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Committee: IAASB Consultative Advisory Group

Meeting Location: Prague

Meeting Date: September 12–13, 2011

Amendments to ISA 500 and ISA 540, and Special Considerations in Auditing Financial Instruments

Report Back and Summary of Significant Comments on Exposure and IAASB Task Force Recommendations

Objectives of Agenda Item

1. The Objectives of this Agenda Item are:
 - (a) To provide a report back on proposals of the Representatives as discussed at the September 2010 CAG Meeting.
 - (b) To present:
 - i. The proposed amendments to ISA 500¹ and ISA 540;² and
 - ii. The proposed final IAPN 1000,³and obtain the Representatives' views on the main issues arising on the IAASB's exposure of proposed IAPS 1000 (ED-1000) and on key issues to be discussed by the IAASB at its September 2011 meeting.

Papers to Be Referred to during Discussion

2. The discussion on this topic will follow the structure of this CAG Paper. **Agenda Item O.3** is the draft proposed IAPN 1000, as provided to the IAASB for approval at its September 2011 meeting. While the draft IAPN 1000 will not be discussed in detail during the IAASB CAG meeting, and therefore the Representatives are not expected to study the material included therein, it is being provided to give context to the Matters for CAG Consideration included in this paper.

¹ ISA 500, *Audit Evidence*

² ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

³ Proposed IAPN 1000, *Special Considerations in Auditing Financial Instruments*. See paragraph 4 below for further explanation of the change in title from IAPS 1000 to IAPN 1000.

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September 12-13, 2010 CAG Discussion⁴

3. Below are extracts from the minutes of the September 2010 CAG meeting,⁵ and an indication of how the project Task Force or IAASB has responded to the Representatives' comments.
4. As explained in **Agenda Item O.1**, the Task Force is recommending that the category of IAPSs be withdrawn and replaced by "International Auditing Practice Notes," or "IAPNs." In the report back below, the term "IAPS" is used to refer to International Auditing Practice Statement (IAPS) 1000 as shown in the ED, whereas the term "IAPN" is used to refer to the document presented in **Agenda Item O.3**, the non-authoritative pronouncement that the IAASB will be asked to vote on in September 2011.

Report Back on Discussion on IAPS Status and Authority

Representatives' Comments	Task Force/IAASB Response
<p>Mr. Attolini noted that the SMP Committee has some concern about the length of the document, and believes that the IAPS is not likely to be relevant in most SME audits. He expressed concern that SMPs would need to read the document to determine its relevance. He appreciated that paragraph 5 of the proposed IAPS clarified that "In particular, this IAPS does not deal with simple financial instruments such as cash, trade accounts receivable and trade accounts payable" but, in his view, this was inconsistent with other material in paragraph 3 of the proposed IAPS that noted that "Many of the considerations in this IAPS can also be applied to simpler financial instruments." He suggested the Task Force could better align these views within the IAPS, as there is a concern that regulators in some jurisdictions may expect SMPs to apply the IAPS to simpler financial instruments. Mr. Gutterman suggested this could be clarified within the Scope Section rather than the Background Section.</p>	<p>Mr. Fogarty explained that the intent of the statement on the authority of the IAPS is not that the auditor has to read every IAPS that exists, but rather to determine which IAPSs may be relevant. The paragraphs referred to by Mr. Attolini were intended to identify ways in which an auditor could discern whether the IAPS applies. Mr. Fogarty agreed that, without a definition of complex financial instruments, it may be more difficult to determine this, in particular because simple financial instruments can become difficult to value when market conditions change. In his view, the matter of whether regulators would expect SMPs to apply the IAPS should be discussed in individual jurisdictions.</p> <p>In discussing the comments received on exposure, the IAASB agreed that the IAPN should address all financial instruments, not just</p>

⁴ Note that the Representatives did not raise any additional comments during the oral presentation on the status and authority at the March 2011 CAG meeting.

⁵ The minutes were approved at the March 2011 IAASB CAG meeting.

