IAASB International Auditing and Assurance Standards Board

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September 28, 2009

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom
Electronically on the Open to Comment tab on www.iasb.org

Dear David,

As indicated in my letter to you on 24 July 2009, the International Auditing and Assurance Standards Board (IAASB) has recently agreed to pursue an initiative intended to help ensure that relevant auditing considerations are part of the input to the development of IFRS and other relevant standards by the IASB.

The aim of IAASB's initiative is straight forward: to implement a process to help the IAASB better monitor the development of IASB projects and, as appropriate, to provide the IASB with timely comments on aspects of its proposed standards that may have potential verifiability or auditability issues. There would seem to be obvious benefits: to the IASB in terms of contribution to the quality of its standards; and to the IAASB in terms of strengthening its ability to identify financial reporting developments that may affect the pronouncements of the IAASB or create a need for new auditing pronouncements.

The IAASB's Process to Facilitate Liaison with the IASB

The IAASB has established small working groups to monitor the progress of selected IASB projects. IAASB members and technical advisors have volunteered to participate in individual working groups based on the selected IASB project(s). Each working group is made up of at least two volunteers.

The working processes for aspects of the initiative are in many ways still evolving and being refined as experience is being obtained. The overall objective however is to facilitate effective dialogue with the IASB so that the IAASB is able to provide useful input to the IASB from an audit perspective at as early a stage of the development of a proposal as possible.

The focus of each working group's efforts is to identify significant aspects of IASB proposals which could pose difficulty in an auditing context – for example, aspects of proposals where preparers' compliance may not be able to be achieved on the basis of objective evidence or where the basis for their judgments may be difficult to substantiate. These are matters where the IAASB members' expertise can add value. In no way, however, should this initiative be construed to mean that the IAASB will now concern itself with the technical merits of IASB's accounting proposals.

Fair Value Measurement and Financial Instruments

The first working group of the IAASB was set up for the purpose of reviewing the Fair Value Measurement and Financial Instruments initiatives currently underway by the IASB. The working group has considered the following publications that are out for comment:

- Exposure Draft ED/2009/5 – Fair Value Measurement
- Exposure Draft ED/2009/7 – Financial Instruments: Classification and Measurement
- Discussion Paper DP 2009/2 – Credit Risk in Liability Measurement
- Request for Information ('Expected Loss Model') – Impairment of Financial Assets: Expected Cash Flow Approach

The attached Appendix includes, in the working group's view, comments on what are likely to be the most substantive issues from an auditing perspective resulting from changes in the proposed standards from current practice. Recognizing that this letter will arrive after the comment period ends for ED/2009/7, the working group has summarized its comments on both ED/2009/7 and ED/2009/5 in one letter. The working group did not believe it was necessary to issue comments on DP 2009/2 or the Request for Information at this time; however, it will continue to follow the IASB's progress on these topics and may choose to comment at a later stage of development.

Where possible, the working group has offered potential solutions for the IASB's consideration as to how language in the standard could be amended to address the issues noted. The working group acknowledges that in many cases the related Bases for Conclusions provide useful information on the IASB's deliberations and intent of the requirements in the standards. However, incorporating some of this useful material explicitly into the body of the standards themselves may increase consistency in practice, both by preparers and auditors alike.

The IAASB looks forward to continuing to work with the IASB as early as possible in its standard-setting processes. I hope you find the comments in the Appendix valuable and encourage you to engage us in further dialogue if necessary as you finalize these proposed standards.

