



International Federation of Accountants

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Committee: IAASB Consultative Advisory Group

Meeting Location: Barcelona

Meeting Date: March 1-2, 2010

Auditing Complex Financial Instruments—Report Back, Summary of Significant Comments on Consultation 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 Representatives on the project proposal for the project to develop guidance on auditing complex financial instruments, discussed at the September 9-11, 2009 CAG meeting; and
 - (b) To discuss responses received on the Consultation Paper (CP) and obtain the Representatives' views on a number of key issues relating to this project.
2. The discussion on this topic will follow the structure this CAG Paper. For reference only, the full set of meeting papers for the March 2010 IAASB meeting are included as CAG Reference Papers.

Background

3. In June 2009, the IAASB agreed to develop guidance relating to auditing complex financial instruments by revising IAPS 1012.¹ In doing so, the IAASB agreed to leverage the UK Auditing Practices Board's (APB) Practice Note 23 (Revised)² as a starting point for doing so, subject to public consultation on the applicability of such work in an international context. The CAG had the opportunity to consider the project proposal and a draft of the CP at its September 2009 meeting.
4. In September 2009, the IAASB approved a CP. At the December 2009 IAASB meeting, the IAASB considered significant issues identified by the project Task Force in advance of responses on the CP, relating primarily to management's use of experts and auditing disclosures.
5. The IAASB will consider a summary of significant comments on consultation and recommendations of the Task Force at its March 2010 meeting, similar to what is presented

¹ International Auditing Practice Statement (IAPS) 1012, "Auditing Complex Financial Instruments."

² Practice Note (PN) 23 (Revised), "Auditing Complex Financial Instruments."

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in this CAG paper, as well as a first read of proposed revised IAPS 1012. The IAASB will be asked to approve proposed revised IAPS 1012 as an exposure draft in June 2010.

September 9-11, 2009 CAG Discussion

6. Below are extracts from the draft minutes of the September 2009 CAG meeting,³ and an indication of how the project Task Force or IAASB has responded to the Representatives' comments.

Representatives' Comments	Task Force/IAASB Response
Mr. Gutterman shared the views of the CAG Working Group, who supported the IAASB's efforts to advance the project. He cautioned that using the term "consultation paper" may lead to misinterpretation. He therefore urged the Task Force to consider the objective of the paper and how it would be positioned. Mr. Morris remarked that while Mr. Fogarty's explanation about the intent of the paper was clear, the manner in which the intent is described in consultation paper is not. Mr. Damant supported this view.	Point noted. The IAASB made minor changes to clarify the intent of the CP after discussion at its September 2009. Responses to the CP indicated support for leveraging the work of a national standard setter as a means of advancing the project.
Ms. Sucher noted it was useful that the paper explicitly asked respondents whether other guidance exists that should be considered by the IAASB in revising IAPS 1012.	Point noted. Respondents to the CP highlighted publications from the International Accounting Standards Board (IASB), U.S. Financial Accounting Standards Board (FASB), U.S. Public Company Accounting Oversight Board (PCAOB), Basel Committee on Banking Supervision (BCBS), UK Financial Services Authority (FSA), Committee of European Banking Supervisors (CEBS), and Institute of International Finance (IIF). The Task Force has incorporated relevant guidance from these sources as appropriate.
Ms. Blomme noted FEE's working party on banking issues was supportive of the issues highlighted by the Task Force and the project as a whole. She advised the IAASB to keep the definition of complex financial instruments principles-based in light of the evolving	Point accepted. See further discussion in Section B.1 below.

³ The minutes will be approved at the March 2010 IAASB CAG meeting.