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Representatives' Comments	Task Force/IAASB Response
	complex financial instruments. See paragraphs 17(b) and 18-24 below and Agenda Item O.1 for the proposals relating to the status and authority of the revised guidance.
Ms. Blomme supported the proposed scope of the IAPS in light of its authority.	Support noted.
Mr. Robberecht agreed that the IAPS appropriately did not impose additional requirements. He questioned the intent of paragraph 18 of Agenda Item E.1 which states: "In preparing financial statement disclosures, management complies with the requirements of the applicable financial reporting framework in their jurisdictions and such other information that may be needed for fair presentation, for example describing significant risks to inform investors." In his view, this may imply that there are additional requirements placed on management in addition to those of the applicable financial reporting framework.	Point accepted. Mr. Fogarty noted that this was premised on the assumption that the framework is a fair presentation framework, and suggested the IAPS could be clarified to note the IAPS does not apply to a compliance framework. See paragraph 7 of Agenda Item O.3.

Report Back on Discussion on Proposed IAPS 1000

Representatives' Comments	Task Force/IAASB Response
REPORT BACK	
Mr. Gutterman, speaking on behalf of the Working Group, was of the view that own credit and non-performance risk should be addressed in the IAPS or in another form. He suggested that, if this could not be done in advance of exposure, then the Task Force should develop the wording in anticipation of receiving further comments on the matter during exposure. Mr. Damant agreed. Ms. Sucher suggested a recent UK Financial Services Authority (FSA) discussion paper on the fundamental review of trading activity regulation may be helpful in this regard, as it provides commentary about	Mr. Fogarty noted that the Task Force recognized that own credit risk is an important issue but was of the view that it might unbalance the document to attempt to deal with the topic comprehensively. However, he noted that it may be possible to include a description of own credit risk to highlight its importance. Point taken into account. In finalizing ED-1000 and in responding to comments received on exposure, the TF noted similar concerns that own credit risk should be

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Representatives' Comments	Task Force/IAASB Response
<p>issues that arise in own credit risk.</p> <p>[In response to Mr. Fogarty's remarks during the meeting,]Ms. Sucher suggested this could address the inconsistent accounting treatment in practice and alert the auditor of the emphasis made in the accounting standards.</p>	<p>highlighted in the document, but agreed with Mr. Fogarty's view that the topic could not be dealt with comprehensively in the IAPN.</p> <p>See paragraphs 59 and 103 in Agenda Item O.3.</p>
RESTRUCTURING OF THE IAPS AND FURTHER MATERIAL THAT COULD BE ADDRESSED	
<p>Ms. Sucher supported the restructuring of the IAPS, noting the sections will help auditors navigate the document. She also supported the Task Force's decision to include additional material on valuation adjustments. In her experience, this has been a key area of audit risk during the global financial crisis. Finally, she noted that there have been a lot of challenges coming out of the crisis that have been addressed in the IAPS.</p>	<p>Support noted. In responding to comments on the ED, the Task Force has also reviewed the structure of the IAPN to further improve clarity and made additional clarification to the material on valuation adjustments (See paragraph 17(e) below and paragraph 30 of Agenda Item O.3.)</p>
<p>Mr. Windsor noted there had been a great improvement in the IAPS since it was last discussed with the CAG and noted it would be a positive addition in its current form. He suggested that the material in Section II could be expanded upon to deal with hedge accounting. Ms. Sucher supported this view, noting that regulators have been concerned with how the accounting requirements have been applied. He also stressed the importance for originators of financial instruments of recognition and derecognition, however, he recognized that addressing this in the IAPS would be a significant addition. Ms. Sucher agreed, noting that while different accounting frameworks may treat Day 1 profits differently, auditors need to pay careful attention to how this has been done. She recommended that the IAPS be exposed as planned, but suggested the Task Force could look at developing this material in anticipation of receiving further comments on exposure. Mr. Ratnayake suggested incorporating principles-based information, for example about Day 1 profits, could be useful.</p>	<p>Point not accepted.</p> <p>Mr. Fogarty explained that a number of these topics are very specific to accounting and regulatory frameworks and so the Task Force has been cognizant of limiting the amount of framework-specific guidance.</p> <p>In responding to comments on the ED, the IAASB determined that it would specifically exclude related accounting issues such as Day 1 profits as a full discussion of these would significantly limit the general applicability and usefulness of the IAPN (See paragraphs 28-30 below and paragraph 5 of Agenda Item O.3.)</p>