Yours sincerely,

Prof. Arnold Schilder

Chairman, IAASB

CC: John Fogarty, Deputy Chair and Working Group Chair, IAASB

Diana Hillier, Board and Working Group Member, IAASB

Jim Sylph, Executive Director, Professional Standards, International Federation of Accountants

James Gunn, Technical Director, IAASB

Comments of the IAASB's Working Group
FAIR VALUE MEASUREMENT EXPOSURE DRAFT
(Issued May 2009)

MOST ADVANTAGEOUS MARKET

Issue Description

The auditor is required by the ISAs to obtain sufficient appropriate audit evidence that financial statements meet the requirements of IFRS. Thus, auditors would be expected to obtain audit evidence regarding the steps taken by management to identify "the most advantageous market", as required by paragraph 10 of the proposed IFRS. Obtaining such evidence may be difficult for reasons that include the following:

(a) Paragraph 10 states that "an entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market." However, the implication is that some form of search should be undertaken unless (as stated in paragraph 11 of the proposed IFRS) "in the absence of evidence to the contrary, an entity assumes that the *principal market* for the asset or liability is the most advantageous market." In addition, the Basis for Conclusions, paragraphs 91 and 92, discuss that "reasonably available information" cannot be ignored.

The audit process entails obtaining evidence regarding the actions taken by management to comply with IFRS. But in our view, under the wording proposed above, management could perform no search, or only a very minimal search, for the most advantageous market and still make a credible claim that they have complied with IFRS, stating that they have no evidence that contradicts the use of the *principal market*. This is because, as currently worded, the proposed standard provides no parameters regarding what would constitute an appropriate search, other than to say it need not be exhaustive. This puts the auditor in a difficult, if not impossible, position of trying to substantiate whether there is really "an absence of evidence to the contrary."

The auditor has to address the possibility that if management had undertaken an appropriate (but not exhaustive) search, such evidence might have been found. It seems likely that, given how the accounting standard is currently drafted, auditors would often conclude that to assess whether management has complied with the IFRS, the auditor will need to perform his or her own search. This, in our view would not be desirable (from a cost/benefit viewpoint) and, in some cases, likely not practicable.

(b) In many cases, the relevant "transaction" to consider may be hypothetical, making it difficult for the auditor to obtain sufficient appropriate audit evidence that the participants in this "most advantageous market" (other than the principal market) would have the attributes set out in paragraph 13 of the proposed IFRS. For example, it would be difficult for management to assess (and for the auditor to obtain evidence supporting) whether a party would be able and willing to enter this hypothetical transaction.

Actions that IASB May Wish to Consider in Addressing the Issue

We agree that to require an exhaustive search to identify the most advantageous market would not be appropriate. We also realize that to define what an "appropriate search" is would entail would require the standard to be drafted in a way that is overly prescriptive. However, to help ensure that auditors and preparers are reasonably consistent in their approach to dealing with the proposed guidance, we feel that the standard should be redrafted so that it does not focus on "absence of evidence to the contrary."

If the IASB retains the concept of *most advantageous market,* we recommend that an assumption be included noting that such market is the *principal market*, unless management has obtained evidence that another market is the most advantageous market. Such evidence would be auditable and this would address our concern that the requirement as currently drafted is not readily auditable.

For example, paragraphs 8-11 of the proposed IFRS could be revised as follows:

8. *A fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the ~~most advantageous market~~* ***principal market*** *to which the entity has access****, unless evidence has been obtained that a market other than the principal market would be the most advantageous market to which the entity has access.*** *The most advantageous market is the market that maximizes the amount that would be received to see the asset or minimises the amount that would be paid to transfer the liability, after considering transactions costs and transport costs.*

Paragraphs 9 and 10 would be deleted in their entirety.

11. *~~In the absence of evidence to the contrary, an entity may assume that the principal market for the asset or liability is the most advantageous market, provided that the entity can access the principal market.~~ The principal market is the market with the greatest volume and level of activity for the asset or liability. Regardless of the market used, an entity shall apply the fair value hierarchy as described in paragraphs 43 and 44.*

Such wording would require management (if it wishes) to be proactive in seeking to, and supporting, an approach different from using the principal market approach. This wording would likely provide clearer direction to preparers, and be more easily auditable, but without being overly prescriptive.

