



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

## Agenda Item E

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Washington

**Meeting Date:** September 9–11, 2009

### **Auditing Complex Financial Instruments—Project Update and Report Back**

#### **Objectives of Agenda Item**

1. The Objectives of this Agenda Item are:
  - (a) To review key matters identified in the Project Proposal approved by the IAASB at its June 2009 meeting.
  - (b) To obtain the Representatives' views on the matters included in the draft Consultation Paper to be discussed by the IAASB at its September 2009 meeting.
  - (c) To provide a brief report back on comments received from Representatives on the Fair Value Auditing Guidance Task Force's recommendations discussed at the March 2009 CAG Meeting.

#### **Background**

2. At their respective March 2009 meetings, the IAASB and its CAG agreed in principle with the recommendation of the Fair Value Auditing Guidance Task Force that the IAASB consider a project to revise IAPS 1012.<sup>1</sup> Such an initiative is consistent with the IAASB's plans described in its *Strategy and Work Program, 2009-2011*, to develop guidance on the subject of auditing fair values.
3. At its June 2009 meeting, the IAASB unanimously approved a project to develop guidance for auditors dealing with complex financial instruments. This project will include:
  - (a) The development of a briefing/consultation paper<sup>2</sup> to raise awareness and highlight a number of practical considerations that are currently posing challenges in audits of complex financial instruments; as well as
  - (b) The revision of IAPS 1012 to bring it in line with the clarified ISAs and, as appropriate, to further expand it for additional guidance for auditors when applying ISAs in the context of complex financial instruments.

***See Agenda Item 9 of the June 2009 IAASB Meeting for the full text of the project proposal***

<sup>1</sup> International Auditing Practice Statement (IAPS) 1012, "Auditing Derivative Financial Instruments."

<sup>2</sup> The Task Force has determined that the label "Consultation Paper" is more suitable than "Briefing Paper," as originally contemplated in the project proposal. ***See paragraphs 14-16 of Agenda Item 4.***

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**as approved by the IAASB.**

4. The IAASB supported the approach taken in the project proposal to the topic. It noted that the planned Consultation Paper, which has a targeted October 15, 2009 release date, would allow the IAASB to draw attention to issues facing auditors in the immediate term, while also helping inform the IAASB about how best to progress the revision of the IAPS.

#### Development of the Consultation Paper

##### *The UK Auditing Practices Board's Work on Complex Financial Instruments*

5. As indicated in the project proposal, the UK Auditing Practices Board (APB) is currently working on a project to revise its Practice Note (PN) 23.<sup>3</sup> The APB's Working Party intends to present a final PN for the APB's approval at its September 17, 2009 meeting. The timing of the APB's approval has been planned for issuance of the PN in time for auditors to use it on audits of December 2009 period ends.
6. The IAASB agreed at the June 2009 meeting that the APB's work should be leveraged to develop the Consultation Paper. The Task Force<sup>4</sup> believes it would be most appropriate to include the draft of the PN that will be discussed by the APB at its September meeting as an Appendix to the Consultation Paper and plans to use this national guidance as a starting point for the revision of IAPS 1012. Questions are included within the Consultation Paper to solicit views as to the IAASB's overall approach and the usefulness of the APB's guidance. **See paragraphs 16-17 and Questions 1-3 of Agenda Item 4-A of the September 2009 IAASB meeting for further discussion of the rationale for doing so.**

#### Matters for CAG Consideration

1. Does the CAG agree with the IAASB's assessment that it would be in the public interest to issue a publication in advance of the upcoming audit season?
2. Does the CAG support the use of the APB's work as a basis for the revision of IAPS 1012, subject to the views raised during consultation?

#### *Objective and Content of the Consultation Paper*

7. Subsequent to the June 2009 IAASB meeting, the Task Force has conducted two teleconferences to discuss the proposed form and content of the Consultation Paper and agree

<sup>3</sup> Practice Note 23, "Auditing Derivative Financial Instruments," issued in April 2002 and based on IAPS 1012.

