fair value measurement and plans to publish an exposure draft of proposed amendments to IAS 39,¹² in the 2nd and 4th quarters, respectively, of 2009.
 - The Center for Audit Quality's comments on the various proposals and guidance issued by the Financial Accounting Standards Board (FASB) and the U.S. Securities and Exchange Commission and its possible further work in the area of fair values.

III. Project Objectives and How It Serves the Public Interest

A. Project Objectives

9. The objectives of the project are:
 - (a) In the immediate term, to highlight a number of practical considerations in audits of complex financial instruments; and
 - (b) In the medium term, to revise IAPS 1012 so that it provides helpful and up-to-date guidance for auditors when applying ISAs in the context of complex financial

¹⁰ Practice Note 23, *Auditing Derivative Financial Instruments*, issued in April 2002 and based on IAPS 1012.

¹¹ Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-than-Temporary Impairments*, issued in April 2009.

¹² International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*.

instruments.

B. How the Project Objectives Serve the Public Interest

10. Communication of issues and challenges in the current economic environment with respect to auditing complex financial instruments will help stimulate thoughtful consideration and development of appropriate practices in the immediate term. Revision of IAPS 1012 will help promote consistency in practice and share good practices in auditing, drawing attention to important features relevant to high-quality implementation of the clarified ISAs in the context of complex financial instruments.

IV. Outline of the Project

A. Project Scope

11. The scope of this project is to provide guidance for auditors on auditing complex financial instruments by:
 - (a) Highlighting current issues by referring to the work of others and soliciting views on the applicability of such work in an international context, through the issue of a Briefing Paper for this purpose; and
 - (b) Updating relevant material in extant IAPS 1012 and, to the extent considered appropriate, developing new guidance to be included in the IAPS to address significant matters noted in practice.

This project does not envision providing guidance on specific financial instruments that may be used in particular industries, nor specific models.

B. Development of a Briefing Paper

12. The current economic environment will continue to prove challenging for both preparers and auditors in relation to fair value accounting estimates, including complex financial instruments, in the upcoming audit season. While a longer-term revision of IAPS 1012 is aimed at promoting consistency in practice, it is in the public interest for the IAASB to consider how best to address auditor needs in the short term.
13. Discussions with auditors have indicated that in order for any guidance to be useful for current year audits, it should be issued by no later than mid-October 2009. It is not feasible for the IAASB to develop and finalize new guidance in this timeframe, however, there is scope for leveraging the work of others in order to highlight a number of practical considerations that are currently posing challenges in audits of complex financial instruments. It is proposed that this best be done in a Briefing Paper to be developed by the task force and considered by the IAASB at its September 2009 meeting.
14. The APB's December 2008 Consultation Draft of an update of Practice Note 23 widened the scope of the practice note to cover complex financial instruments. It also included guidance that drew upon the IAASB's Staff Audit Practice Alert, *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*, as well as guidance issued by the APB in Bulletin 2008/1, *Audit Issues when Financial Market Conditions are Difficult and*

Credit Facilities may be Restricted. Responses to this Consultation Draft have indicated support for the revision and have highlighted areas on which additional guidance may be helpful.

15. The APB's Working Group is in the process of revising the Consultation Draft in response to comments received and is planning to have a draft revised Practice Note by September 2009. It is proposed the revised Practice Note would be included in its entirety as an Appendix to the Briefing Paper, as it is useful guidance and aims to achieve much of what the IAASB would do in revising IAPS 1012.