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Representatives' Comments	Task Force/IAASB Response
nature of these instruments.	
Mr. Roussey was also of the view that the availability of evidence supporting valuation of complex financial instruments may lead to questions as to the level of assurance that can be provided on these instruments. He believed that this is both an accounting and an auditing issue that may have implications for the auditor's report and the IAASB's broader work on assurance engagements.	Point accepted. The Task Force agrees that the auditor's ability to obtain sufficient appropriate audit evidence is based on the evidence management has to support its valuations. See further discussion in Section C.1 below.
Ms. Sucher expressed her concern that more robust guidance is needed relating to the audit of financial instrument disclosures. In her view, it is likely this need will increase with the revision of International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement." She supported the consultation paper's inquiries about disclosures, but cautioned that there is an expectations gap between users and auditors about the extent of audit work performed on disclosures. Mr. Damant noted that the issue of disclosures becomes heightened in the case of non-linear derivatives that have future cash flow effects, when fair value does not give the whole picture of the risk involved with the instruments.	Point accepted. During the meeting, Mr. Fogarty agreed that disclosures are an important issue for the revision of IAPS 1012. The challenge, will be developing guidance that is framework-neutral. The IAASB agreed at its December 2009 meeting that further guidance should be developed on disclosures. The Task Force considered the responses received on consultation and has incorporated additional guidance in revised IAPS 1012. See further discussion in Section D below.
Mr. Krantz commended the IAASB on working to move this project forward quickly. He suggested there may be opportunities for auditors to leverage work of clearinghouses that have begun clearing both sides of a complex financial instrument transaction in looking for evidence of valuation.	Point accepted. The use of clearinghouses has been highlighted in revised IAPS 1012.
Mr. Krantz inquired as to the IAASB's views as to its ability to meet the expectations set forth by the Financial Stability Board (FSB).	Prof. Schilder explained that IAASB staff is in the process of drafting a letter to the FSB that will highlight the IAASB's efforts through this and other projects in responding to the FSB's calls for more guidance. Mr. Damant suggested that this letter could be circulated to the CAG

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Representatives' Comments	Task Force/IAASB Response
	when finalized. [Note: This correspondence was circulated to the Representatives via email on October 21, 2009.]

Matters for CAG Consideration

7. The comment period for the CP closed on January 15, 2010. Thirty-three responses were received, as follows: member bodies (12), other professional organizations (3), national auditing standard standards (3), public sector organizations (1), regulators and oversight authorities (5), firms (8), and individuals and others (1). Overall, respondents were broadly supportive of the IAASB's plans to develop guidance relating to auditing complex financial instruments by revising IAPS 1012, and supported the material that had been included in the APB's PN.

A. Use and Status of IAPSs

8. A number of respondents were of the view that the status and authority of IAPSs should be reassessed before finalizing revised IAPS 1012. Some suggested that their views on the form and content of a revised IAPS 1012 would likely differ if the status and authority were elevated. One respondent noted that it would not support any significant reduction in the guidance as a result of a change in status or authority; in their view the level of guidance provided will help practitioners in performing audits and promote greater understanding and consistency in the performance of audits in this complex area.

9. While the CP did not explicitly acknowledge the project to consider the status and authority of IAPSs, the Task Force has considered the IAASB's discussions at its December 2009 meeting to retain the current status and authority of the IAPSs included in the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" (the Preface). An oral report on **Agenda Item E** about the IAASB's plans for further discussion on the status and authority of the IAPSs will be provided during the meeting in the session immediately prior to this session.

10. The Task Force has included language in the IAPS to more clearly articulate how the IAPSs are to be viewed in the context of the ISAs, in particular that (a) auditors are required to comply with all ISAs relevant to the audit; (b) reading the IAPS is not a substitute for reading the ISAs themselves; and (c) the IAPS does not refer to all requirements in the ISAs that may be relevant in the audit of financial instruments.

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B. Nature of Financial Instruments and Applicability of the IAPS to Audits of Entities of All Sizes