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Representatives' Comments	Task Force/IAASB Response
<p>Ms. Sucher suggested the guidance in Table 5 relating to the financial reporting framework mirrored what is currently being discussed by the accounting standard-setters. However, it is not clear when the accounting proposals would be finalized.</p>	<p>Point accepted.</p> <p>After the issuance of ED-1000, IAASB staff requested IASB staff to review the draft pronouncement to comment on any inconsistencies with the accounting literature and no comments were raised.</p> <p>The Task Force is cognizant of the need to not contradict the financial reporting frameworks, while still remaining sufficiently high-level to enable application of the IAPS in diverse contexts. See paragraphs 28-30 below for further discussion.</p>
<p>Mr. Baumann supported the IAPS, echoing Mr. Windsor's comment that it will be an excellent addition to the literature. He questioned whether, in light of the references to accounting frameworks, the IASB or Financial Accounting Standards Board (FASB) had reviewed the draft.</p>	<p>Point accepted.</p> <p>During the meeting, Mr. Fogarty had noted that it had not been reviewed by IASB or FASB representatives, but a number of experts familiar with the accounting requirements had been involving in reviewing the IAPS.</p> <p>After the issuance of ED-1000, IAASB Staff requested IASB staff to review the draft pronouncement to comment on any inconsistencies with the accounting literature. No substantive comments were raised.</p>
<p>Mr. Hallqvist suggested repetition could be minimized in the document by including a decision tree of the most common situation an auditor may encounter and then expand the guidance based on what might be done. In his view, this would shorten and clarify the IAPS.</p>	<p>Point not accepted.</p> <p>Mr. Fogarty noted that the Task Force had aimed to simplify what most agree is a very complex subject. In his view, designing a decision tree would be quite difficult, and the current structure of the IAPS is aimed at allowing people to navigate through the guidance based on how familiar they are with the material in Section I. Mr. Damant supported this view.</p>

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Representatives' Comments	Task Force/IAASB Response
<p>Regarding the auditor's procedures, Ms. Blomme noted that experts within FEE had suggested that analytical procedures may be quite useful when the auditor is dealing with a large pool of similar transactions. She also suggested reference could be made to the importance of looking at bank confirmations for derivatives or currency forwards that may only materialize in the financial statements at the end of their contractual lives, to assist both the entity and the auditor in identifying these types of transactions at their initiation.</p>	<p>Points taken into account.</p> <p>The proposed IAPN notes that, while analytical procedures may be useful in making risk assessments, they may be less effective as substantive procedures due to the complex interplay of factors (See paragraph 89 of Agenda Item O.3).</p> <p>The Task Force agrees that derivatives may pose particular challenges for auditors as they may not have a large initial investment. Further, the proposed IAPN notes that confirmations may not identify the existence of embedded derivatives as they often contained in contracts for non-financial instruments which may not be included in confirmation procedures, though the importance of confirmation procedures is noted throughout the IAPN (See paragraphs 24, 96 and 97, for example, and Appendix 2 of Agenda Item O.3).</p>
<p>Ms. Bastolla questioned whether the requirement in ISA 540 for the auditor to determine whether to use specialized skills or knowledge in the audit was intended to encompass internal audit. If so, in her view, this was inconsistent with the material included in relation to ISA 610⁶ regarding whether or not such individual would be considered a part of the engagement team.</p>	<p>Point accepted.</p> <p>Mr. Fogarty clarified that the material in the IAPS dealing with specialized skills or knowledge did not relate to internal audit. Ms. Hillier noted the material within the IAPS, in particular paragraph 110, is consistent with proposed revised ISA 610.</p> <p>As IAPN 1000 is due for approval at the September 2011 IAASB meeting, and Proposed Revised ISA 610 is not due for approval until the December 2011 meeting, the Task Force has relocated and revised material on internal audit to remain consistent with the extant ISA 610.</p>