B.1 OBJECTIVES AND PROPOSED OUTLINE OF THE BRIEFING PAPER

16. The principle objective of the Briefing Paper will be to highlight a number of practical considerations that are currently posing challenges in audits of complex financial instruments in advance of the 2010 audit season, in the context of the APB's work as a possible starting point for the IAASB's planned revision of IAPS 1012. Its secondary objective is to obtain feedback on these and other issues that may help inform the IAASB's work on IAPS 1012.
17. In order to achieve the objectives of, and timeframe envisioned for, the Briefing Paper, its focus will need to be on a limited number of issues, drawing on the knowledge of the task force and input received to date.
18. What is envisioned for the Briefing Paper is as follows:
 - An introductory section that provides a clear statement of the purpose and intended use of the Briefing Paper, and its context in relation to IAASB's project to revise IAPS 1012.
 - A background section that emphasizes the challenges in auditing complex financial instruments in the current environment, and makes reference to the IAASB's recent Staff Audit Practice Alerts, relevant pronouncements that are currently in effect and, as appropriate, to the relevant Clarified ISAs.
 - A synopsis of practical considerations that are currently posing challenges in audits of complex financial instruments, likely to include the following: [Note: It is anticipated that these issues will be the same as those identified for purposes of the revision of the IAPS. They are further described in Section C below.]
 - Application of the risk assessment standards
 - Relevance and reliability of audit evidence
 - Professional judgment
 - Disclosure and reporting considerations.
 - Reference to guidance as included in the APB's Practice Note, if applicable, for each of the main issues. This would include an explanation of the Appendix with the APB's Practice Note, indicating the context in which the APB's Practice note has been prepared (i.e., at a national level). [Should other national standard setters issue guidance relating to complex financial instruments or fair values generally, the task force would consider how this could be incorporated in the Briefing Paper, if the timing permits.]
 - Invitation for views on the issues identified and, as appropriate, on whether the APB's

guidance is helpful in the circumstances, and on what other matters additional guidance would be helpful in an international context.

19. Responses received to the Briefing Paper would be considered in the context of the revision of IAPS 1012.

C. Revision of IAPS 1012 – Major Problems and Key Issues that Will Be Addressed

C.1 AREAS FOR ADDITIONAL GUIDANCE

20. While at a minimum the IAPS will be revised to bring it in line with the clarified ISAs, the task force will need to resolve the question of the extent to which the IAPS should be expanded to reflect current issues in the marketplace. The task force will need to do this bearing in mind what will be most useful to auditors while ensuring that any guidance in the IAPS does not, and is not seen to, override the principles-based nature of the ISAs by prescribing audit procedures.
21. The UK's revision project expanded the scope of their practice note to cover other complex financial instruments, as well as derivatives, as many of the audit considerations are the same. The task force will consider the merits of following a similar approach, while balancing the view that guidance in the IAPS is likely to also be applicable to financial instruments that are less complex and may be relevant to auditors in an SME environment. The IAPS should not imply that the guidance is not useful for less complex financial instruments or small and medium practitioners.
22. In addition to updating IAPS 1012 to align it with changes made in clarifying the ISAs, the task force will address the extent to which additional guidance is needed on the following:
 - *Application of the Risk Assessment Standards* – The task force will consider whether guidance is needed to explain the need for the auditor to understand the purpose for which an entity is using complex financial instruments and the process that may (or may not) be in place to assess the risks of using such instruments. For example, non-financial services entities have been significantly challenged during the economic crisis, in part because management of these entities does not always have valuation experience and may not have adequate knowledge of the underlying risks of the complex financial instruments in their treasury portfolios, leading to undue reliance on the work of experts.
 - *Relevance and Reliability of Audit Evidence* – The question of what constitutes sufficient appropriate audit evidence, in particular when markets are illiquid, has been a significant issue in practice. In the absence of guidance for preparers that discusses the audit evidence that is appropriate to support measurements and disclosures under particular financial reporting frameworks, auditors have been challenged to evaluate the sources of audit evidence and its cumulative nature. The task force will consider whether there is scope for developing additional guidance for auditors discussing the sufficiency and appropriateness of evidence, including:
 - The use of pricing services for independent price verification.
 - The use of broker quotes when there is no observable price.

- The use of experts by management and auditors.
 - The use of service organizations and internal audit.
 - The use of an auditor-developed model.
 - The determination of whether a market is active, including how recent changes to accounting standards may affect the auditor's work.
 - *Professional Judgment* – The task force will consider whether additional guidance focusing on the application of professional judgment to decisions about obtained sufficient appropriate audit evidence and the scope of procedures to be performed should be developed.
 - *Disclosure and Reporting Considerations* – The task force will consider whether further guidance on evaluating disclosures, in particular as they relate to significant estimation uncertainty, could be developed. This may include guidance for auditors on how to evaluate whether an entity's level of risk in using complex financial instruments is adequately explained in the financial statements and whether users of the financial statements have a comprehensive view of an entity's position and risk tolerance.
23. The task force will also evaluate whether guidance on basic types of financial instruments, their key characteristics, and types of issues typically encountered by auditors in practice would be helpful.

