



**Meeting:** IAASB Consultative Advisory Group

**Meeting Location:** Brussels

**Meeting Date:** March 6–7, 2012

## Agenda Item

# E.1

### IPN 1000 and Status and Authority of IAPs—Report Back

#### Objectives of Agenda Item

1. To provide a report back on proposals of the Representatives on these projects as discussed at the September 2011 CAG Meeting.

#### Papers to Be Referred to during Discussion

2. The discussion on this topic will follow the structure of this CAG Paper.

#### Project Status and Timeline

3. At the September 2011 CAG meeting, the CAG provided input on a draft International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*, proposed amendments to ISA 500<sup>1</sup> and ISA 540,<sup>2</sup> and a proposed amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*.
4. The IAASB approved the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* at its September 2011 meeting which created a new category of non-authoritative pronouncements, IAPNs. IAPN 1000 was approved at the same meeting to be the first of this new category.
5. In approving the IAPN, the IAASB noted the concerns of the CAG about the proposed amendments to ISA 500 and ISA 540 relating to third-party pricing sources. The IAASB agreed with the advice of the CAG to further consider the issues and, accordingly, deferred approval of the proposed ISA amendments. The IAASB noted that when further considering the nature of any changes to the ISAs in relation to the issue of third-party pricing sources, there may be merit in also reviewing the application material of the ISAs in light of the useful material contained in IAPN 1000, with a view to potentially further enhancing the ISAs.
6. The IAASB's *Strategy and Work Program, 2012-2014* indicate that the IAASB intends to pursue projects regarding further issues related to fair value accounting estimates and related considerations, third-party pricing sources, issues including impairment and loan loss provisioning, and using the work of experts such as actuaries (See Agenda Item D.1, paragraphs 29–32)

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<sup>1</sup> ISA 500, *Audit Evidence*

<sup>2</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure*

7. The IAASB also decided to withdraw the existing category of pronouncements known as IAPSSs and the six existing IAPSSs. This decision also reflected the IAASB's view that retaining the extant IAPSSs in any form is potentially misleading and unhelpful given they are out-of-date and inconsistent with the clarified ISAs. The IAASB viewed the risks of potential confusion as outweighing any potential limited benefits.
8. The papers presented to the CAG at its September 2011 meeting also referenced the proposal by the Task Force to re-expose the proposal to remove IAPS. The IAASB considered varying viewpoints on this but, on balance, concluded that further consultation on the decision to remove IAPSSs would be more confusing than helpful. The IAASB's decision will eliminate any ambiguity about what constitutes authoritative guidance, which was the fundamental goal of this initiative. Any alternative approach proposed in a re-exposure draft would essentially be dealing with the same issues already addressed by ED-Authority, and the re-exposure would delay the issuance of the important material in IAPN 1000.

### September 12–13, 2011 CAG Discussion

9. Below are extracts from the draft minutes of the September 2011 CAG meeting,<sup>3</sup> and an indication of how the project Task Force or IAASB has responded to the Representatives' comments.

Representatives' Comments	Task Force/IAASB Response
<b>IAPS Status and Authority</b>	
Mr. Gutterman explained that the CAG Working Group expressed general unease with the proposal for the guidance to be non-authoritative, but that no better solution than that proposed by the Working Group was identified.	The IAASB considered the alternative of making the IAPSSs authoritative. On balance, the IAASB determined that having authoritative material outside the ISAs would continue the uncertainty about the status of the material, would spread authoritative material across two different types of documents, and that much of the material in IAPS 1000 would not be appropriate for inclusion in application material. The IAASB remains open as to whether authoritative guidance might be needed at some stage in the future although, currently, it anticipates that such material is best included in the ISAs
Ms. Sucher noted that she understood the difficulties encountered by the IAASB, and understood the logic of keeping all application material in the ISAs. She was unsure about the IAASB's willingness to make changes to standards if inconsistent practice eventuated. She noted	Prof. Schilder noted that some found the current authority of IAPSSs confusing, and that they posed no obligations beyond those in the ISAs. He explained that the IAASB was now more open about amending the ISAs. Mr. Fogarty added that

<sup>3</sup> The minutes will be approved at the March 2012 IAASB CAG meeting.