<sup>4</sup> The Task Force comprises: John Fogarty, Chair; Jon Grant, IAASB member and Member of UK Auditing Practices Board Working Party on Complex Financial Instruments; Tomokazu Sekiguichi, IAASB member; Gregory Fletcher, Public Company Accounting Oversight Board; John Hughes, KPMG and Member of UK Auditing Practices Board Working Party on Complex Financial Instruments; Tom Omberg, Deloitte; and Marc Pickeur, Basel Committee on Banking Supervision. The International Valuation Standards Council has also been invited to join the Task Force but has not yet nominated a representative.

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the draft wording for discussion at the September 2009 IAASB meeting. IAASB Staff has also participated in two of the APB's Working Party meetings to ensure that the content of the IAASB's Consultation Paper accurately reflects the most current thinking of the APB's Working Party.

8. The draft of the Consultation Paper is included as **Agenda Item 4-A of the September 2009 IAASB meeting**. It closely follows the outline that was set forth in the project proposal, acknowledging that the current economic environment will continue to prove challenging for both preparers and auditors in relation to fair value accounting estimate, including complex financial instruments, in the upcoming season. It makes reference to the standards and guidance that currently apply for auditors, refers to ISA 540 (Revised and Redrafted)<sup>5</sup> insofar as it may contain useful guidance for auditors to consider in advance of its effective date, and highlights the October 2008 Staff Audit Practice Alert.<sup>6</sup>
9. In order to achieve the objectives of, and timeframe envisioned for, the Consultation Paper, its focus is on a limited number of issues and reference is made to the applicable guidance in the APB's PN to illustrate how these issues could possibly be addressed in a revised IAPS. The selection of these issues was based on themes that had been raised throughout the Fair Value Auditing Guidance Task Force's discussions with auditors, as well as comments received from the IAASB and CAG in past discussions. At its June 2009 meeting, the IAASB agreed that these were likely the most pressing issues on which additional guidance may need to be developed.
10. The following matters are highlighted in the Consultation Paper, with specific questions as to whether the guidance contained in the APB's PN is adequate and useful in an international context, or whether additional guidance is needed:
  - The definition of complex financial instruments and the applicability of the PN to audits of entities of all sizes; **(See paragraphs 19-22 and Questions 5-7 of Agenda Item 4-A of the September 2009 IAASB meeting)**
  - Application of the audit risk standards; **(See paragraphs 23-28 and Questions 8-11 of Agenda Item 4-A of the September 2009 IAASB meeting)**
  - Sufficient appropriate audit evidence, including relevance and reliability of fair value information; **(See paragraphs 29-39 and Questions 12-16 of Agenda Item 4-A of the September 2009 IAASB meeting)**
  - Disclosure and reporting considerations; and **(See paragraphs 40-48 and Questions 17-21 of Agenda Item 4-A of the September 2009 IAASB meeting)**

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<sup>5</sup> International Standard on Auditing (ISA) 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

<sup>6</sup> IAASB Staff Audit Practice Alert, "Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment."

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- Other matters. *(See paragraph 49 and Questions 22-24 of Agenda Item 4-A of the September 2009 IAASB meeting)*

11. Responses are also solicited as to whether there are areas not covered by the PN that may warrant further guidance in the revised IAPS, and whether there are currently any national standards or guidance that should be considered by the IAASB in the revision project.

#### Matters for CAG Consideration

3. Does the CAG agree that the issues identified in paragraph 10 are likely to be the most important in the context of auditing complex financial instruments?
4. Are there other matters that should be highlighted in the Consultation Paper?

#### *Issuance of the Consultation Paper*

12. As noted at the June 2009 meeting, the IAASB will need to consider how best to issue the Consultation Paper (i.e., as a Staff document, Task Force document, or IAASB document). IAASB practice in this area has been varied. For example, the Consultation Paper on the *Strategy and Work Program, 2009-2011* was issued by the IAASB, while the September 2008 Consultation Paper, “Matters to Consider in a Revision of International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Financial Statements*,” was a joint paper prepared by three national standard-setters and labeled as such.
13. The Task Force believes that it would be preferable for the paper to be issued as an IAASB paper. This is not only due to the fact that the IAASB will have the opportunity during its September 2009 meeting to review and comment on the paper, but also because the paper itself focuses on the IAASB’s planned approach to the project.<sup>7</sup>
14. Recognizing the brief development cycle, however, the Task Force is of the view that it is appropriate to highlight the following within the Consultation Paper:
  - The paper, including its Appendix, is not meant to be authoritative.
  - The matters raised in the paper are not intended to prejudice the approach the IAASB may take in developing guidance relating to auditing complex financial instruments, the objectives it should achieve, or what the final outcome might be.
  - The IAASB has not yet discussed the proposed wording of the APB’s PN in detail, and such wording will be subject to full deliberation in accordance with the IAASB’s stated due process.
  - The revision of IAPS 1012 will also include the issuance of an exposure draft for public comment before the guidance is finalized.

