

**Special Considerations in Auditing Complex Financial Instruments—Issues
and IAASB Task Force Proposals****I. Matters for IAASB Consideration****A. Status and Authority of the IAPS**

1. At its June 2010 meeting, the IAASB approved for exposure clarified wording to describe the authority attaching to International Auditing Practice Statements (IAPSs). This wording will replace the current wording in the *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (the Preface), and will be exposed concurrently with the proposed revised IAPS 1000.¹ The proposed authority attaching to revised IAPS 1000, and any new IAPSs that may be developed by the IAASB in the future, is as follows:

International Auditing Practice Statements (IAPSs) are issued to provide practical assistance to auditors in implementing ISAs and to promote good practice. IAPSs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with the requirements of all ISAs relevant to the audit. Auditors should determine whether any IAPS is relevant to the circumstances of the audit and, if so, obtain an understanding of its content. Depending on the nature of the topic(s) covered, an IAPS may assist the auditor in:

- (a) Obtaining an understanding of the circumstances of the entity, and in making judgments about the identification and assessment of risks of material misstatement;
 - (b) Making judgments about how to respond to assessed risks, including judgments about procedures that may be appropriate in the circumstances; or
 - (c) Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.
2. The Task Force is of the view that the content of proposed revised IAPS 1000 is appropriate in light of this authority. In particular, the Task Force believes that:
 - The IAPS as drafted does not impose additional requirements on the auditor beyond those included in the ISAs;
 - The Scope section of the IAPS (see paragraphs 1-3 of **Agenda Item 5-B**)² adequately explains the applicability of the IAPS to entities of all sizes and across all industries,

¹ Proposed IAPS 1000, *Special Considerations in Auditing Complex Financial Instruments*

² All paragraph references are to Agenda Item 5-B, unless otherwise noted.

while highlighting that the guidance is particularly applicable to complex financial instruments measured or disclosed at fair value; and

- The revised structure of the IAPS allows for auditors who are familiar with the background and educational material in the IAPS (for example, auditors in the financial services industry who deal with financial instruments on a regular basis) to easily navigate to the auditing guidance in order to understand its content (see Section B below).

Matter for IAASB Consideration

1. Does the IAASB agree that the material within proposed revised IAPS 1000 is appropriate in light of its status and authority? If not, IAASB members are asked to point to specific paragraphs that are considered to be inappropriate.

B. Restructuring of the IAPS

3. At its June 2010 meeting, the IAASB discussed an outline proposing how the IAPS could be restructured to more clearly differentiate between the background / educational material and the auditing guidance within the IAPS. The IAASB asked the Task Force to proceed on this basis, with a particular emphasis on:
 - Including two discrete sections within the document – (i) background information about complex financial instruments, and (ii) audit considerations relating to complex financial instruments;
 - Differentiating background and educational material through the use of tables and shading;
 - Restructuring the section on audit considerations around financial statement assertions;
 - Deleting material that only refers to the ISAs or does not contain any references to complex financial instruments; and
 - Incorporating feedback received from financial instruments experts (see Section C below).
4. The Task Force believes the current draft meets the requests to both retain educational material that may be needed by some auditors and highlight auditing considerations that are applicable to all auditors dealing with complex financial instruments.

B.1 Additions and Deletions of Material within the IAPS

5. At its June 2010 meeting, the IAASB agreed that it was not necessary for the Task Force to present a marked-up draft of proposed revised IAPS 1000 given the significance of the planned restructuring. However, the IAASB asked the Task Force to signal areas in which new guidance had been added, or previous guidance had been deleted, from the draft discussed at the June 2010 meeting.
6. The following illustrates, in the Task Force's view, the most significant changes made to the draft since the June 2010 meeting and the rationale for doing so. Discussion of certain

key issues arising from the meetings with the expert groups is included in Section C of this paper.

