

**Special Considerations in Auditing Complex Financial Instruments–
Summary of Significant Comments on Exposure
and IAASB Task Force Recommendations**

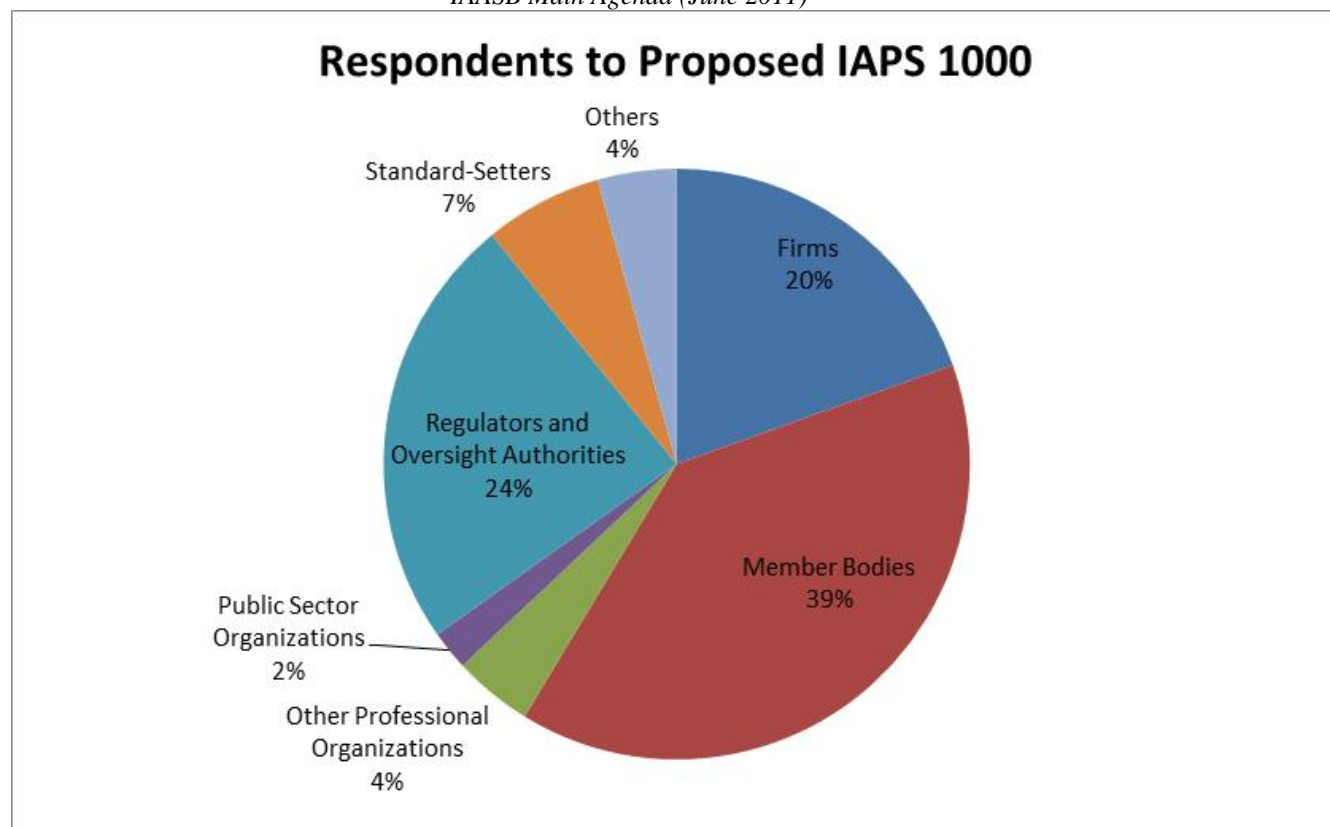
I. Introduction

1. This Paper sets out significant issues, in the Task Force's view, raised by respondents on exposure of proposed IAPS 1000¹ (ED-IAPS1000), and the Task Force's recommendations in response. The majority of issues raised by respondents affect predominantly the Introduction section of the IAPS (paragraphs 1–11) and Section II (paragraphs 20–115) dealing with audit considerations. Accordingly, the Task Force has focused its deliberations and drafting efforts on these sections of the IAPS.
2. The Task Force has not had to the opportunity to complete its deliberations on respondents' comments on Section I of the IAPS, which concerns background and education material, and certain other elements of the IAPS. While some consequential changes to Section I are reflected in the revised draft IAPS 1000, the Task Force will present a summary of issues and recommendations pertaining to Section I and all other elements of IAPS 1000 at the September 2011 IAASB meeting, along with some possible further reorganization of material and drafting changes arising from a consistency review.
3. This Paper is structured as follows:
Section II – Overview
Section III – Significant Issues and Task Force Recommendations
Section IV – Structure and Other Matters
4. The revised draft of proposed IAPS 1000 (Agenda Item 4-C) has been prepared on the basis of the proposed authority of IAPs, as presented for discussion in Agenda Item 3. Accordingly, the objective of proposed IAPS 1000 is to provide auditors with material that may be of practical assistance in dealing with financial instruments, including relevant background and educational material as appropriate.