⁶ ISA 610, *Using the Work of Internal Auditors*

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	<i>(See paragraphs 77-79 of Agenda Item O.3 of the September 2011 IAASB meeting)</i>
Mr. Uchino noted the material in the IAPS was well-organized. In particular, he supported the emphasis on the fact that the nature and extent of internal control that exists at an entity influences the auditor's determination of the balance between tests of controls and substantive procedures. He also supported including matters for the auditor to consider, including those on an entity's risk management practices, based on the experiences noted in Japan where risk management practices were not functioning as intended.	Support noted.
Ms. Sucher suggested material that appeared to have been deleted regarding the auditor's review of whether narrative information in the financial statements is consistent with the entity's risk assessment and control procedures should be reinstated.	Point not accepted. The Task Force notes that the nature and extent of the auditor's procedures relative to disclosures more broadly is the subject of the IAASB's pending project on Disclosures. The Task Force's recommendations to the IAASB are that the IAPN maintain consistency with extant ISA requirements, as to go further is not in keeping with the status of IAPNs. Nevertheless, given the importance of disclosures in relation to financial instruments, a section for the auditor's consideration of presentation and disclosures continues to be included in proposed IAPN 1000 (<i>See paragraphs 60-64 and 138-141 of Agenda Item O.3</i>).
Mr. White supported the discussion within the IAPS about communication with those charged with governance and others. He suggested that earlier communication with risk committees and audit committees regarding financial instruments could be further emphasized. Mr. Koster agreed, noting the matters cited in the IAPS should always be matters of	Point taken into account (<i>See paragraphs 68 and 143-145 of Agenda Item O.3</i>)

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Representatives' Comments	Task Force/IAASB Response
governance interests. He also suggested the auditor should endeavor to communicate frequently with regulators.	
Mr. Koster noted the depth of the paper was impressive. However, in his view, the expectation gap in relation to what the auditor does in relation to complex financial instruments has grown to be more significant in light of the global financial crisis. He suggested further consideration could be given within the IAPS to more clearly differentiate the auditor's responsibilities from that of management. In his view, auditing complex financial instruments may become more forensic driven, in particular as it becomes more necessary to dig into an entity's valuations. He noted concerns expressed by regulators that auditors cannot simply accept a valuation and questioned what more needs to be done to direct auditors to do the appropriate level of work. Mr. Damant was of the view that the IAPS appropriately does so.	<p>Point taken into account.</p> <p>The Task Force has restructured the document to further distinguish background and education material from the audit considerations. The Task Force has also considered the extent of material on valuations (See paragraphs 98–137 of Agenda Item O.3).</p> <p>The Task Force also notes that the proposed amendments to ISA 500 and ISA 540 may assist in further clarifying audit considerations relative to financial instruments (See the Appendix).</p>
Mr. Koster also questioned whether the guidance for auditors on developing a point estimate or range to be compared with that of management may be stepping into the role of management. In his view, there may be risks if auditors to create an independent model. Mr. Koster suggested this could be further clarified in the IAPS, highlighting in particular the need for the auditor to consider whether creating an independent model is practicable.	Mr. Fogarty explained that the material is consistent with ISA 540. However, he noted that in practice this may not be common because the auditor may not have all the information necessary to do so.
MULTIPLE SOURCES OF EVIDENCE AND THE AUDITOR'S PROCEDURES	
Mr. Gutterman noted that relying on the same expert would not be good practice, as the expert's work would not be considered to be independent.	Point taken into account (See paragraph 118 of Agenda Item O.3)
Mr. Peyret noted the view expressed in some regulatory reports, in particular relating to testing of impairment, that the auditor should do more than just test	<p>Point taken into account.</p> <p>The Task Force determined that the IAPN</p>