<sup>7</sup> Further, positioning it as an IAASB Consultation Paper would make clear it is a Board document and therefore subject to the provisions in the IAASB’s due process that comments received through the issue of a consultation paper are considered in the same manner as comments received on an exposure draft.

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15. The Task Force also considered whether the Consultation Paper should have a definitive comment period or whether the paper should allow for responses to be sent to the IAASB at any time. The Task Force concluded that a defined comment period would be preferable so that responses could be summarized and presented to the IAASB at its March 2010 meeting. They agreed that a 90-day comment period, ending no later than January 15, 2010, would be most appropriate, as it will allow for the Consultation Paper to be translated where necessary.
16. The Task Force also suggested that a separate dialogue with representatives from the audit firms could be held after the conclusion of the 2010 audit season to ensure that there are no other issues to consider in revising the IAPS that had not been raised via the consultation process.

#### Matters for CAG Consideration

5. Does the CAG agree with presenting the Consultation Paper as an IAASB paper?
6. Does the CAG agree with the proposed comment period for the Consultation Paper?

#### Report Back on the March 9-10, 2009 CAG Proposals

17. Below is an extract from the draft minutes of the March 2009 CAG meeting,<sup>8</sup> and an indication of how the IAASB Task Force or the IAASB responded to the Representatives' comments.

Representatives' Comments	Task Force/IAASB Response
<ul style="list-style-type: none"><li>Mr. Damant expressed support for the recommendation to revise IAPS 1012, but was of the view that the project should be expanded to address the broader topic of auditing complex financial instruments.</li></ul>	<p>Point accepted.</p> <p>In approving the project proposal, the IAASB agreed to expand the scope of the revision project to complex financial instruments.</p> <p><b>See paragraph 4 of Agenda Item 9 of the June 2009 IAASB Meeting.</b></p>
<ul style="list-style-type: none"><li>Mr. Gutterman reported that the CAG Working Group on this topic is in general agreement with the recommendations. He also suggested work on audits of models as an area requiring further attention.</li></ul>	<p>Point accepted.</p> <p>The APB's Practice Note includes a separate section noting matters for the auditor's consideration about models and the Consultation Paper specifically references to these paragraphs to solicit views on the usefulness of the material, including whether further guidance is necessary.</p> <p><b>See paragraph 36 and Question 15 of Agenda Item</b></p>

<sup>8</sup> The minutes will be approved at the September 2009 IAASB CAG meeting.