Representatives' Comments	Task Force/IAASB Response
<p>that the proposals would result in the ISAs getting longer, but that this would not be of great concern.</p> <p>She also asked how the IAASB proposed to approach the audit of insurance contracts and any revision of IAPS 1004 and IAPS 1006.</p>	<p>IAPSs were not always adopted by jurisdictions adopting the ISAs so the IAASB must include all application material inside the ISAs. He explained that the IAASB accepted that making additions to ISAs was a necessary consequence of keeping all authoritative material in the ISAs. Paragraph 5 above e</p> <p>Prof. Schilder responded that the IAASB had had some initial discussions with the Basel Committee on Banking Supervision, but that it was too early to decide what would be done in that space.</p>
<p>Mr. Morris asked if the IAASB would be asked to approve IAPN 1000 if it voted to withdraw IAPSs and re-expose this decision.</p>	<p>Mr. Fogarty explained that re-exposure of IAPNs does not affect the approval of IAPN 1000. Ms. de Beer noted that the CAG has commented on a number of occasions that the material in IAPN 1000 is urgently needed.</p>
<p>Ms. Blomme supported the need to issue IAPN 1000, and noted the difficulty in having educational material and authoritative material in a single document. She asked about the due process for IAPNs, and what would happen to the extant IAPSs.</p> <p>Ms. Blomme noted in her view that the change from IAPSs to IAPNs, making them non-authoritative, would need to be re-exposed as this was not proposed in the Exposure Draft.</p>	<p>Support noted.</p> <p>Prof. Schilder noted that the IAASB has not decided on any future IAPNs, and will determine the development process for IAPNs when the IAASB approves the respective project proposals. He also noted that consultation on the content of any new IAPN would probably be needed but that the IAASB also needs the ability to respond on a timely basis. In relation to the extant IAPSs, Prof. Schilder noted that they are outdated and would be withdrawn, as consulted on during exposure.</p> <p>The IAASB decided not to re-expose the Preface (see paragraph 8 above).</p>
<p>Mr. Bradbury explained that he found the proposal to re-expose the removal of the IAPS vehicle, but not exposure of the creation of IAPNs, difficult to understand. He asked how the IAASB would respond if there was an overwhelming response to retain IAPSs.</p>	<p>Mr. Gunn responded by noting the urgent need to get IAPN 1000 out for this reporting season. In relation to the removal of IAPSs, he noted that it is not clear what the IAASB could do if there was overwhelming support for retaining the IAPSs. However, this was the main issue raised in the exposure draft and respondents flagged concerns with the existing status. The IAASB does not have</p>

Representatives' Comments	Task Force/IAASB Response
	<p>a different solution to describe material outside of the ISAs.</p> <p>See paragraph 8 above for an explanation of the IAASB's debate about re-exposure.</p>
<p>Mr. Roussey noted that he found paragraphs 20 and 21 of the draft Preface confusing as it did not appear that the IAASB's purpose in issuing IAPNs included assistance in interpreting ISAs. He also questioned the reference to "practice statements" in paragraph 20, and asked whether the reference to tailoring IAPNs to address particular national standards implied that ISAs could be modified. Mr. Roussey proposed that the first line of paragraph 20 should state that "IAPNs provide practical assistance in the form of background material and educational material."</p>	<p>Mr. Fogarty responded that the proposals were an attempt to highlight the importance of IAPNs without making them authoritative.</p> <p>The IAASB decided that the authority of the IAPNs should be described as "International Auditing Practice Notes (IAPNs) do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance."</p>
<p>Mr. James asked about the due process for creating a new vehicle for the IAASB's material, and whether the IAASB can create a new category of pronouncements without exposing the proposals.</p>	<p>Prof. Schilder noted that the Preface has been through an extensive due process and the current proposals are in response to comments received on exposure, and that both IAPN 1000 and the Preface in this instance will go to the PIOB for its approval of due process applied. Ms. Hillier added that changing from IAPs to IAPNs was intended to help clarify the status of the material, but she did not believe practitioners would approach the material differently. Mr. Fogarty and Mr. Gunn noted that the IAASB's Terms of Reference already provide for the IAASB to issue non-authoritative documents.</p>
<p>Mr. Gutterman highlighted that the International Actuarial Association (IAA) is also addressing the status of its pronouncements at the moment, and that it was also calling its category of non-authoritative documents "notes."</p>	<p>Support for the new title "International Auditing Practice Notes" noted.</p>