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Representatives' Comments	Task Force/IAASB Response
management's process.	should not include material on various related accounting issues, including impairment testing, as this would significantly limit the general applicability and usefulness of the IAPN. However, the Task Force also notes that, while paragraph 13(b) of ISA 540 permits testing management's process of making the accounting estimate as a way of obtaining sufficient appropriate audit evidence, it also requires the auditor to evaluate whether the method of measurement used is appropriate in the circumstances and the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. <i>(See paragraphs 5, 69 and 120 of Agenda Item O.3)</i>
Mr. Baumann suggested that the paragraph should further stress that if the auditor uses the same source of information that management has used, it is still necessary for the auditor to understand the assumptions and key inputs that were used, rather than simply relying on management's process.	Point accepted. The proposed IAPN includes an expanded section on the use of third party pricing sources, including material that further clarifies how the auditor may obtain an understanding of how management used the information from the third party pricing source <i>(See paragraphs 110–120 and 128–132 of Agenda Item O.3)</i>
Mr. Hallqvist suggested field testing of the IAPS might be appropriate, in particular to determine whether, if the IAPS had been applied, discoveries would have been made in relation to high-profile cases noted during the financial crisis.	Point not accepted. Mr. Fogarty noted that, while field testing is not planned due to the practicalities involved, the discussions held with experts included consideration of whether those experts would find the material in the IAPS useful to educate newer staff on the fundamentals of auditing complex financial instruments.
Mr. Fogarty explained that the IAASB would be asked to approve the IAPS for exposure at its September 2010 meeting. Mr. Gutterman noted the Working Group's	Support noted.

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Representatives' Comments	Task Force/IAASB Response
consensus that the pronouncement had been significantly improved and that it is important to move toward exposure. In his view, the IAPS as it currently standard will be extremely helpful in many jurisdictions in advance of the upcoming audit season, and will surely be improved through the process in arriving at a final pronouncement. Mr. Damant encouraged the MOs to respond to the exposure draft when it is issued, whether in respect to general views or specific inputs, as the topic is complex and vital in his view.	

Matters for CAG Consideration

8. In response to issues raised on IAASB's exposure of proposals on status and authority of IAPS and proposed IAPS 1000, **Agenda Items O and O.1** explain the recommendation that, when necessary, matters requiring authoritative guidance (i.e., guidance that is needed to enhance the consistent understanding and application of a requirement(s)) should be addressed through amendment of the ISAs themselves. This recommendation is made acknowledging the related proposal that the new IAPN 1000 would be non-authoritative in nature.
9. Section I below summarizes the proposals of the Task Force to amend ISAs 500 and 540. Section II below summarizes issues and proposals in relation to IAPN 1000 dealing with special considerations in auditing financial instruments.

I. Proposed Amendments to ISA 500 and ISA 540

10. A key issue of concern for the Task Force was respondents' comments on the auditor's response to management's use of third party pricing sources. Paragraph A35 of extant ISA 500 provides guidance on determining if such a pricing source is a management's expert, and 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 Task Force believes that the ISAs are less clear on the circumstances where a pricing source is not a management's expert, and is of the view that the ISAs' application material could be improved in this respect.
11. The Appendix to this Agenda Item shows the proposed amendments that the IAASB will be asked to consider at its September 2011 meeting.

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Proposed Amendments to ISA 500

12. The Task Force proposes to amend paragraph A35 of ISA 500, which is linked to paragraph 8 that deals with management's experts. The purpose of the 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.
13. 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 in contrast to a real estate valuation, for example, that may be sought by an entity in respect of a single, unique asset, a pricing service provides prices on many thousands of different securities, 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 because there are multiple users of the information.

Proposed Amendments to ISA 540

14. The Task Force proposes to insert additional application material into ISA 540 to provide guidance on audit considerations when management uses a third party pricing source. The proposed new paragraphs: explain further how a third party 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.
15. The Task Force also proposes 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 guidance on: 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.