HIGHEST AND BEST USE

Issue Description

Auditors will have significant difficulty in obtaining sufficient appropriate audit evidence that the steps taken by management to identify "the highest and best use" in meeting the requirements of the proposed IFRS are adequate. This difficulty arises for reasons that include the following:

Paragraph 18 of the proposed IFRS states that:

18. *Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, an entity need not perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.*

As with the issue relating to the "most advantageous market" described above, there is an implication that some form of search be performed by management, and the absence of evidence is dependent of the nature and extent of any search undertaken by management. In order to obtain the sufficient amount of evidence required by the ISAs, and determine that management has appropriately concluded that there is no evidence to suggest that the current use is not the highest and best use, the auditor may need to perform a search of his or her own to verify completeness of the information considered by management.

Actions that IASB May Wish to Consider in Addressing the Issue

To reasonably limit the boundaries of these "searches" (performed both by management and the auditor), while at the same time considering that the current use may not be the highest and best use, we recommend revising paragraph 18 of the proposed IFRS as follows:

18. *~~Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, an entity need not perform an exhaustive search for other potential uses if there is no evidence to suggest that the current use of an asset is not its highest and best use.~~* ***<u>An entity shall assume that the current use of the asset is its highest and best use, unless evidence has been obtained that, from the perspective of market participants, a different potential use would be considered higher and better.</u>***

DISCLOSURE OF SENSITIVITY ANALYSIS

Issue Description

We strongly support the disclosure requirements included in paragraphs 56 through 61 of the proposed IFRS, as we believe that transparency is crucial in explaining the increased level of uncertainty that may exist for certain fair value measurements. However, we believe that paragraph 57(g) of the proposed IFRS, as currently written, does not require disclosures sufficient to avoid the financial statements from possibly being misleading. This paragraph requires disclosure of:

- The fact that changing one or more of the inputs to reasonably possible alternative assumptions for fair value measurements categorized within Level 3 would change fair value significantly. For example, the disclosure may simply read "Changing the inputs and assumptions used to calculate the value of the asset may change the fair value significantly."
- The effect of those changes. For example, the disclosure may read, "The value of the asset could vary between $1 million and $2 million if the inputs were changed."

As measurement uncertainty grows because of unobservable inputs, accurate, complete and understandable disclosure of the range of fair value outcomes become vital to the user of the financial statements. If there is adequate disclosure in the footnotes to describe the circumstance leading to the increased measurement uncertainty and the reasons behind it, the user will have enough information to more fully understand how imprecise the number they are dealing with is. Without such disclosure, users of financial statements could be misled. The ISAs specifically require the auditor consider potential implications for the auditor's opinion when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

To avoid users being misled, the disclosures required by paragraph 57(g) should include a discussion of the inputs the entity considered significant in its sensitivity analysis, a quantitative disclosure of such analysis, and why management believes those are the inputs which were important to the fair value. Enough information should be provided in the notes to the financial statements to allow the reader to appropriately form his or her own conclusion about the value.

Actions that IASB May Wish to Consider in Addressing the Issue

We recommend that paragraph 57(g) of the proposed IFRS be revised to include additional, detailed disclosure requirements regarding Level 3 inputs. Specifically, we recommend that portions of paragraph 103 from the Basis for Conclusions be included in paragraph 57(g) as follows:

57(g). for fair value measurements categorised within Level 3 of the fair value hierarchy, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose ***<u>the inputs the entity considered significant, and</u>*** *the effect of those changes. An entity shall disclose how it calculated those changes* ***<u>by including a quantitative disclosure of significant sensitivity</u>***

inputs. *For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.*

INCREASED FAIR VALUE EXPERTISE REQUIRED

Issue Description

Multiple elements of the proposed IFRS will necessitate the use of experts in the field of fair value, both by management and by auditors. For example:

- Consideration of different types of markets to determine the most advantageous market (see paragraph 8)
- Recognizing characteristics and assumptions of market participants (see paragraph 14)
- Consideration of different uses for assets to determine the highest and best use (see paragraph 17)
- Consideration of non-performance risk in valuing a liability (see paragraph 29)
- Complex valuation techniques (see paragraphs 38 through 40)
- Need for multiple valuation techniques (see paragraph 39)
- Use of unobservable inputs that are subjective and highly dependent on judgment (see paragraphs 41(b) and 54)
- Adjustments to Level 2 inputs (see paragraph 52)
- Performance of thorough sensitivity analyses (see paragraph 57(g))
- Consideration of hypothetical transactions, including the thought process of others (throughout the proposed IFRS)

There is a risk that a shortage of expertise may result in non-compliance with the financial reporting framework by management, resulting in qualified or adverse modifications to the auditor's report. Similarly, if auditors do not have access to fair value expertise, qualified opinions for scope limitations may result.

Actions that IASB May Wish to Consider in Addressing the Issue

We do not have any specific actions for the IASB to consider, other than recognizing the potential cost and resource implications of their proposals.

FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT EXPOSURE DRAFT

(Issued July 2009)

REMOVAL OF PRACTICABILITY OPTION

Issue Description

Elements of the proposed IFRS will necessitate the increased use of experts in determining fair value. For example, the proposed IFRS requires an entity to measure all financial assets and financial liabilities (including debt instruments) at fair value if they don't meet the criteria of (1) having basic loan features and (2) being managed on a contractual yield basis. This may increase the number of items measured at fair value, thus increasing resources necessary to perform these valuations. This will be especially true for unquoted equity investments, which were previously allowed to be measured at cost less impairment when fair value was unreliable (which we refer to as the "practicability option").

When developing accounting standards, consideration should be given to whether the practices required by such standards are auditable. We understand that the IASB has focused on developing standards which promote neutrality of financial statements, but we believe that auditability along with practicability are also critical elements that should not be given reduced weight.

We are concerned about the removal of the practicability option when fair value is unreliable, because it may leave management and auditors in the untenable position of attempting to support an amount in the financial statements which they believe to be unreliable.

As we mentioned in the "increased fair value expertise required" issue in relation to the Fair Value Measurement Exposure Draft, we are concerned that management, especially in emerging markets and developing economies, may not currently (or in the near future) have access to the expertise necessary to develop a reliable fair value measurement. As a result, they may not have a basis for being able to comply with the IFRS fair value requirements, which, if the impact could be material, would result in the financial statements requiring a qualified or adverse auditor's opinion. Thus, the removal of the practicability test can be expected to result in an increase of modified opinions.

In addition, if the auditor does not have access to the appropriate expertise as required by the ISAs, the auditor may need to qualify the report due to a scope limitation.

Actions that IASB May Wish to Consider in Addressing the Issue

We recommend that the IASB reconsider its decision to remove the practicability option. If the IASB feels that the exception is too widely used in practice by misinterpretation, we recommend that the IASB emphasize in either the main text of the proposed IAS 39 or in its Basis for Conclusions that the basic principle of IAS 39 is to require fair value measurement, and that the exception is limited only to cases where the reliability of fair value measurement is not ensured. The IASB may also consider requiring increased disclosure when the practicability option is exercised.

DEFINITIONS

Issue Description

The proposed IFRS suggests financial instruments be measured at amortised cost only if (i) the instrument has basic loan features, and (ii) the instrument is managed on a contractual yield basis.

We are concerned that the proposed IFRS does not provide sufficient, operational guidance on whether an instrument has “basic loan features” and “is managed on a contractual yield basis.” Although auditors are required by the ISAs to exercise professional judgment in planning and performing an audit, a condition for acceptance of an assurance engagement is that suitable criteria (in the case of a financial statement audit, accounting standards) enables reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment.

Actions that IASB May Wish to Consider in Addressing the Issue

We suggest clarifying these definitions, so as to promote consistent application of the auditor’s professional judgment.