II. Overview*Overview of Responses to Exposure Draft*

5. The IAASB received forty-four comment letters on ED-IAPS 1000. Appendix 2 of this Paper provides a list of the respondents. The respondents represented the following stakeholder groups:

¹ Proposed International Auditing Practice Statement (IAPS) 1000, *Special Considerations in Auditing Complex Financial Instruments*



6. Respondents were generally supportive of the scope and content of the IAPS. Several respondents noted that the content provides direction in key areas and examples of common areas of risk and issues that often arise. However, respondents were of the view that the IAPS would benefit from further clarification of the intended scope of the IAPS, including to whom the document is primarily directed. Respondents also were of the view that the IAPS could helpfully elaborate on certain key areas, including use of valuation models and specific issues that are presently posing audit challenges. Broadly, respondents also supported the structure of the IAPS, but some suggested further refinements.
7. The comment letters also indicate the general view that the material within the IAPS is consistent with the status and authority of the IAPS as proposed in the ED, and that it appropriately does not appear to impose requirements on the auditor.

Overview of Task Force Proposals

8. The following summarizes the Task Force's key proposals:
 - (a) Audience—The Task Force believes that the primary readers of the IAPS, and those most likely to benefit most from assistance with “de-mystifying” financial instruments and the IAPS’ educational/background material and auditing considerations, will be auditors who are generally less familiar with financial instruments. The Task Force has, therefore, drafted the IAPS with the recognition that the IAPS has been written with this audience in mind, and for this audience to serve as the basis for drafting and context decisions.

- (b) Changing the focus of the IAPS to “Financial Instruments”–The Task Force believes that the IAPS should cover not only complex financial instruments but all financial instruments (other than the simplest such as bank accounts, simple loans, trade accounts receivable and payable). Covering financial instruments more broadly reflects the intended audience above, with consequential changes to the title and drafting.
 - (c) Models/Valuation Techniques–The Task Force proposes to enhance the material around models, including providing further educational material on the use of models and further material on how models may be tested.
 - (d) Third Party Pricing Sources–The Task Force proposes further educational material and practical assistance in regard to the use of broker quotes and pricing services (“third party pricing sources”), particularly with regard to determining if such sources are management’s experts, and some possible responses to management’s use of them. Consistent with the proposals regarding the authority of IAPSs (Agenda Item 3), the Task Force also proposes that the ISAs would benefit from additional application material explaining how the requirements of ISA 500² and ISA 540³ may apply relative to the auditor’s consideration of third party pricing sources.
 - (e) Structure–The Task Force proposes some amendments to the structure of the IAPS, including removal of the shaded tables, relocation of some material and consideration of the need for enhanced tools for navigation.
9. Some respondents urged the IAASB to consider covering in the IAPS complex accounting matters, such as hedge accounting, day 1 gains or losses, repurchase transactions and loan loss provisioning. The Task Force does not recommend that IAPS 1000 be used to address these matters.
10. The above proposals and issues are discussed in further detail in the remainder of this Paper.

III. Significant Issues and Task Force Recommendations

A. Audience of the IAPS

11. ED-IAPS 1000 sought to present material in a manner intended to be helpful to auditors of both financial sector and non-financial sector entities with varying level of financial instrument transactions. Respondents were asked for their views on whether the balance of material included in the IAPS is appropriate in light of its purpose of assisting a wide range of auditors on an international basis.
12. Broadly, respondents were of the view that the IAPS achieved an appropriate balance of material. However, there were some strong views that the IAPS should provide more

² ISA 500, *Audit Evidence*

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

material in relation to more complex entities, and equally some strong views suggesting more material for entities with less extensive experience with financial instruments.

13. Some respondents⁴ suggested greater focus on the applicability of the IAPS to small and medium practitioners and entities. Various suggestions were made to emphasize SMP consideration as well as to aid readability (see Section III for the implications for the structure of the IAPS). These included comments that the IAPS should explain the intended audience of the IAPS, including specific mention of SMPs and other auditors who may have less extensive experience with financial instruments⁵ and should have sections on “Considerations Specific to Smaller Entities.”⁶ Suggestions for these sections included how risk management is approached if no risk management function exists and in entities where dealing with financial instruments are not routine transactions⁷ and tools to assist navigation for those with less experience in CFIs.⁸
14. Others⁹ were of the view that the IAPS should address considerations relevant to large financial institutions and those who actively trade complex financial instruments, including banks, insurance companies, investment funds or systemically important financial instruments. This was proposed given the degree to which these entities are exposed to complex financial instruments.
15. The Task Force is of the opinion that it is necessary to address the nature of the intended audience, as recommended by some respondents, in order to resolve questions pertaining to the direction and content of the IAPS.
16. In considering this, the Task Force deliberated, and determined that the IAPS could not fully address the needs of the auditors of large financial institutions as the IAPS would become too lengthy and detailed for other parties to use effectively. This is due to the need that would arise to specifically address the most sophisticated and complex instruments, and the difficulty in maintaining the document to cater for new products and practices in the financial sector. It would also significantly diminish the intended goal of producing a broadly applicable international pronouncement.
17. Accordingly, the Task Force recommends that the IAPS should focus primarily on the needs of those auditors who have less frequent contact with financial instruments as they would benefit the most from the IAPS. This is not necessarily the same group as SMEs and their auditors, as some SMEs may be heavy users of financial instruments (for example, small banks and hedge funds). The Task Force does not recommend that an explicit statement of the intended audience be made, however, as such a statement could be misread in various ways.