Matter for CAG Consideration

1. The Representatives are asked for their views on the proposed amendments to ISA 500 and ISA 540, which if approved by the IAASB would be exposed for public comment.

II. Proposed IAPN 1000

16. Respondents were generally supportive of the scope and content of the proposed IAPS 1000. 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

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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.

17. The following summarizes the Task Force’s key amendments in finalizing IAPN 1000, which were agreed to at the June 2011 IAASB meeting:
 - (a) Audience—The primary readers of the IAPN, and those most likely to benefit most from assistance with “de-mystifying” financial instruments and the IAPN’s educational/background material and auditing considerations, will be auditors who are generally less familiar with financial instruments. The Task Force has, therefore, drafted the IAPN with the recognition that the IAPN 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 IAPN to “Financial Instruments”—The IAPN should cover not only complex financial instruments (CFIs) 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 material around models has been enhanced, including providing further educational material on the use of models and further material on how models may be tested.
 - (d) Third Party Pricing Sources—Further educational material and practical assistance in regard to the use of broker quotes and pricing services (“third party pricing sources”) has been included, particularly with regard to determining if such sources are management’s experts, and some possible responses to management’s use of them.
 - (e) Structure—The Task Force proposes some amendments to the structure of the IAPN, including removal of the shaded tables, relocation of some material and consideration of the need for enhanced tools for navigation. This process has resulted in the amalgamation of the material related to management’s processes to the background and education material in Section I of the IAPN, and has also enabled the removal of duplicated material to produce a more readable document.

Significant Issues and Related Proposals

Audience of the IAPN

18. ED-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 levels of financial instrument transactions. Respondents were asked for their views on whether the balance of material

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included in the IAPS is appropriate in light of its purpose of assisting a wide range of auditors on an international basis.

19. 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 material in relation to more complex entities, and equally some strong views suggesting more material for entities with less extensive experience with financial instruments.
20. Some respondents⁷ suggested greater focus on the applicability of the IAPS to small and medium practices (SMPs) and small- and medium-sized entities (SMEs). Various suggestions were made to emphasize SMP considerations as well as to aid readability. 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 instruments⁸ and should have sections on “Considerations Specific to Smaller Entities.”⁹ 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 transactions¹⁰ and tools to assist navigation for those with less experience in CFIs.¹¹
21. Others¹² were of the view that the IAPS should address considerations relevant to large financial institutions and those who actively trade CFIs, including banks, insurance companies, investment funds or systemically important financial instruments. This was proposed given the degree to which these entities are exposed to CFIs.
22. 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.
23. In considering this, the IAASB 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.

⁷ FEE, ICAI, ICPAS

⁸ FEE

⁹ FEE, ICAI, ICPAS

¹⁰ FEE

¹¹ NIVRA, AIU&APB

¹² BCBS, IAIS

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24. Accordingly, the IAASB decided 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 IAASB does not intend to make an explicit statement of the intended audience, however, as such a statement could be misread in various ways.

Financial Instruments versus Complex Financial Instruments

25. In developing ED-1000, the IAASB deliberated which financial instruments would be within its scope and concluded that the IAPS should apply to “CFIs.” Although ED- 1000 contained 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.
26. Respondents varied widely in their comments on the coverage of financial instruments. Some¹³ 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,¹⁴ and should also take into account the standards developed by parties such as the accounting standard setters, banking supervisors and other recognized stakeholders.¹⁵
27. The IAASB decided that the IAPN should 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. This means that the IAPN would no longer refer exclusively to “complex” financial instruments.