B.1 Types of Financial Instruments Addressed in the IAPS

11. Though there was broad support for using the PN as the basis for revising IAPS 1012, some respondents were of the view that more was needed in order to make the IAPS relevant. Comments from respondents reflect the challenge between providing guidance that highlights key issues relevant to auditors working with financial instruments of varying complexities, as compared to having a detailed “master class” for those who are actively engaged in the audit of such instruments or having the IAPS be more comprehensive for audits of larger financial institutions.
12. Respondents to the CP had mixed views as to whether the term “complex financial instruments” was sufficiently clear. Those who supported how complex financial instruments were described agreed that the PN clearly defined what is meant by the term and provides illustrative examples that will aid users in better understanding the nature of these instruments, and acknowledged that going further to define them would be difficult given the constantly evolving nature of these instruments.
13. A number of respondents were of the view that including examples of more and less complex instruments was helpful to illustrate the applicability of the IAPS in a wide variety of circumstances. Respondents noted that it is difficult to get a common understanding of where the threshold between complex and non-complex financial instrument lies, and suggested the complexity of a financial instrument might also be regarded with respect to (a) the sector in which a company operates, and (b) the measurement basis. Some respondents suggested it was less important to explain how the guidance can be applied to a range of entities and more important to explain how the guidance can be applied to more and less complex financial instruments; in their view, the level of complexity and the resulting risks of material misstatements are the drivers of the audit approach. It was also suggested that the IAPS could articulate that seemingly simple financial instruments can become complex when markets become inactive.
14. A number of respondents supported expanding the guidance to all financial instruments, with a few of these respondents suggesting that the proposed pronouncement cover all but the simplest financial instruments, by perhaps specifically scoping out items such as cash, trade accounts receivable, trade accounts payable, and perhaps other financial instruments that may be carried at amortized cost. These respondents believed that much of the guidance is not exclusive to complex financial instruments, and that it should seek to compare complex financial instruments to financial instruments as a whole, including derivatives. One respondent promoted the benefit of having a single, comprehensive source of audit literature for all financial instruments including both assets and liabilities and both derivative and non-derivative instruments.
15. Those who did not support expanding the IAPS to all financial instruments noted the

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16. A few respondents suggested that not referring to “complex” in the title of the IAPS and retaining the paragraphs dealing with the levels of complexity and the applicability of the guidance in a number of circumstances may assist in promoting the use of the IAPS to the broadest extent.

Task Force Recommendations

17. Taking account of all the comments received, the Task Force determined that the IAASB’s work to develop the IAPS would have the most benefit if the IAPS was seen to be applicable to the broadest base. While the Task Force agrees there is a need for detailed guidance on auditing complex financial instruments, it also believes that auditors dealing with all types of financial instruments could benefit from this additional guidance. Entities and auditors may not realize the complexities involved with certain instruments, for example contracts that have embedded derivatives, or the conditions in which the instruments are held (for example, when markets become inactive). Focusing the guidance on the auditor’s risk assessment and highlighting factors that may drive the complexity of financial instruments allows the IAPS to be scalable to audits of all financial instruments.
18. The Task Force recognizes, however that, by expanding the guidance to all financial instruments, the guidance may not meet the needs of those who would like for the IAPS to be a comprehensive audit guide for auditors of financial institutions dealing with very complex financial instruments. The Task Force believes that auditors dealing with large financial institutions or entities that engage in a high volume of financial instrument transactions are likely not those who most need the additional guidance that could be placed in an IAPS. Accordingly, it believes that the IAASB’s efforts should be focused on developing guidance to improve practice in this area by those who may not be as familiar with the issues surrounding valuation, including suggesting that both management and auditors may need to supplement their expertise in this area.
19. The Task Force proposes the following:
 - Scoping out the simplest financial instruments, and explaining that the IAPS applies to financial instruments measured at fair value (noting that certain instruments carried at amortized cost may be required to be disclosed at fair value and are therefore covered by the IAPS in that regard).
 - Explaining factors that may influence the complexity of particular financial instruments, and the affect this complexity has on the auditor’s risk assessment and audit procedures.

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- Including additional examples of financial instruments, including reference to structured products and embedded derivatives.
- Incorporating material from extant IAPS to define certain financial instruments and highlight key terms used in practice in an Appendix.
- Specifically acknowledging that the IAPS is designed to be applicable to both financial and non-financial institutions, and can be applied by auditors of entities of all sizes with financial instruments of varying complexities, including audits of small- and medium-sized entities.