⁴ FEE, ICAI, ICPAS

⁵ FEE

⁶ FEE, ICAI, ICPAS

⁷ FEE

⁸ NIVRA, AIU&APB

⁹ BCBS, IAIS

Matter for IAASB Consideration

Q1. Does the IAASB agree that the primary audience of IAPS 1000 should be auditors with less frequent contact with financial instruments?

B. Financial Instruments versus Complex Financial Instruments

18. In developing ED-IAPS 1000 IAASB deliberated which financial instruments would be within its scope and concluded that the IAPS should apply to “complex financial instruments” (CFIs). Although ED-IAPS 1000 contains guidance as to the nature of CFIs, it did not define CFIs due to the practical difficulties in doing so, particularly with respect to subjective considerations.
19. Respondents varied widely in their comments on the coverage of financial instruments. Some¹⁰ recommended coverage of all but the simplest financial instruments. However, other respondents recommended that the IAPS should have more material on the most complex and structured financial instruments,¹¹ and should also take into account the standards developed by parties such as the accounting standard-setters, banking supervisors and other recognized stakeholders.¹²
20. The Task Force recommends that the IAPS address all but the simplest financial instruments, but should not specifically cover the most complex instruments that auditors with less frequent contact with financial instruments are unlikely to come into contact with. Accordingly, proposed revised IAPS includes a statement to the effect that many of the considerations in the IAPS would also be applicable to simpler financial instruments, as suggested by one respondent. (See paragraph 5 of Agenda Item 4-C). This above means that the IAPS would no longer refer exclusively to “complex” financial instruments.

Matter for IAASB Consideration

Q2. Does the IAASB agree that IAPS 1000 should cover all financial instruments, other than the simplest?

C. Coverage of Complex Accounting Requirements

21. ED-IAPS 1000 explicitly excluded loan-loss provisioning and was silent on other accounting issues such as hedge accounting, day 1 gains or losses, purchase transactions and risk transfers. The Explanatory Memorandum of ED-IAPS 1000 explained that it would not be possible or appropriate to develop comprehensive guidance on the other matters without significantly limiting the general applicability and usefulness of the IAPS.

¹⁰ FEE, NZICA

¹¹ IAIS, BCBS

¹² BCBS

22. Some respondents were of the view that matters such as hedge accounting¹³, day 1 gains or losses¹⁴, derecognition¹⁵ and loan loss provisions¹⁶ should be covered by the IAPS. It was noted that these give rise to particular challenges in the audit of fair value measurements and revenue recognition for financial instruments and, therefore, should be considered in more detail in the IAPS. Others supported the exclusion of hedge accounting and recognition/de-recognition issues¹⁷ as they noted that these are matters for the accounting standard setters to address.
23. The Task Force deliberated these comments and resolved that, consistent with ED-IAPS 1000, the IAPS should continue to exclude these issues (see paragraph 6 of Agenda Item 4-C), and focus on more pervasive issues regardless of the financial reporting framework. The Task Force agrees with the observation by some respondents that further material on specific accounting issues may be viewed as interpreting accounting standards, and may differ significantly depending upon the financial reporting framework. Further, the Task Force believes that these can be complex matters to address in auditing pronouncements, and that if the IAASB concludes that material is needed then this should be achieved via additional IAPSs. Dealing with all such topics in this IAPS would significantly increase the length and complexity of the IAPS, as acknowledged by some respondents, and would make the document less useful to the intended audience.

Matter for IAASB Consideration

- Q3. Does the IAASB agree that IAPS 1000 should continue to omit discussion of further related accounting issues as described in paragraph 6 of Agenda Item 4-C?

D. Models/Valuation Techniques

24. ED-IAPS 1000 included material on:
- (a) The entity's considerations when using models;
 - (b) Considerations when adjustments for valuation uncertainty may be needed to model outputs;
 - (c) The nature of inputs used in models; and
 - (d) Factors considered by the auditor in evaluating whether models used by the entity, including related controls, are appropriate.
25. Broadly, respondents supported the material on models included in ED-IAPS 1000. However, respondents,¹⁸ including some regulators, recommended that further material on the topic be included. They were of the view that the use of valuation models by an entity

¹³ IAIS, IOSCO, IRBA

¹⁴ EBA, IRBA

¹⁵ EBA

¹⁶ IDW

¹⁷ CICPA, ICAEW, PWC

¹⁸ APB, BCBS, BDO, CPAB, EBA, GAO, IAIS, IOSCO, C. Bernard

often gives rise to a significant risk and therefore should receive a commensurate level of attention in the IAPS. Aspects noted in particular were with regard to how models are used, risk-based selection of models for testing, testing strategies and assumptions and inputs to models, and the auditor’s approach to performing audit procedures on models.