C.2 STRUCTURE OF THE IAPS

24. IAPS 1012 includes guidance on derivative instruments and activities, and then loosely follows the typical progression of an auditor's work – outlining the responsibilities of management, those charged with governance and the auditor, discussing the auditor's need to understand the business and key financial risks, and highlighting substantive procedures that may be typical in an audit of derivative financial instruments.
25. The task force will be asked to consider whether this structure remains appropriate. While a direct link to each phase of the audit may be desirable, the task force will explore whether it would be more useful for the IAPS to address key areas known to cause difficulties in practice, such as: entity's risk assessment processes; requirements in applicable financial reporting frameworks; professional judgment; audit evidence considerations; and disclosures.

V. Implications for Any Specific Persons or Groups

26. The project has particular implications for the following:
- (a) Forum of Firms and auditors in general.
 - (b) National standards setters that are involved in, or are contemplating, the development of additional guidance relating to complex financial instruments.
 - (c) Regulatory bodies.
 - (d) Public sector auditors and INTOSAI.

VI. Development Process, Public Consultation, Project Timetable and Project Output

27. The revision of IAPS 1012 will follow due process for the development of a pronouncement. Specific consideration will be given to the need to hold focus groups or roundtables to ensure relevant feedback is obtained to from those with direct experience in auditing complex financial instruments. In addition, input from members of the broker-dealer firms and pricing services will be considered.
28. Because of a number of ongoing initiatives in the area of fair values, the project approach will include appropriate dialogue with national standards setters actively developing guidance in this areas and with other interested parties so that relevant experiences can be leveraged and consistent guidance can be developed, to the extent possible while not extending the scope of this project.

A. Project Timetable

29. The timetable for the issuance of the Briefing Paper is mid-October 2009.
30. The final timing of the revised IAPS 1012 will depend on the issues identified by the task force, including matters noted in response to the Briefing Paper. It is anticipated that the earliest the revised IAPS may be completed is December 2010.

B. Project Outputs

31. A Briefing Paper and a revised IAPS dealing with auditing complex financial instruments.

C. Impact Assessment Considerations

32. Neither the Briefing Paper nor the IAPS are intended to impose new obligations on practitioners.

VII. Resources Required

33. A project task force consisting of up to 8 individuals, including a member of the IAASB as chair. The task force will be comprised of appropriate representatives from industry (for example, the banking industry), audit firms, national standard-setters and the regulatory community. Correspondence members with relevant expertise will be sought as appropriate.
34. IAASB technical staff will provide staff support to the task force.

VIII. Relevant Sources of Information that Address the Matter Being Proposed

35. Relevant sources of information include the following:
 - UK Auditing Practices Board – Consultation Paper and Responses:
<http://www.frc.org.uk/apb/publications/pub1830.html>
 - IASB Responses to the Financial Crisis:
<http://www.iasb.org/About+Us/About+the+IASB/Response+to+the+credit+crisis.htm>

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- PCAOB Staff Audit Practice Alert No. 4:
http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2009/04-21_APA_4.pdf

Appendix 1

COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board or committee proposing to undertake the project.

Note: The project proposal is currently out for comment from the IFAC Technical Managers. A verbal report on their comments, if any, will be given at the meeting.

Technical Manager to the Compliance Advisory Panel

Signed: _____

Date: _____

Technical Manager to the Developing Nations Committee

Signed: _____

Date: _____

Technical Manager to the IAESB

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Date: _____

Technical Manager to IESBA

Signed: _____

Date: _____

Technical Manager to the PAIB Committee

Signed: _____

Date: _____

Technical Manager to the IPSASB

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Date: _____

Technical Manager to the SMP Committee

Signed: _____

Date: _____

Technical Manager to the Transnational Auditors Committee

Signed: _____

Date: _____