B.2 Applicability to Audits of Entities of All Sizes

20. While most respondents believed the guidance explaining the applicability of the PN to audits of entities of all sizes was helpful, a number of respondents were of the view that more could be done to make the applicability to SMEs more clear, such as:
- Including considerations specific to smaller entities, or to entities with a small portfolio of complex financial instruments.
 - Including guidance as to the types of internal controls typically in place in a large entity with high levels of trading as compared those in place in a small entity with relatively few transactions, and highlighting the need to balance the work performed over internal controls and the extent of substantive procedures; however, the IAPS should not assume such controls are effective in larger entities.

Task Force Recommendations

21. The Task Force believes that changes to the IAPS described in Section B.1 of this Paper will further highlight the applicability of the guidance to auditors dealing with SMEs. In addition, the IAPS now highlights that the relevance of each area of guidance may differ considerably between different entities and is dependent on the complexity of the financial instruments being audited.
22. The Task Force did not consider it appropriate to highlight considerations specific to smaller entities because of its decision to focus the IAPS on the complexity of the instruments as the driver of the auditor's risk assessment and audit procedures. As noted by one respondent, it would be inappropriate for the guidance to be interpreted to suggest that the audit effort would be proportionate with the sophistication and complexity of the entity. In their view, it is not the size of the entity that influences the type of audit procedures that are appropriate. Rather, it is the nature and characteristics of the financial instruments that the entity holds, and the related controls in place, that are relevant. The Task Force has, however, sought to explain in the IAPS that certain controls may not be in place for smaller entities and has made changes to the PN to avoid implying that controls will always be effective (or will form the majority of the auditor's procedures) in larger entities.

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23. One challenge for auditors of smaller entities is that they may not have the same knowledge and experience with auditing financial instruments as auditors of entities in industries in which these sorts of instruments and related risks are core to their audits. At the same time, management of smaller entities may have less experience in managing investments in financial instruments and controlling the related risks. Accordingly, the Task Force has made changes within the IAPS to highlight the need for both management and the auditor to ensure that they have the appropriate expertise to understand the financial instruments in which the entity and invests.

Matters for CAG Consideration

1. Do Representatives agree with the Task Force's proposal to expand the scope of the IAPS to auditing all financial instruments, scoping out the simplest instruments?
2. Do Representatives support the Task Force's view that it is important to highlight the relationship between the complexity of financial instruments and the extent of an entity's use of them and risks of material misstatements? Does doing so make it clearer that the IAPS is applicable to auditors dealing with SMEs and allow for wider use of the IAPS?

C. Valuation of Financial Instruments

C.1 Use of a Management's Expert, Including Broker Quotes and Pricing Services

24. The knowledge and experience of management and those charged with governance is an important element of the control environment, as is management's philosophy and operating style. The use of financial instruments without relevant expertise within the entity may result in the entity assuming significant risk, often unintentionally. When management does not have this expertise, it often engages third-party experts, such as brokers and pricing services, to provide assistance with valuation of its financial instruments.
25. The majority of respondents agreed that further guidance should be included to describe broker quotes and pricing services, in particular:
- More comprehensive guidance on the use of independent pricing services and valuation models, including guidance indicating how those charged with governance or management may involve the use of independent experts in providing pricing services and designing valuation models and the types of audit procedures that may be appropriate.
 - Linking to the requirements in ISA 500⁴ for the auditor to evaluate the competence, capabilities and objectivity of management's expert and the appropriateness of the expert's work as audit evidence.

⁴ ISA 500, "Audit Evidence."

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- Acknowledgement that access to management's expert's methodologies is often challenging, especially in emerging markets, and highlighting that management retains the responsibility for the assumptions and methodologies used in the valuation.
26. Two of these respondents suggested that this material could be included as an Appendix to the document, incorporating the Glossary of Terms from extant IAPS 1012.
 27. Those that did not support including additional material about brokers and pricing services noted that circumstances may be largely jurisdictionally driven and suggested such guidance would be better developed by national standard setters, and also noted such material would likely be duplicative of that produced by the IASB's Expert Advisory Panel (EAP).⁵

Responsibility for Management to Understand the Methods and Assumptions Used by Management's Experts