26. The Task Force agrees with respondents’ observations that further elaboration on particular elements of models, and auditor’s consideration thereon, would benefit the IAPS. Nevertheless, the Task Force is cognizant of the need to ensure applicability of the IAPS across entities of varying levels of complexity and sophistication, while promoting sound and consistent audit judgments. Accordingly, the Task Force proposes additional material in the revised IAPS around models, in particular:
- Greater specificity in the guidance on adjustments to valuation techniques (see paragraph 56 of Agenda Item 4-C).
 - How models may be tested (see paragraphs 60d-e of Agenda Item 4-C).
 - Further educational material on the use of models (see primarily paragraphs 60a-c of Agenda Item 4-C).
27. In proposing these changes, the Task Force was cognizant of the need for the IAPS to be capable of broad application, particularly to avoid providing excessively detailed guidance on issues that auditors with less frequent contact with financial instruments are likely to encounter.
28. The Task Force is also considering using the term “valuation technique” rather than “model” to align the terminology with relevant financial reporting frameworks. “Valuation techniques” is used in International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP) and using the term may make comprehension of the IAPS easier. However, “model” is used extensively in ISA 540 and may be more commonly understood.

Matter for IAASB Consideration

- Q4. The IAASB is asked to share its views on whether IAPS 1000 should refer to “valuation technique” or “model”?

E Third Party Pricing Sources

29. ED-IAPS 1000 provided material on the use of pricing services and brokers, emphasizing how such information may be used by management. Importantly, ED-IAPS 1000 did not establish a “bright line” to determine whether pricing services and brokers are management’s experts.
30. Several respondents,¹⁹ including regulators, commented on the ED proposals with respect to management’s use of broker quotes and pricing services. In particular, concern was

¹⁹ APB&AIU, CICPA, ICAEW, IRBA, HKICPA, PWC

expressed about when a broker quotes or pricing services (“third party pricing sources”) could be a management’s expert, within the meaning of paragraph 8 of ISA 500.

31. The Task Force has formed the preliminary conclusion that the use of third party pricing sources requires further elaboration, particularly about the differences between a broker quote and a pricing service (see paragraphs 70a and 70e) and to provide further practical assistance when considering such pricing sources (see paragraphs 70b-70c, 73a and 86a-86b).

Summary of Proposed Amendments to Application Material in the ISAs

32. A key issue of concern for the Task Force was the auditor’s response to management’s use of third party pricing sources which are not management’s experts. Paragraph A35 of ISA 500 provides guidance on determining if such a pricing source is a management’s expert. The Task Force is of the view that ISA 500 and ISA 540 together are appropriate when the pricing source is a management’s expert, however, the auditor’s response to a pricing source that is not a management’s expert is less clear. The Task Force believes that the application material within ISA 500 and ISA 540 could be improved in this respect, recognizing the proposed authority of IAPSs.²⁰ As such, Appendix 1 includes a preliminary proposal of proposed amendments to ISA 500 and ISA 540.

Draft Proposed Amendments to ISA 500

33. The Task Force proposes to amend paragraph A35, which is linked to paragraph 8 that deals with management’s experts. The purpose of the draft proposed amendment is to clarify when a third party pricing source is a management’s expert as requested by some respondents, and further distinguish when a pricing service is not a management’s expert.
34. The Task Force believes that it is unlikely that a third party pricing service, as it is commonly used by management, should be a management’s expert. The Task Force notes that, while a real estate valuation may be sought by the company in respect of a single, unique asset, a pricing service provides prices on many thousands of different asset classes, with the prices available via a direct feed to management, using a subscription model. A pricing service makes its prices available to all who subscribe to the service. As such, the risks of bias inherent in, for example, a real estate valuation are not equally valid for a pricing service.

Draft Proposed Amendments to ISA 540

35. The Task Force proposed to insert three new paragraphs, A69(a)-(c) to ISA 540, which will be linked to paragraph 13(b) that discusses testing how management made the

²⁰ Agenda Item 3-A sets out the IAPS Status and Authority Working Group’s recommendations and states, at paragraph 12 “In developing material for an IAPS under Option A, there may be cases where it becomes apparent that additional application material providing further explanation of the requirements of an ISA (which may explain more precisely what a requirement means or is intended to cover) is needed within an ISA(s) itself. Under this option, the IAASB would be asked to consider the need to amend the application material of the ISAs directly, rather than using an IAPS to introduce such guidance.”

accounting estimate. The proposed new paragraphs explain further how a pricing service may be used by management, provide useful guidance on procedures that may be of use with differing asset classes and indicate when testing how management made the accounting estimate may not be useful in gathering audit evidence (that is, when management does not understand how the estimate was made).

36. The Task Force also proposed to amend paragraphs A87 and A91 which are both linked to paragraph 13(d) regarding developing a point estimate or range. The purpose of these paragraphs is to provide, as an example, circumstances when the auditor's own estimate may provide useful audit evidence, how a pricing service may assist in making an auditor's own estimate and examples of procedures for evaluating whether evidence from a pricing service is reliable.