Additions	Rationale
Clarification that the volume of financial instrument transactions affects the control environment and the auditor’s procedures. See paragraph 10.	The expert groups thought this was useful signposting to explain the relevance of the IAPS.
New material relating to the auditor’s determination of whether to test controls, perform substantive procedures, or a combination of both, and the timing of such procedures. See paragraphs 30-44.	The expert groups suggested this differentiation would be appropriate to provide greater context to auditors dealing with non-financial institutions.
Reference to the risks of material misstatement relating to completeness and accuracy of recording. See paragraph 45.	The IAASB supported including a discussion of the risks of material misstatement relating to completeness and accuracy. The expert groups further suggested that the nature of the evidence considerations should be highlighted.
New material on controls over completeness and accuracy and additional procedures the auditor may consider performing, including review of individual contracts and testing of journal entries. See paragraph 46 and paragraphs 7-11 of Table 4.	The expert groups suggested these were key controls that the auditor may consider testing in order to place reliance.
Substantive revisions to the section on the valuation assertion, including new material addressing valuation uncertainty.	See Section C.2 below.

Deletions	Rationale
<p>Paragraphs that merely referred to the ISAs and did not contain material unique to complex financial instruments, including ISA requirements dealing with:</p> <ul style="list-style-type: none"> • Determining the need for specialized skills or knowledge. • Fraud and indicators of management bias. • Significant risks. • Understanding an entity’s internal audit function and the external auditor’s use of the internal auditor’s work. 	As per the IAASB June 2010 discussion.

<ul style="list-style-type: none"> • Deficiencies in internal control. • Service organizations. • Going concern. • Evaluating misstatements. • Emphasis of Matter and Other Matters paragraphs. 	
Reference to the complexity of a financial instrument being influenced by the characteristics of the instrument.	The expert groups did not believe this characterization was appropriate and suggested revisions to the IAPS. See paragraph 6.
Simplification of the risks described in Table 1.	The expert groups believed only the principal types of risks should be included in the table, as those added were not necessarily described in a manner in which all would agree and distracted from the key messages.
Deletion of previously proposed additional guidance on financial liabilities.	While some respondents to the CP as well as the CAG suggested more could be said about financial liabilities, the expert groups were not convinced that a distinction needed to be made. Rather, reference was made to financial liabilities in paragraphs 3, 48, 70, and 92.
Appendix 1 – Glossary of Terms	The expert groups did not believe the Appendix was useful, since a number of the terms contained in it were not used in the IAPS, and suggested that different jurisdictions may use different definitions.
Appendix 4 – Additional Information about Broker Quotes and Pricing Services	The expert groups were of the view that, since this material was based on material developed by the International Financial Reporting Standards (IFRS) Board, a cross-reference would be more appropriate than replicating the guidance.

Expert Points Not Accepted	Rationale
Clarification that disclosures in the financial statements are a snapshot at a point in time rather than a predication of what effect the financial instrument activities may have in future periods.	One expert group was of the view that it was necessary to emphasize this point rather than create false expectations of what these disclosures may achieve, given the views of some regulators that enhanced disclosure could have mitigated some concerns arising from the financial crisis. The Task Force did not believe that it was necessary to explicitly highlight this

in the draft.

Matter for IAASB Consideration

2. During the detailed review of the draft, the IAASB will be asked to comment on the additions to the material. The IAASB is also invited to raise concerns over any material that has been deleted from the previous draft.

C. Discussions with Financial Instruments Experts

7. At its June 2010 meeting, the IAASB agreed with the Task Force's recommendation that further involvement of financial instrument experts was necessary prior to exposure. Two meetings were held to review a revised draft of IAPS:
 - (i) In London with a Working Party of the UK Auditing Practices Board, which had developed Practice Note (PN) 23 (Revised), *Auditing Complex Financial Statements*, which had been included in the IAASB's October 2009 Consultation Paper (CP) and used as the starting point for IAPS 1000; and
 - (ii) In New York with a group of US experts that had been identified by the Transnational Auditors Committee (TAC) members on the IAASB.
8. These experts supported the restructuring of the IAPS and offered suggestions on how the material could be further tailored to enhance its readability and usefulness to auditors dealing with entities of all sizes. Editorial comments have been made within the IAPS based on their feedback. The significant concerns of the expert groups and the Task Force's responses are highlighted below.