28. There are differing views among auditors and others as to whether the auditor's degree of understanding of the entity and its complex financial instruments changes depending on whether the process is done within the entity or whether one or more third-party experts are used. For example, if the management's expert is a well-known, competent and objective expert, some argue that the auditor can rely on the expert's competency and experience and may not need as thorough of an understanding of the valuation processes, assumptions and methods for a particular instrument. They likewise argue that in such cases the auditor does not need to test the assumptions and methods as thoroughly. However, others contend that reliance on the expert's competency and expertise is not sufficient to discharge the auditor's responsibility to obtain an understanding of the expert's assumptions and methods and also to evaluate the reasonableness and appropriateness of them.

Task Force Recommendations

29. The Task Force believes that the use of experts by management is one of the most significant issues in practice and, accordingly, has highlighted the matter as a key consideration in the IAPS. The Task Force has substantially revised the PN to incorporate additional guidance and highlight issues surrounding the use of management's experts. First, it is important that experts are engaged when management does not possess the expertise needed in dealing with financial instruments. However, doing so does not relieve management for its responsibilities for the preparation of the financial statements.
30. The IAPS now specifically notes that an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged their responsibilities for the preparation of the financial statements, including

⁵ EAP Report issued October 2008, "Measuring and disclosing the fair value of financial instruments in markets that are no longer active."

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where relevant their fair presentation.⁶ The PN has been restructured to describe “Management’s Method for Valuing Its Financial Instruments,” which now explains that management is responsible for obtaining evidence to support its valuations, and that using inputs from brokers and pricing services is one aspect of doing so.

31. Following this, the IAPS further highlights the importance of management understanding the assumptions and methods on which brokers and pricing services have compiled their quotes in order to assist management in evaluating the relevance and reliability of this evidence to support management’s valuations. This is consistent with language used in ISA 540⁷ that clearly states: “Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management’s assumptions.” Management also has a responsibility⁸ to provide written representation whether they believe significant assumptions used in making accounting estimates are reasonable. The Task Force believes it will be very difficult for management to meet their responsibilities if they are unable to “get behind” the assumptions and methods used by brokers and pricing services to arrive at prices and valuations.
32. The auditor’s ability to comply with the requirements in ISA 540 to understand how management makes its accounting estimates, and test those estimates, is highly dependent on the evidence management has obtained to support its valuations. The use of an expert by management has implications for the auditor, which have been addressed by the IAPS, for example, on:
 - The auditor’s risk assessment and planned procedures, including the possible identification of significant risks and the procedures required by the ISAs when significant risks are identified;
 - The need for the auditor to use an auditor’s expert when management has used a management’s expert;
 - The potential inability for the auditor to obtain sufficient appropriate audit evidence when management is unable to obtain an understanding of management’s expert’s method and assumptions.
33. The Task Force acknowledges that there have been difficulties in this area in practice, insofar as brokers and pricing services have been unwilling to provide this information to management and auditors often attempt to obtain it directly from brokers and pricing

⁶ ISA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,” paragraphs 4 and A2.

⁷ ISA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures,” paragraph A31.

⁸ ISA 540, paragraph 22.

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services. However, the Task Force believes it is necessary that the IAPS highlight the auditor's requirements under the ISAs and the potential effects of the scope limitation when management does not have the evidence necessary to support its valuation.

C.2 Use of Models

34. Many respondents agreed that the guidance on the use of models was sufficient. Those that did not believe the guidance was sufficient believed more guidance could be incorporated about: features of widely-used common models, how they operate, and the risks associated with them; financial instruments valued using customized approaches such as discounted cash flow analysis and option pricing models; the need for the auditor to exercise professional judgment when evaluating valuations performed through the use of models, including challenging management's approach and the reasonableness of management's assumptions; and auditors consider the validity of inputs to models, including internal controls over inputs and whether inputs and assumptions used in models are internally consistent and reflect management's intent and ability to undertake a particular course of action; and the auditor's evaluation of an entity's existing valuation reserve methodologies (e.g., model risk reserves) to incorporate risks and valuation methodology

Task Force Recommendations

35. The Task Force has considered the requests for more detailed guidance on the use of models. In general, additional guidance has been included about actions of the auditor in evaluating models and the professional judgment involved in doing so, including considering the validity of the model and the inputs, including management's intent and ability to undertake a particular action. Further guidance has also been included to explain why valuation adjustments to model outputs may occur, based on guidance in the IASB's EAP report.
36. The Task Force does not believe it is practicable to attempt to develop guidance explaining commonly used models, given the rapidly changing environment and the judgment involved by management in selecting a model, or specified procedures that auditors would undertake for specific models.