Way Forward for Proposed Amendments to ISA 500 and ISA 540

37. Amendments to the ISAs, even if restricted to the application material, need to be subject to due process, including public consultation and review by the Public Interest Oversight Board.
38. The Task Force proposes that IAPS 1000 be issued as soon as possible, and that it should not be delayed whilst the IAASB considers the proposed amendments to ISA 500 and ISA 540. The Task Force recognizes the need for auditors to have appropriate material relative to financial instruments as soon as possible. In particular, the Task Force believes there is a need for practical guidance on auditing fair value measurements, which continues to present challenges in valuing and providing disclosures for financial instruments. The Task Force acknowledges that, as with other IAASB pronouncements, the IAPS may require conforming amendments as these and other changes are made to the IAASB's pronouncements.
39. On a preliminary basis, assuming an ED is approved by the IAASB at the September 2011 meeting, it is anticipated that any proposed amendments to ISAs 500 and ISA 540 could be completed by Q2 2012. The Task Force believes that it is preferable to progress the proposed amendments to ISA 500 and ISA 540 contemporaneously with the approval of IAPS 1000.

Matters for IAASB Consideration

- Q5. Does the IAASB support the enhanced material within IAPS 1000 on the use of third party pricing sources?
- Q6. Does the IAASB support the proposed amendments to the application material in ISA 500 and ISA 540?
- Q7. Does the IAASB agree with the Task Force's proposal that IAPS 1000 be issued as soon as possible, without waiting for any amendment to ISA 500 and ISA 540 to be exposed and approved?

F. Other Recommended Changes

40. Respondents variously suggested other matters for the IAASB's consideration in enhancing the IAPS, as follows:
- Competence—Some respondents²¹ highlighted the requirement under the IESBA Code²² for auditors to be competent when accepting engagements involving financial instruments, particularly those that are more complex. The Task Force agrees with this recommendation, and proposes new paragraph 20a.
 - Professional Skepticism and Management Bias—Some regulators²³ commented that references to professional skepticism needed to be strengthened, and further weight needed to be placed on the risks associated with management bias in several sections. In response to these suggestions, the Task Force proposes changes to paragraphs 22-23 and 52 of Agenda Item 4-C.
 - Own Credit Risk—Respondents²⁴, including some regulators, commented on the need to strengthen the guidance on own credit risk, noting that this was often a highly material and challenging audit consideration. In response, the Task Force has added further material to assist auditors by highlighting some of the practical considerations and valuation approaches (see paragraphs 72-72b of Agenda Item 4-C).
 - Fraud Risk—A few respondents²⁵ from various stakeholder groups commented on the need to include further mention of fraud risk at key points in the IAPS (see Table 1 and paragraphs 22 and 47 of Agenda Item 4-C).
41. A respondent²⁶ recommended that the IAPS make explicit references to financial reporting frameworks such as IFRS or US GAAP, and recommended that the IAASB not issue the IAPS until the completion of the financial instruments accounting standards²⁷. The opposite view was held by other respondents,²⁸ who preferred that the IAPS be more generic in its use of language and requirements from financial reporting frameworks.
42. The Task Force is of the view that the generic references to concepts in both IFRS and US GAAP remain appropriate. In the Task Force's view, this will reduce the need to revise the IAPS when the relevant accounting standards change while still providing material relevant to current issues. In regard to waiting for the completion of the financial instruments accounting standards, the Task Force support issuance of the IAPS as soon as possible, as waiting for the final accounting standards may delay the IAPS unreasonably.

²¹ FEE, NZICA

²² See, for example, paragraph 210.6 of the IESBA *Code of Ethics for Professional Accountants*

²³ BCBS, CPAB, EBA

²⁴ AOB, BCBS, CPAB, IAIS, IOSCO, KPMG

²⁵ BDO, IAIS, NYSSCPA

²⁶ KPMG

²⁷ The final exposure drafts of elements of Phases 2 and 3 of IFRS 9, *Financial Instruments*, are not expected to be issued until Q4 2011.

²⁸ NZICA, IDW

If the final accounting standards raise significant issues with the IAPS, the Task Force proposes that the IAASB consider the need to revise IAPS 1000 at that time.

43. In addition to the above, some respondents made the general observation that Section II of the proposed IAPS contains many references to management's activities, but did not equally emphasize the auditor's considerations. This was particularly evident in paragraphs 50-81, which concern understanding management's methodology for valuing its financial instruments. The Task Force has found this to be a difficult concern to address. The Task Force believes that the proposed wording in the IAPS appropriately focuses on what the auditor may expect from management in preparing financial statements with financial instruments, and help the auditor gauge the audit implications of engagement circumstances. The Task Force acknowledges more direct language may improve clarity, but is also cognizant of the need to avoid wording that implies an imperative to the auditor in an IAPS. The Task Force would welcome the IAASB's views on this matter.
44. To ensure clarity, the Task Force proposed that the IAPS makes clear that the audit is conducted on the premise that management acknowledge certain responsibilities, and that the IAPS imposes no obligations on management (see paragraph 3B of Agenda Item 4-C). This is consistent with what is stated in the ISAs, and the Task Forces believe worth reiterating in the IAPS.