C.1 Existence and Occurrence

9. While the expert groups supported the restructuring of the IAPS to highlight the financial statement assertions most relevant to complex financial instruments, they did not believe it was necessary to distinguish between existence and occurrence and completeness and accuracy, as suggested by the IAASB at its June 2010 meeting. In their view, the risks associated with both assertions and the procedures to test the assertions were substantively the same. They suggested that wording to this effect could be included within the IAPS (see paragraph 45).

C.2 Valuation Methodology, Including the Use of Models and the Consideration of Valuation Uncertainty

10. Both expert groups expressed concern that the IAPS is not clear on how models are used to value complex financial instruments. In their view, the IAPS incorrectly implied that entities would either value a financial instrument by comparison to direct market prices *or* by using a model. In practice, entities typically establish a valuation methodology for each type of financial instrument and, depending on the complexity of the instrument and the availability of evidence to be used in calculating a fair value, determine a value using a combination of approaches, including the use of one or more models. The challenges in establishing a valuation methodology become more obvious when entities are dealing with

instruments whose valuation consists of level 2 and level 3 inputs. In the expert groups' view, it would more meaningful to explain how an entity's valuation methodologies are developed, since the auditor's procedures would typically begin with an understanding of such methodology. In addition, they were of the view that the IAPS should further address the need for entities to have formal valuation policies and documentation supporting their compliance with these policies. Finally, the experts believed the IAPS should acknowledge that auditors may test controls around the models, if such controls exist, as this is common in practice.

11. The Task Force has therefore revised the valuation section to accommodate these concerns, and believes that the concepts in the IAPS are consistent with ISA 540.³ However, introductory language has been reinstated into the IAPS to link these concepts more closely with the requirements of ISA 540. See paragraphs 49-103.
12. The experts also believed that an important consideration for the auditor is how management's valuation methodology addresses valuation uncertainty. In their view, while the previous draft of the IAPS briefly touched upon the concepts of valuation uncertainty and adjustments to models, it is necessary to be more explicit as valuation uncertainty is a market-based assumption, taken into account by entities to determine what a willing buyer would require in the pricing to take account of the uncertainties in the outcome of the product they are buying. The expert group agrees that it is not appropriate for entities to reserve for conservatism, but suggested that the IAPS should explain how valuation uncertainty and estimation uncertainty as defined by ISA 540 are related.
13. Accordingly, paragraph 52 states: "Valuation uncertainty is an aspect of estimation uncertainty, which is defined in ISA 540 as 'the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.'" Further discussion of valuation uncertainty is in paragraphs 52-56.

C.3 Broker Quotes and Pricing Services as Management's Experts

14. While the experts agreed that there may be some merit in including educational material on broker quotes and pricing services, they were of the view that the IAPS incorrectly scoped in *all information* received from brokers and pricing services as being the work of a management's expert subject to ISA 500.⁴ In their view, it is important to differentiate within the IAPS that a broker or pricing service may or may not be considered a management's expert.
15. Accordingly paragraph 75 of the IAPS now states: "Individuals such as brokers and organizations such as pricing services may possess expertise in the application of models to estimate the fair value of complex financial instruments for which there is no observable market and may offer such services to entities in addition to providing pricing data. For example, an entity may engage a broker or pricing services to value an entity's complex financial instrument portfolio, typically by using proprietary models. Regardless of whether

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

⁴ ISA 500, *Audit Evidence*

such individuals or organizations are considered management's experts, management's understanding includes the process described in paragraph 67.”

16. The expert groups agreed the contextual material explaining that management retains responsibility for the valuations even when a management's expert is used, and what effects this may have on the audit if management is unable to support the assumptions used by the expert, should remain. See paragraphs 71-77.

Matters for IAASB Consideration

3. Does the IAASB agree with how the material is presented in the Valuation section to address the concerns of the expert groups?
4. Does the IAASB agree with the material in paragraphs 71-77?

D. Consideration by IAASB of Significant Matters Identified by Task Force

17. In the Task Force's view, the significant matters the Task Force has identified as a result of its deliberations since the beginning of this project, and the Task Force's considerations thereon, have all been reflected in the issues papers presented at the IAASB meetings in December 2009, March 2010, June 2010, and this meeting. In the Task Force's view, there are no significant matters discussed within the Task Force on this project that have not been brought to the IAASB's attention.