C.3 Linkage to the Fair Value Hierarchy Explained in Accounting Standards, Including Reference to Inactive Markets

37. A few respondents were of the view that more should be explained in the IAPS about the levels of the fair value hierarchy and the difficulty that unobservable inputs pose, in particular when markets are inactive. Some suggested that the IASB's EAP document provided useful guidance that could be incorporated into the IAPS.
38. The Task Force was of the view that accounting for fair value measurement under U.S. GAAP and IFRS is becoming more similar, and these frameworks are that which will be encountered by most auditors dealing with financial instruments. Accordingly, reference has

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been added within the IAPS to the fundamental concepts of the fair value hierarchy, including the use of 3 levels to describe inputs and disclosure requirements related to these levels. The Task Force is of the view that, while this may be seen as less framework-neutral than what is typically done in an IAASB pronouncement, highlighting how the accounting requirements may be viewed in the context of auditing challenges is appropriate.

39. Guidance to explain what is meant by “inactive markets” and how management and auditors may need to respond to inactive markets, including changing approaches to valuations and obtaining multiple sources of evidence to corroborate management’s valuation, have also been incorporated into the IAPS.

Matters for CAG Consideration

3. Do Representatives agree with the Task Force’s assessment of the responsibilities of both management and auditors with regard to understanding how brokers and pricing services arrive at pricing information used as inputs to valuations?
4. Do Representatives agree with the Task Force’s decision to include reference to the fair value hierarchy as explained in IFRS and US GAAP?

D. Presentation and Disclosure

D.1 Sufficiency of Guidance on Disclosures Included in the PN

40. Nearly all respondents believed the guidance included about disclosures was useful. One respondent noted that disclosures are mainly driven by the relevant accounting framework and was of the view that the guidance should be framework neutral. A few respondents did not find it useful as some of the guidance merely seemed to repeat the accounting requirements. A number of respondents suggested improvements that could be made to the guidance, including providing more guidance on auditing qualitative and quantitative disclosures of, for example, operational risk, and emphasizing the need for the auditor to apply professional judgment to determine whether qualitative disclosures comply with the requirements of the applicable financial reporting framework. One respondent highlighted the need for the auditor to keep in mind the information value of the disclosures when auditing them, to ensure they are understandable to readers of the financial statements and are also comprehensive, meaningful, consistent and comparable.
41. A few respondents supported including more guidance on information systems that are not otherwise used to generate financial statements. One respondent, supported by another, suggested that it would be useful to incorporate such guidance into the section of the IAPS dealing with evaluating the control environment and internal control, because auditors should obtain this information during the course of the audit to determine the nature and extent of procedures required on this information. A few respondents believed controls

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⁹ disclosure requirements.

