

## Special Considerations in Auditing Financial Instruments—Proposed Exposure Draft of Changes to ISA 500 and ISA 540

**[Marked Showing Changes from June 2011 IAASB]**

### 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,<sup>1</sup> 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)

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*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 for the entity to use 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 provides prices or pricing-related data for a variety of financial instruments and this information is available to other customers of the individual or organization, such prices and pricing-related data, if used as audit evidence, are ~~subject to paragraph 7 of this ISA~~ not subject to paragraph 8 of this ISA (see paragraph 13 of ISA 540 regarding responses to the assessed risks of material misstatement regarding accounting estimates).

<sup>1</sup> 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,<sup>2</sup> 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)

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

[No changes are proposed for paragraphs A68 to A69]

Third-party pricing sources

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<sup>2</sup> ISA 330, paragraph 5.

A69a. 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.

A69b. The nature and extent of procedures to test management's use of third party pricing sources depends in part on the availability of information from the source to understand the methods and assumptions used. Pricing services often provide information about their methods and assumptions by asset class rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker indicative quotes for individual securities. Accordingly the ability of the auditor to assess the reliability of the pricing information from the pricing source may vary significantly depending on the type of asset and the pricing source.  
~~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 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.~~

A69c. The more observable inputs used and the less complex the valuation technique the lower the risk of material misstatement is likely to be. Accordingly the nature and extent of procedures that the auditor needs to perform to test the reliability of

information from a third party pricing source will vary depending on the observability of inputs and complexity of methods for a specific security or asset class. For example, when testing the reliability of pricing information from a pricing service, less extensive procedures may be needed to test the reliability pricing information for a corporate bond than for non-government agency asset backed securities.

A69d. The following factors are important considerations about the general reliability of evidence from a third party pricing source:

- The competence, capability and objectivity of the third-party pricing source;
- The type of third party pricing source, for example a pricing service or a broker quote;
- The controls and processes used by the pricing source over their valuations; and
- Past experience of the auditor with the pricing source and its reliability.

A69e. The following factors are important considerations about the reliability of prices for specific securities:

- The competence and capability of the third party pricing source for the asset classes of interest to the auditor;
- The controls and processes over valuations for the asset classes of interest to the auditor;
- The reasonableness of valuation techniques, assumptions and inputs for either the specific security or asset class of interest to the auditor; and
- Whether the third party provided prices are reasonable in relation to prices from other third party sources or the entity's estimate

A69f. Possible approaches to gathering evidence concerning the reliability of information from third party pricing sources include:

- Obtaining a service auditor's report that covers the controls over validation of the prices.
- Understanding disclosures provided by third party pricing sources about their the controls and processes, valuation techniques, inputs and assumptions.
- Performing procedures at the third party pricing source to understand the controls and processes, valuation techniques, inputs and assumption used for asset classes or specific securities of interest.
- Independently estimating prices for some securities priced by the third party and comparing whether the results were within a reasonable range of each other.

~~A69ge. 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 perform the planned procedures due to an inability 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 many cases, alternative audit procedures may be required, and the auditor may decide in many cases to develop a point estimate or range to evaluate management's point estimate. Although Use of one or more obtaining another prices or quotes from one or more third-party pricing source(s) may provide corroborative evidence, but it 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~~Obtaining prices from third-party sources. Examples of procedures the auditor may consider when the auditor he or she engages obtains prices from 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.the matters discussed in A69f.