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<b>IAPN 1000 and Related Amendments to ISA 500 and ISA 540</b>	
<p>Mr. Baumann explained that he understood that IAPN 1000 would be non-authoritative, and in his view there is useful guidance in IAPN 1000. He expressed concern with the proposed amendments to ISA 500 and ISA 540, in particular that these were premature, as the issue is only starting to be debated, e.g. the PCAOB's Pricing Sources Task Force has just commenced exploring the issues and considering responses.</p> <p>He believed that the proposed amendment indicating that pricing sources are not management experts would result in a significant weakening of the ISAs. Mr. Baumann explained that paragraph 13(c) of extant ISA 540 allows testing the operating effectiveness of controls over how management made the accounting estimate with appropriate substantive procedures as an audit procedure. He expressed the view that paragraph 13(c) of ISA 540, in combination with the proposed changes to ISA 500, is weaker than the extant ISA. He added that the PCAOB continues to develop an understanding of the processes of the third-party pricing sources, and drew a parallel with the recent responses to the actions of the credit rating agencies leading up to the financial crisis. He added that it was important to gain further understanding of the controls that third-party pricing sources have in place. Mr. Baumann was also of the view that, under the current PCAOB and ISA requirements, the auditor would need to understand the valuation process for a sample of financial instruments. The proposed amendment would end this practice and create a significant difference with the PCOAB standards and more importantly, a significant gap in the audit procedures required by the ISAs.</p>	<p>Mr. Fogarty noted that the due process for the amendments would be the same as any amendment to the ISAs, meaning that the proposals would need to be exposed and approved by the IAASB and the PIOB. Mr. Fogarty noted that the IAPN 1000 Task Force had benefited from the involvement of a staff member of the PCAOB on the Task Force and his own involvement with the PCAOB's Pricing Sources Task Force. He also noted that the proposals were intended to clarify the existing situation rather than leave it unclear as it may be if referring only to the provisions regarding management's experts. He welcomed further input from the PCAOB and the wider community during the exposure process.</p> <p>Paragraphs 5 and 6 above explain the IAASB's decision to postpone changes to the ISA to enable further consideration of the issues.</p>
<p>Ms. Sucher expressed the view that determining whether a third-party pricing source is an expert or not based on whether prices are "available to other customers" is a weak test. She noted that this implied that a consensus pricing service with only five customers, after the elimination of the highest and lowest estimate received from those customers, would qualify. She also noted that the material on indicative prices and executable prices in proposed</p>	<p>Mr. Fogarty noted that the proposed amendments to ISA 500 and ISA 540 are about third-party pricing sources that develop prices only to sell to customers but are not trying to provide executable prices. He noted that the key issue is that prices obtained from third-party pricing sources are not like other evidence, and that the IAPN and ISA 540 are clear on the need for the auditor to</p>

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<p>paragraph A69b of ISA 540 was insufficient. Mr. Gutterman agreed with Ms. Sucher regarding the weakness of the test of whether a third-party pricing source is an expert. He noted that merely having multiple users of the pricing source would have unintended consequences, as this applies to many other models including those used by actuaries.</p>	<p>understand how the pricing service develops the prices.</p> <p>See paragraphs 5 and 6 above.</p>
<p>Mr. Gutterman noted the view of the CAG Working Group that IAPN 1000 contains good material but needs further work. He supported the explanation that a model comprises a methodology, assumptions and data. However, he noted there was no further mention of data throughout IAPN 1000 and that the IAPN sometimes confuses terminology regarding assumptions and inputs.</p> <p>He highlighted the use of the term “independence” in Appendix 1 and that it needed to be made clear that this was not the same as auditor independence. He also expressed the view that remaining references to “complex” financial instruments should be removed.</p>	<p>The IAASB considered usage of data, assumptions and inputs within IAPN 1000 and made some changes to clarify the terms used where necessary.</p> <p>Points accepted.</p>
<p>Mr. Bollmann supported the content of IAPN 1000. He noted that models can be constructed in a highly technical manner and, accordingly, the skills and experience of the person operating the model are critical considerations.</p>	<p>Support noted.</p>
<p>Ms. Sucher supported the material in the IAPN regarding the fair value hierarchy, in light of the sovereign debt crisis. She also noted that the IAPN contained useful material on existence and completeness and on example procedures on an asset backed security.</p> <p>She acknowledged that the IAPN needed to be framework-neutral but expressed disappointment that the IAASB had not included material on day 1 profits and hedge accounting, as there was some evidence in the U.K. that these accounting issues are not being approached by auditors in a consistent manner.</p>	<p>Support noted.</p> <p>Point not accepted.</p> <p>The IAASB agreed with the observation by respondents that further material on specific accounting issues may be viewed as interpreting accounting standards, that such accounting issues may differ significantly depending upon the jurisdiction and the financial reporting framework, and that dealing with all such topics would significantly increase the length and complexity of the document.</p>

**Matters for CAG Consideration**

10. The Representatives are asked to note the Report Back above, in particular the changes made as a result of the CAG's comments.