Task Force Recommendations

42. The Appendix to this paper includes the relevant paragraphs in the IAPS dealing with disclosures. The Task Force specifically considered how it could make clear the auditor's responsibilities to ensure the disclosures are fairly presented, including whether they are understandable to readers of the financial statements and are also comprehensive, meaningful, consistent and comparable (see paragraphs 166-169 in the Appendix). The Task Force, however, did not believe it was appropriate to provide examples of auditing procedures that could be undertaken and sources of audit evidence that could be obtained to assess the transparency and reasonableness of disclosures. Rather, it modified the IAPS to explain that evaluating the reasonableness and adequacy of disclosures in the financial statements relating to financial instruments involves essentially the same types of considerations applied when auditing financial instruments recognized in the financial statements. A linkage to the requirements in ISA 540 relating to disclosures of estimation uncertainty has now been made.
43. Material has also been incorporated from recent publications from the Basel Committee on Banking Supervision, Institute of International Finance, and the UK Financial Services Authority, as cited by respondents.
44. At the December 2009 meeting, the IAASB asked the Task Force to consider how the auditor's responsibilities might differ based on the placement of disclosures. For example, IFRS allows for placement of certain disclosures outside of the financial statements. The Task Force did not come to a consensus in this area. Some Task Force members are of the view that any disclosures required by the applicable financial reporting framework are covered by the auditor's opinion regardless of placement, and therefore subject to audit procedures. Other Task Force members believe that disclosures outside of the audited financial statements would not be audited, and would only be considered by the auditor in accordance with ISA 720.¹⁰
45. Given this difference in opinion, the Task Force members were of the view that this circumstance should not be addressed in the IAPS, with the exception that it may be necessary to comment on the need for disclosures to be clearly labeled whether they are audited or unaudited.

⁹ IFRS 7, "Financial Instruments: Disclosures."

¹⁰ ISA 720, "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements."

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Matters for CAG Consideration

5. Do the Representatives agree with the guidance for about the auditor's responsibilities for disclosures, as included in the Appendix?
6. What are the Representatives' views on the auditor's responsibilities with regard to disclosures required by the applicable financial reporting framework that are positioned outside of the financial statements?

Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

Agenda Item 6-B of the March 2010
IAASB Meeting – Auditing Complex
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[Link to follow](#)

Agenda Item 6-C of the March 2010
IAASB Meeting – Auditing Complex
Financial Instruments—Draft of Proposed
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[Link to follow](#)

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Appendix

The following guidance is extracted from Agenda Item 6-C of the March 2010 IAASB Meeting. It highlights the relevant section in the IAPS dealing the auditor's procedures on disclosures. Additional guidance is included in the IAPS about management's responsibilities relating to disclosures.

The Auditor's Responses to Assessed Risks

Substantive Procedures Related to Financial Statement Assertions

Presentation and Disclosure

Responsibilities of the Auditor

Evaluating the entity's presentation of financial statements

164. In assessing whether the classification of financial statement presentation is appropriate, it is important for auditors to consider whether master netting agreements are in effect and relevant assets and liabilities that subjects to such netting contracts are identified comprehensively. In addition, if the total assets or liabilities are used to determine the incentive compensation for managements or corporate tax payments, it is also important for auditors to be alert to the fraud risk that netting is not appropriately made with a fraudulent intent.

Evaluating the reasonableness and adequacy of disclosures

165. Evaluating the reasonableness and adequacy of disclosures in the financial statements relating to financial instruments, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing financial instruments recognized in the financial statements. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance as the range of possible outcomes of the financial instruments increases in relation to materiality.
166. Determining the extent of audit work on disclosures is a matter of professional judgment. The auditor's primary consideration is where the work performed is sufficient to conclude that the financial statements have been prepared in accordance with the applicable financial reporting framework and achieve fair presentation. ISA 700¹¹ requires the auditor, to evaluate, among other things, whether:
- The financial statements adequately disclose the significant accounting policies selected and applied;
 - The information presented in the financial statements is relevant, reliable, comparable and understandable; and

¹¹ ISA 700, "Forming an Opinion and Reporting on Financial Statements."

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- The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.

Consideration of whether qualitative disclosures are presented in a transparent and understandable manner is a key component of this evaluation.

167. For example, in evaluating the information included in disclosures, the auditor may identify areas for improvement and encourage management and those charged with governance to avoid unnecessarily long disclosures that could result in additional complexity rather than clarity. Auditors may also consider whether the disclosures are coherent, for example, all relevant information may be included in the financial statements (or accompanying reports) but it may be insufficiently drawn together to enable users of the financial statements to obtain an understanding of the position.
168. As part of complying with ISA 315, the auditor will have obtained information regarding the entity's risk assessment process and control activities. It is important that narrative disclosures required by the accounting framework are consistent with this information, in particular with regard to:
- The entity's objectives and strategies for using financial instruments;
 - The entity's control framework for managing its risks associated with complex financial instruments; and
 - The risks and uncertainties associated with the financial instruments;
- and are consistent with the amounts included for financial instruments in the financial statements. If disclosures are made in the financial statements with which the auditor is not familiar, supporting evidence for such disclosures will need to be obtained to support the auditor's opinion on the financial statements. Such evidence may include supporting papers and written representations from management.

