Special Considerations in Auditing Financial Instruments —
Issues and Task Force Recommendations

Background

1. At its June 2011 meeting the IAASB discussed significant comments received on exposure of proposed IAPS 1000\(^1\) (ED-1000). The IAASB broadly supported the Task Force’s proposals regarding the intended audience and scope of the document, including the recommendation to not develop specific guidance on particular accounting issues which may be viewed as providing interpretive accounting guidance and which may significantly limit the general applicability and usefulness of the IAPS. In addition, the IAASB supported the Task Force’s proposal to provide additional material on models, noting however that further refinement may be needed to clarify the components of a model.

2. The IAASB also supported the Task Force’s proposal to provide additional material on third-party pricing sources, both within the proposed IAPN (formerly IAPS) and the ISAs through amendments to ISAs 500 and 540\(^2\), as appropriate. The IAASB noted that refinement to the material may also be needed to further explain the differences between types of third-party pricing sources such as pricing services, consensus pricing services and brokers, to enhance the distinctions of experts from third-party pricing sources, and to improve the discussion of related audit considerations.

Issues for IAASB Consideration

Proposed Amendments to ISAs 500 and 540\(^3\)

3. Agenda Item 3-C presents the proposed amendments to extant ISAs 500 and 540 regarding third-party pricing sources. Agenda Item 3-D shows changes from the June 2011 IAASB meeting.

4. The main changes being proposed from the June 2011 draft relate to the guidance in ISA 540. Broadly, the changes elaborate and clarify points presented in summary form in the previous draft. In particular, the material now more clearly recognizes that: [See paragraphs A69b and A69c]

- 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.

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

\(^2\) ISA 500, *Audit Evidence* and ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

\(^3\) As explained in Agenda Items 2&3, the Task Force did not have the opportunity to read the final version of the material presented. This was due to the significant weather conditions experienced late August 2011 in the eastern corridor of North America which adversely affected the timing of the Task Force’s planned final review. Nevertheless, the Task Force supported release of the material to the IAASB in the interest of progressing Board discussions.
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.

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.

5. The Task Force has also distinguished audit evidence considerations for the third-party pricing source overall from those that apply to classes of securities [see paragraphs A69d and A69e]. In addition, it has refined the proposed guidance on approaches to gathering evidence concerning the reliability of information from third-party pricing sources [See paragraph A69f].

Other Material in Proposed IAPN 1000

6. As previously discussed with the IAASB, the matter of use of third-party pricing sources had been identified as giving rise to challenges in practice. Accordingly, the above amendments to the application material of the ISAs are limited to this issue, with the intent of providing additional guidance to assist in the consistent application of ISA requirements.

7. The Task Force recognizes that some stakeholders may see merit in further amendments to the ISAs (ISA 540, for example, or other ISAs) to incorporate additional elements of the material in IAPN 1000 on the subject of auditing financial instruments. It also recognizes, however, that this would be a matter requiring deliberation by the IAASB of content as well as the advantages and disadvantages of doing so.

8. In light of the relative urgency to finalize additional guidance relating to third-party pricing sources, the Task Force believes that delaying the exposure of the amendments to ISAs 500 and 540 would not be in the public interest. Nevertheless, as part of the invitation for comment on the exposure of the proposed amendments, the Task Force believes that the IAASB would benefit from hearing stakeholder views on the need for, and extent of, further possible amendments to the ISAs in light of the material in IAPN 1000 (or otherwise) on auditing considerations related to financial instruments. This could usefully inform the IAASB’s consideration of any separate, further project work on the topic.

Matters for IAASB consideration

1. Does the IAASB agree with the proposed amendments to ISAs 500 and 540?

2. Subject to approval for exposure, the IAASB will be provided with a draft explanatory memorandum for comment prior to release. The IAASB is asked for its views on whether there are specific questions that should be asked to stakeholders in relation to the proposed ISA 500 and 540 amendments? The IAASB is also asked for its views on the matter of soliciting input on elements of IAPN 1000 that may be usefully incorporated in the ISAs as part of any separate, further project work?
Proposed IAPN 1000

9. In addition to changes to align material between the proposed amendments to ISAs 500 and 540 and IAPN 1000, as appropriate, on the topic of third-party pricing sources, the Task Force has further clarified several aspects of the proposed IAPN 1000 in response to comments at the June 2011 IAASB meeting. Broadly, these clarifying changes are in relation to:

(a) The introduction, including explaining more clearly the intended focus of the IAPN, and to improve the flow of the paragraphs; [See paragraphs 1-14]

(b) Models, particularly further clarifying language regarding components of a model such as assumptions and data as well as the audit considerations; [See paragraph 40-44 and related material in Section II]

(c) Further explaining the differences between types of third party pricing sources such as pricing services, consensus pricing services and brokers; [See paragraphs 45-56 and related material in Section II]

(d) Additional discussion of valuation issues relevant to financial liabilities; [See paragraphs 58-59]

(e) The design of procedures, variously in Section II, including clarification of the material regarding dual purpose testing and the timing of tests.

Restructuring and Consolidation of Existing Material

10. At the June 2011 IAASB meeting, the Task Force noted that a number of drafting improvements relating to the structure and readability of the IAPN remained outstanding. These included: incorporating the shaded tables in ED-IAPS 1000 into the text of the document; considering the extent of explanation of management’s processes that was included in Section II; and other ancillary measures to improve readability, such as providing “road maps” of key sections where necessary.

11. As part of the above and a review of the flow of the document, material was relocated as appropriate. In particular, the Task Force amalgamated material related to management’s processes to the background and education material in Section I of the IAPN. In addition, the Task Force took the opportunity to improve readability by eliminating duplicative material, a matter noted by some respondents in relation to the overall length and complexity of ED-1000. This restructuring has made it impractical to provide a useful marked version of the changes from the June 2011 draft. Accordingly, the IAASB is asked to review the clean draft presented in Agenda Item 3-B.

Matter for IAASB consideration

3. The IAASB is asked whether it agrees with the content of proposed IAPN 1000?

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4 See footnote 3.
Re-exposure

12. Broadly, the key changes from ED-1000 are improvements to, or clarification of, material in relation to the following areas:
   - The use of specialized skills or knowledge in the audit
   - Professional skepticism
   - Fraud risk
   - The entity’s risk management and controls
   - Valuations, particularly greater specificity regarding valuation adjustments and the use of models
   - Third party pricing sources (as discussed above).

In addition, wording changes have been made to reflect consistent use of terms such as “measurement uncertainty,” “models,” and to achieve alignment, where necessary and to the extent appropriate, with key financial reporting frameworks.

A comparison of key sections between ED-1000 and proposed IAPN 1000 will be handed-out at the September 2011 IAASB meeting, for reference purposes.

13. The changes reflected in the proposed IAPN have been primarily in response to matters raised by respondents to ED-1000, including the changes intended to address the length and streamline the flow of the document in order to improve clarity. In staff’s view, the changes do not fundamentally change the key messages in the ED or represent changes of substance to key matters addressed in the exposure draft. Accordingly, staff believes that re-exposure of the IAPN is not necessary.

Consideration by IAASB of Significant Matters Identified by the Task Force

14. 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 to the IAASB at its meetings. 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.