Matter for IAASB Consideration

Q8. Does the IAASB believe the IAPS, particularly Section II, is appropriately balanced in terms of the responsibilities between management and the auditor?

45. The Task Force continues to explore other comments received on exposure, including descriptions of common IT controls and possible material on prior period estimates. These issues require further consideration by the Task Force.

IV. Structure and Other Matters

46. ED-IAPS 1000 contained two sections to separate the background/educational material from the auditing considerations. It also contained shaded boxes to enable readers to quickly refer back to relevant material. Both of these were designed to help overall readability and navigation.
47. The use of two sections was supported by respondents from most stakeholder groups²⁹ though there were many other suggestions for improvement including incorporating the tables into the text, moving the tables to an appendix, moving the education material to an appendix³⁰ and providing "road maps" for less sophisticated auditors to easily get to

²⁹ AAP, ACAG, ACCA, AOB, AIU&APB, AuAASB, BDO, C Bernard, CAASB, CICPA, CPAB, D. Juvenal, DFSA, DTT, EBA, EYG, FACPCE, FICPA, GT, HKICPA, IAIS, ICAI, ICPAS, IOSCO, IRBA, JICPA, KPMG, MIA, NYSSCPA, NZICA, PwC, RACOPK, RSM, SAICA

³⁰ IAIS, NZICA

relevant material (see Section III-A above). Another questioned whether readers will wonder if the IAASB intends the two sections to have differing levels of authority.³¹

48. Those commentators that recommended moving the educational material to the appendix,³² or outside of the IAPS³³ noted that doing so would make the IAPS clearer and make its authoritative nature better understood. Others believed that there was some educational material in Section II, which should be shaded to distinguish it.³⁴ One respondent³⁵ believes that the heading above Section I of the IAPS was not needed, and that Section II of the IAPS should precede Section I, as Section II is the main purpose of the document.
49. Respondents expressed mixed views on the use of shaded tables. While some respondents³⁶ supported them, others³⁷ expressed various concerns. These concerns included that they were too long, they created uncertainty about the status of the text, they appear to be background material to background material, they disrupted the flow of the IAPS or otherwise impeded readability, they should be moved to an appendix, in whole or in part, they should be more tailored to a specific concept and that they should all be incorporated into Section I of the IAPS.
50. One commentator³⁸ noted that the shaded tables may impact adoption of the IAPS. This commentator noted that putting the shaded tables in an appendix would remove a potential obstacle for endorsement in Europe as the European Commission distinguished between:
- Authoritative requirements relevant for the audit in ISAs and supplemental guidance outside the ISAs; and
 - Guidance from the auditing standard setter regarding material from the financial reporting standard setter that may or may not be endorsed in Europe under the endorsement criteria for financial reporting.
51. In light of the comments, the Task Force proposes that the two sections be retained as this was generally supported by many respondents. Given the lower level of support for the shaded table, and the broad variety of perceived difficulties encountered by respondents, the Task Force recommends that the shaded tables be relocated into the text, and, for the tables included in Section II of the IAPS, to consider whether any of these would be better placed in Section I. Whilst, some respondents recommended moving the material in the shaded tables into an Appendix, the Task Force's previous discussions and the majority of

³¹ IOSCO

³² BCBS

³³ ICAEW

³⁴ AIU&APB, EYG

³⁵ FEE

³⁶ AOB, BDO, C. Bernard, CPAB, D. Juvenal, DFSA, DTT, EYG, FACPCE, FICPA, GT, HKICPA, ICPAS, JICPA, KPMG, MIA, NYSSCPA, RACOPK, RSM, SAICA

³⁷ AAP, ACCA, AIU&APB, AuAASB, BCBS, BDO, CICPA, FEE, ICAEW, ICAI, ICJCE, IOSCO, IRBA, NIVRA, NZICA, PWC,

³⁸ FEE

respondents indicated that having the material within the body of the IAPS, although segregated from the auditing considerations, would be preferable.

52. The Task Force has discussed, at a preliminary level, the relocation of the tables into the text of the IAPS. At the moment, only selected tables have been relocated in accordance with the Task Force’s preliminary discussions. The remaining tables will be incorporated into the text after the June 2011 IAASB meeting.

Related Structural issues

53. Three respondents³⁹ suggested the inclusion of a glossary of terms. The IAASB and the Task Force have discussed a glossary previously, and noted that it had not been possible to find generally accepted definitions for many of the items. Nevertheless, consistent with the intended audience of the IAPS, the Task Force continues to investigate whether some helpful definitions can be provided on some of the terms and will make proposals, as appropriate, at the September IAASB meeting.
54. The Task Force also addressed whether a navigation tool (such as a “roadmap”) would be practical and useful to some users. It was decided that a “roadmap” would largely duplicate the table of contents. The Task Force has discussed whether a specific response should be made, including whether an appropriately detailed table of contents or index would assist readers in locating relevant content.

Matters for IAASB Consideration

- Q9. Does the IAASB support retaining both Section I and Section II of the IAPS, but removing the shaded tables?
- Q10. Does the IAASB believe an enhanced navigation tool, such as an expanded table of contents or index would improve readability?