Estimation uncertainty and significant risks

169. In addition to the auditor's determination of whether disclosures relating to financial instruments are in accordance with the applicable financial reporting framework, ISA 540 also requires the auditor to perform further procedures on disclosures relating to accounting estimates that give rise to significant risks to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.¹²
170. In relation to financial instruments having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude

¹² ISA 540, paragraph 20.

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that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality.

171. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. ISA 705¹³ provides guidance on the 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.

Categories of Disclosures

172. Disclosure requirements can typically be characterized in three main categories:
- (a) Quantitative disclosures that are derived from the amounts included in the financial statements – for example, categories of financial assets and liabilities;
 - (b) Quantitative disclosures that require significant judgment – for example, sensitivity analysis for each type of market risk to which the entity is exposed; and
 - (c) Qualitative disclosures – for example, those describe the entity's objectives, policies and procedures for managing each type of risk arising from financial instruments and the methods used to measure the risks.
173. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:
- A summary of significant accounting policies.
 - The assumptions used.
 - The method of estimation used, including any applicable model.
 - The basis for the selection of the method of estimation.
 - The effect of any changes to the method of estimation from the prior period.
 - The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognized or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether disclosures are in accordance with the requirements of the applicable financial reporting framework.

¹³ ISA 705, "Modifications to the Opinion in the Independent Auditor's Report."

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174. Disclosures that give information about the significance of financial instruments to an entity's financial position and performance and may be required by the applicable financial reporting framework may include:

- Disclosures about the carrying amounts of financial assets and liabilities;
- Disclosures about reclassifications of financial assets;
- Disclosures about the carrying amounts of financial assets that have been pledged as collateral, including the terms and conditions;
- Disclosures about net gains or net losses on particular categories of financial assets and financial liabilities; and
- Disclosures about financial instruments designated as hedging instruments.

In many cases, such disclosures are prepared from the underlying books and records that support the financial statements and can be easily verified. In other cases, such as in evaluating whether management's designation of an instrument as a hedge, audit procedures may be needed to evaluate whether such treatment is appropriate in accordance with the applicable financial reporting framework (see paragraphs 146-147).

175. Entities may also be required under certain financial reporting frameworks to give quantitative disclosures such as:

- Summary data about the exposures at the reporting date; and
- Market risk information such as a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date.

These disclosures are based on the information provided internally to key management personnel of the entity, for example those charged with governance. These types of subjective quantitative disclosure allow users to evaluate the effect of a change in future expectations if the assumptions and probabilities of the occurrence of various scenarios are made clear.

Disclosures Required about the Fair Value Hierarchy

176. As noted in paragraph 108, some financial reporting frameworks may also establish a fair value hierarchy that reflects the significance of the inputs used in making the measurements and may require quantitative disclosures about the level in the fair value hierarchy into which the fair value measurements are categorized in their entirety. They may also required the entity to disclose whether changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly and, if so, how the effect of a change in assumptions was calculated. While these disclosures may be quantitative in nature in that an amount is calculated, the selection of reasonably possible alternative assumptions can often be a subjective process.

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177. For example, the additional disclosures required for financial instruments with fair value measurements that are in level 3 of the hierarchy are aimed at informing users of financial statements about the effects of those fair value measurements that use the most subjective inputs. Because the inputs to these fair value measurements reflect the entity's own assumptions about assumptions that market participants would use, including assumptions about risks, it is critical that disclosures are meaningful and balanced. Guidance included in paragraphs 154-157 relating to evaluating management's use of assumptions is equally applicable when evaluating disclosures of the assumptions and sensitivity analyses.