Coverage of Complex Accounting Requirements

28. ED-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-1000 explained that it would not be possible or appropriate to develop comprehensive guidance on these other matters without significantly limiting the general applicability and usefulness of the IAPS.
29. Some respondents were of the view that matters such as hedge accounting,¹⁶ day 1 gains or losses¹⁷, derecognition¹⁸ and loan loss provisions¹⁹ should be covered by the IAPS. It was

¹³ FEE, NZICA

¹⁴ IAIS, BCBS

¹⁵ BCBS

¹⁶ IAIS, IOSCO, IRBA

¹⁷ EBA, IRBA

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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 issues²⁰ as they noted that these are matters for the accounting standard setters to address.

30. The IAASB deliberated these comments and agreed that, consistent with ED-1000, the IAPS should continue to exclude these issues (see paragraph 5 of **Agenda Item O.3**), and focus on more pervasive issues regardless of the financial reporting framework. The IAASB 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 IAASB 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 IAPNs. Dealing with all such topics in this IAPN would significantly increase the length and complexity of the IAPN, as acknowledged by some respondents, and would make the document less useful to the intended audience.

Models/Valuation Techniques

31. ED-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.
32. Broadly, respondents supported the material on models included in ED-1000. However, respondents,²¹ 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 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.

¹⁸ EBA

¹⁹ IDW

²⁰ CICPA, ICAEW, PWC

²¹ APB, BCBS, BDO, CPAB, EBA, GAO, IAIS, IOSCO, C. Bernard

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33. The IAASB agrees with respondents' observations that further elaboration on particular elements of models, and auditor's consideration thereon, would benefit the IAPN. Nevertheless, the IAASB is cognizant of the need to ensure applicability of the IAPN across entities of varying levels of complexity and sophistication. Accordingly, the Task Force proposes additional material in the revised IAPN around models, in particular:
- Greater specificity in the guidance on adjustments to valuation techniques (see paragraph 30 of **Agenda Item O.3**).
 - How models may be tested (see paragraphs 120-127 of **Agenda Item O.3**).
 - Further educational material on the use of models (see primarily paragraphs 40-44 of **Agenda Item O.3**).
34. In proposing these changes, the Task Force was cognizant of the need for the IAPN 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.

Third Party Pricing Sources

35. ED-1000 provided material on the use of pricing services and brokers, emphasizing how such information may be used by management. ED-1000 did not establish a "bright line" to determine whether pricing services and brokers are management's experts.
36. Several respondents,²² including regulators, commented on the ED proposals with respect to management's use of broker quotes and pricing services. In particular, concern was expressed about when third party pricing sources could be a management's expert, within the meaning of paragraph 8 of ISA 500.
37. The IAASB has formed the view that the use of third party pricing sources requires further elaboration, in particular:
- Further education material on different types of third party pricing sources (see paragraphs 45-52 of **Agenda Item O.3**); and
 - Further guidance when considering such pricing sources (see paragraphs 110-120 of **Agenda Item O.3**).

As noted above, the IAASB will also be considering exposing proposed amendments to ISA 500 and ISA 540 to provide additional application material on the topics within the ISAs themselves.

²² APB&AIU, CICPA, ICAEW, IRBA, HKICPA, PWC

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Matter for CAG Consideration

2. The Representatives are asked for their views on the issues and related proposals pertaining to the content of proposed IAPN 1000.

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Appendix

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

[Marked Showing Changes from Extant ISAs]

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,²³ 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 to 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~~applies~~ that expertise in making a fair value estimate which for the entity uses 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 ~~merely provides prices data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods or~~

²³ 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.”

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pricing-related data for a variety of financial instruments and this information is available to other customers of the individual or organization, 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 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).

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 330,²⁴ 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)

²⁴ ISA 330, paragraph 5

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- (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 to paragraphs A68 to A69]

Third-party pricing sources

- 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.
- 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 of 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;

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- 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 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.

A69g. Further, there is a risk that 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 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 obtaining another price or quote from one or more third-party pricing source(s) may provide corroborative evidence, it is unlikely to provide sufficient appropriate audit evidence on its own.

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[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.
 - Obtaining prices from third-party sources. Examples of procedures the auditor may consider when the auditor obtains prices from a third-party pricing source include the matters discussed in paragraph A69f.