Effective Date

55. While ED-IAPS 1000 did not include an effective date, it noted that the extant IAPSs became effective on issuance as they did not establish any requirements. However, the IAASB observed that this may not be appropriate due, in part, to the need to allow jurisdictions sufficient time to translate the IAPSs and for firms and auditors to consider the guidance relative to their training programs and audit methodologies. This issue was of particular concern given the proposed changes to the status and authority of new IAPSs.
56. Most respondents noted that an effective date was needed for the reasons given above. However, there was wide disparity in views as to the period necessary for effective implementation. The range of suggested effective dates was from 3 months to 2 years. Whilst there was no clear reason for the disparity in recommended dates, respondents variously noted that processes, such as translations, training, reading and understanding

³⁹ AOB, MIA, BDO

the IAPS and local adaptation would require time, and may reflect the circumstances of each jurisdiction.

57. Other respondents⁴⁰ were of the view that an effective date is neither necessary nor appropriate. It was argued that were not needed, and the reasons given were (a) the IAPS does not contain any requirements, so application is not mandatory and (b) that giving an effective date may lead some to ascribe more authority to the IAPS than was intended. These arguments were raised and considered by the IAASB in its deliberations when approving the ED.
58. Under the authority of IAPS as proposed in the ED, the Task Force believed that an effective date is warranted, however it is noted that the proposals in Agenda Item 3-A regarding status and authority may warrant a different response.

⁴⁰ AAP, ACAG, AOB, DFSA, GAO, GT, ICPAS, JICPA, NYSSCPA, NZICA

Appendix 1

Proposed Amendments to ISA 500, *Audit Evidence*

[Paragraphs 7-8 are provided for reference purposes only. No amendments are proposed to these paragraphs]

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26–A33)
8. If information to be used as audit evidence has been prepared using the work of a management's expert,⁴¹ the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34–A36)
 - (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37–A43)
 - (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44–A47)
 - (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

Reliability of Information Produced by a Management's Expert (Ref: Para. 8)

[No changes are proposed for paragraph A34]

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this ISA applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization is engaged by the entity to apply that expertise in making a fair value estimate which for the entity to uses in preparing its financial statements, the individual or organization is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides prices data regarding private transactions not otherwise available to the entity or pricing-related data for a variety of financial instruments and this information is available to other customers of the individual or organization as an input to which the entity's uses in its own estimation methods, such information prices and pricing-related data, if used as audit evidence, is are subject to paragraph 7 of this ISA but is not the use of a management's expert by the entity (see paragraph 13 of ISA 540 regarding responses to the assessed risks of material misstatement regarding accounting estimates).

⁴¹ For reference only, the definition of a management's expert in paragraph 5(d) of ISA 500 is "An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements."

Proposed Amendments to ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

[Paragraph 13 is provided for reference purposes only. No amendments are proposed to paragraph 13]

13. In responding to the assessed risks of material misstatement, as required by ISA 330,⁴² the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Paragraph. A59–A61)
- (a) Determine whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate. (Ref: Paragraph. A62–A67)
 - (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Paragraph. A68–A70)
 - (i) The method of measurement used is appropriate in the circumstances; and (Ref: Paragraph. A71–A76)
 - (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Paragraph. A77–A83)
 - (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Paragraph. A84–A86)
 - (d) Develop a point estimate or a range to evaluate management’s point estimate. For this purpose: (Ref: Paragraph. A87–A91)
 - (i) If the auditor uses assumptions or methods that differ from management’s, the auditor shall obtain an understanding of management’s assumptions or methods sufficient to establish that the auditor’s point estimate or range takes into account relevant variables and to evaluate any significant differences from management’s point estimate. (Ref: Paragraph. A92)
 - (ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Paragraph. A93–A95)

Testing How Management Made the Accounting Estimate (Ref: Para. 13(b))

[No changes are proposed for paragraphs A68 to A69]

A69(a) Management may make use of a third-party pricing source, such as a pricing service or broker quote in valuing certain assets, for example, financial instruments. In some cases, the third-party pricing source is engaged by the entity to apply their expertise to make a fair value estimate for the entity to use in preparing its financial statements. In such cases, paragraph 8 of ISA 500 applies. However, in many cases, the third-party pricing source provides– prices and other pricing-related data for a variety of financial instruments and those prices and pricing-related data are available to other customers of the third-party pricing source. In such cases, the prices and pricing-related data, if used as audit evidence, are subject to paragraph 7 of ISA 500.

A69(b) The procedures to test management’s use of third party prices and pricing-related data depends on the type of assets, the observability of inputs and the complexity of any models used. For example less extensive procedures may be needed to test the use of third party information about high quality corporate bonds

⁴² ISA 330, paragraph 5.

that trade frequently than private label asset backed securities that trade infrequently. This is because, among other things, there is more observable data when a financial instrument trades. Examples of procedures the auditor may consider when testing management's use of prices and pricing-related data from the third-party pricing source include:

- Evaluate the competence, capability and objectivity of the third-party pricing source.
- Inquire about how the third-party pricing source generates prices, and the controls that the third-party pricing source have in place over valuation and validation of the prices.
- Obtain a service auditor's report that covers the controls over validation of the prices.
- Evaluate the reasonableness of assumptions and inputs.
- Evaluate the appropriateness of the model or valuation technique
- Compare the prices and pricing-related data used by management with the data provided by the third-party pricing source.