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Representatives' Comments	Task Force/IAASB Response
	<b>4-A of the September 2009 IAASB Meeting.</b>
<ul style="list-style-type: none"> <li>Mr. Waldron supported the view expressed in the agenda material that while the development of a plain man's guide and liaison with pricing services would be beneficial initiatives, concentrating on revising IAPS 1012 to help to add clarity to the audits of fair values generally seemed to have the most merit. Ms. Blomme also supported the prioritization of the revision of IAPS 1012. She noted that the IAPS has relevant guidance on auditing disclosures which could be updated to deal with IFRS 7.<sup>9</sup> In her view, the adequacy of disclosures is the most pressing issue in the European context. Mr. Krantz supported the project as a means to respond to calls from auditors encountering difficulty with valuations.</li> </ul>	<p>Point accepted.</p> <p>The Consultation Paper includes as a specific matter for respondents' consideration a section on "Disclosure and Reporting Considerations." It incorporates material from ISA 540 (Revised and Redrafted) about disclosures that may be permitted or prescribed by the applicable financial reporting framework. It also makes reference to the qualitative nature of disclosures under IFRS, with reference to the corresponding paragraphs in the Practice Note.</p> <p><b>See paragraphs 40-47 and Questions 17-18 of Agenda Item 4-A of the September 2009 IAASB Meeting.</b></p>
<ul style="list-style-type: none"> <li>Mr. Pickeur expressed his concern that the IAASB would not pursue further liaison with pricing services. He noted this is an area in which that the Basel Committee on Banking Supervision has some questions, in particular surrounding their controls and the use of pricing services by both preparers and auditors. He also suggested that IAPS 1006<sup>10</sup> was in need of revision and was currently not fit for purpose.</li> </ul>	<p>Point taken into account.</p> <p>While the IAASB will not formally pursue further liaison with pricing services, the Consultation Paper explicitly describes the use of pricing services and broker quotes for valuation and the auditor's consideration thereof. It also solicits views on whether more guidance on the types of pricing services that may be used and how this information is typically gathered is necessary; should respondents indicate that more guidance is required, the Task Force will engage pricing services in its development.</p> <p><b>See paragraphs 36-39 and Question 14 of Agenda Item 4-A of the September 2009 IAASB Meeting.</b></p> <p>The matter of the revision of IAPS 1006 will be part of the IAASB's broader consideration as to the status and authority of the IAPSs, which will be discussed at</p>

<sup>9</sup> IFRS 7, "Financial Instruments: Disclosures."

<sup>10</sup> IAPS 1006, "Audits of the Financial Statements of Banks."



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	its December 2009 meeting.
<ul style="list-style-type: none"> <li>Ms. Sucher, supported by Mr. Krantz, suggested that further guidance on what constitutes a market may be useful, as would guidance about different segments of markets and the auditor's response in relation to different kinds of financial instruments.</li> </ul>	<p>Point not yet fully considered.</p> <p>While the Practice Note does give examples of types of complex financial instruments, it does not differentiate the auditor's responses based on the type of instrument. Because the definition of what constitutes a market may be determined by the applicable financial reporting framework and the IAASB's standards are meant to be framework-neutral, it may not be possible to develop further guidance from an auditing standpoint.</p> <p>The Task Force will consider this further when it moves into the revision of the IAPS.</p>
<ul style="list-style-type: none"> <li>Ms. Sucher supported the development of guidance on confirmations for investment funds, as there are risks around the perception that third-party evidence is the highest form of evidence when it may not be in particular circumstances. Ms. Blomme noted that guidance on private equity investment funds may be less relevant from a European perspective.</li> </ul>	<p>Point accepted.</p> <p>At its June 2009 meeting, the IAASB agreed to commission the development of a Staff Audit Practice Alert on external confirmations to be issued in the fall. It is anticipated that the alert will incorporate guidance that has been issued by the US American Institute of Certified Public Accountants on the use of confirmations to support valuation of investment funds.</p> <p><b><i>See paragraph 10 of Agenda Item 10-A of the June 2009 IAASB Meeting.</i></b></p>
<ul style="list-style-type: none"> <li>Mr. Uchino cited concerns for governments to value "bad banks" and the need for transparency in the public sector.</li> </ul>	<p>Point taken into account.</p> <p>During the meeting, Mr. Schilder acknowledged a similar point was raised at the IFAC Chief Executives meeting from a public sector perspective, which may indicate that the International Public Accounting Sector Board is in a better position to address the topic than the IAASB.</p>

#### Action Requested

18. The IAASB CAG is asked to review and comment on the key issues highlighted in this paper, as well as on any other matters related to the project proposal or draft Consultation Paper.

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#### **Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY**

Agenda Item 9 of the June 2009 IAASB Meeting – Project Proposal – Complex Financial Instruments

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4807>

Agenda Item 4 of the September 2009 IAASB Meeting – Auditing Complex Financial Instruments – Cover Sheet

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4972>

Agenda Item 4-A of the September 2009 IAASB Meeting – Auditing Complex Financial Instruments – Draft IAASB Consultation Paper dated September 2009

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4973>

Agenda Item 10-A of the June 2009 IAASB Meeting – External Confirmations Staff Audit Practice Alert

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4796>