A69(c) In some cases, management may value a financial instrument based on a third party pricing source without further inquiry or understanding of how the third-party pricing source generated the price or pricing-related data. For example, there is a risk that an entity may account for changes in the fair value of a financial instrument by reference only to statements provided by brokers to their customers even where the broker is a counterparty of the entity's transaction. Further, there is a risk that management and the auditor may not be able to gain an understanding of the process used to generate the price, including any controls over the process of how reliably the consensus price is determined, or may not have access to the model, including the assumptions and other inputs used. In such cases, alternative audit procedures may be required, and the auditor may decide to develop a point estimate or range to evaluate management's point estimate. Use of one or more prices or quotes from one or more third-party pricing source(s) may provide corroborative evidence, but is unlikely to provide sufficient appropriate audit evidence on its own.

[No changes are proposed for paragraphs A70 to A86]

Developing a Point Estimate or Range (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response where, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in developing a point estimate or a range.
- Management has used a third-party pricing source, but does not understand the process used to generate the price, including any controls over the process, or does not have access to the model, including the assumptions and other inputs.

[No changes are proposed for paragraphs A88 to A90]

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.
- Engaging a third-party source to provide prices. Examples of procedures the auditor may consider when he or she engages a third-party pricing source to provide prices include developing an understanding of the process, evaluating the reasonableness of the assumptions and other inputs, and evaluating the appropriateness of the model or valuation technique.

Appendix 2

LIST OF RESPONDENTS-EXPOSURE DRAFT OF IAPS 1000 <i>Special Consideration in Auditing Complex Financial Instruments</i>		
#	Abbrev.	Respondent (44)
Member Body (18)		
1.	AAP	Joint Response from CPA Au, ICAA, NIA
2.	ACCA	The Association of Chartered Certified Accountants
3.	CICPA	Chinese Institute of Certified Public Accountants
4.	CIPFA	Chartered Institute of Public Finance and Accountancy
5.	FACPCE	Federación Argentina de Consejos Profesionales de Ciencias Económicas
6.	FEE	Federation des Experts Comptables Europeens
7.	FSR	Foreningen af Statsautoriserede Revisorer
8.	HKICPA	Hong Kong Institute of Certified Public Accountants
9.	ICAEW	The Institute of Chartered Accountants in England and Wales
10.	ICAI	The Institute of Chartered Accountants in Ireland
11.	ICAP	Institute of Chartered Accountants of Pakistan
12.	ICJCE	Instituto de Censores Jurados de Cuentas de España
13.	ICPAS	Institute of Certified Public Accountants of Singapore
14.	IDW	Institut der Wirtschaftsprüfer
15.	JICPA	The Japanese Institute of Certified Public Accountants
16.	MIA&MICPA	Malaysian Institute of Accountants & The Malaysian Institute of Certified Public Accountants
17.	NIVRA	Koninklijk Nederlands Instituut van Registeraccountants (Royal NIVRA)- Comment letter sent in by NBA
18.	SAICA	The South African Institute of Chartered Accountants
Regulators and Oversight Authorities (9)		
19.	AIU&APB	Audit Inspection Unit & Auditing Practices Board (Financial Reporting Council, United Kingdom)
20.	AOB	Audit Oversight Board (Malaysia)
21.	BCBS	Basel Committee on Banking Supervision
22.	CPAB	Canadian Public Accountability Board
23.	DFSA	Dubai Financial Services Authority
24.	EBA	European Banking Authority
25.	IAIS	International Association of Insurance Supervisors
26.	IOSCO	International Organization of Securities Commissions
27.	IRBA	Independent Regulatory Board for Auditors, South Africa
National Auditing Standard Setters (3)		
28.	AuAASB	Australian Auditing and Assurance Standards Board
29.	CAASB	Canadian Auditing and Assurance Standards Board

30.	NZICA	New Zealand Institute of Chartered Accountants
Public Sector Organizations (2)		
31.	ACAG	Australasian Council of Auditors-General
32.	GAO	United States Government Accountability Office
Accounting Firms (8)		
33.	BDO	BDO Global Coordination B.V.
34.	DTT	Deloitte Touche Tohmatsu
35.	EYG	Ernst & Young Global
36.	GT	Grant Thornton International
37.	KPMG	KPMG
38.	PwC	PricewaterhouseCoopers
39.	RACOPK	Riaz Ahmad and Company, Chartered Accounts
40.	RSM	RSM International Limited
Other Professional Organizations (2)		
41.	FICPA	Florida Institute of Certified Public Accountants
42.	NYSSCPA	New York State Society of Certified Public Accountants
Individuals and Others (2)		
43.	C. Barnard	Chris Barnard
44.	D. Juvenal	Denise Silva Ferreira Juvenal