

Basis for Conclusions:
International Auditing Practice
Note (IAPN) 1000,
Special Considerations in
Auditing Financial Instruments

*Prepared by the Staff of the International Auditing and
Assurance Standards Board*

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BASIS FOR CONCLUSIONS:

IAPN 1000, SPECIAL CONSIDERATIONS IN AUDITING FINANCIAL INSTRUMENTS

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*, which was approved by the IAASB in September 2011, by the affirmative vote of 18 out of the 18 IAASB members.¹

Background

1. The International Standards on Auditing (ISAs) specifically deal with auditing fair value measurements and related disclosures in ISA 540.² Amongst other matters, ISA 540 addresses audit considerations relating to the measurement, presentation and disclosure of accounting estimates, including consideration of estimation uncertainty and indicators of possible management bias.
2. Matters discussed in the application and other explanatory material of ISA 540 were influenced by the changes occurring in the credit markets in late 2007 just prior to the finalization of the ISA. At the end of 2008, the IAASB released an IAASB Staff Audit Practice Alert³ to highlight areas within the ISAs that are particularly relevant to the audit of fair value accounting estimates in times of market uncertainty, including related issues regarding uncertainty as to an entity's ability to continue as a going concern.⁴ Notwithstanding these initiatives, however, the IAASB anticipated that there would be a need for additional practical guidance on auditing fair value accounting estimates associated with complex financial instruments given emerging economic developments.
3. In June 2009, the IAASB commenced a project to revise International Auditing Practice Statement (IAPS) 1012.⁵ IAPS 1012 provides guidance to the auditor in planning and performing auditing procedures for financial statement assertions related to derivative financial instruments, focusing on derivatives held by end users, including banks and other financial sector entities. However, since its release in 2001, the landscape in which audits of derivative financial instruments are conducted has changed, as have the ISAs themselves, and the use of fair value accounting has become more prevalent. The IAASB also recognized that the economic environment resulting from the global financial crisis,

¹ See minutes of the September 19–23, 2011 IAASB meeting at www.ifac.org/sites/default/files/meetings/files/20111205-IAASB-Beijing_September%202011_Public_Session_Minutes_Approved_%20Final.pdf.

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

³ The Staff Practice Alert, *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*, is available at www.ifac.org/sites/default/files/downloads/Staff_Audit_Practice_Alert.pdf.

⁴ Amongst other inputs, in April 2008, the Financial Stability Forum recommended the IAASB consider the lessons learned during the market turmoil and, where necessary, enhance the guidance for audit of valuations of complex or illiquid financial products and related disclosures.

⁵ IAPS 1012, *Auditing Derivative Financial Instruments*. The IAASB project proposal to revise IAPS 1012 is available at www.ifac.org/IAASB/Meeting-FileDL.php?FID=4807.

which gave rise to issues in relation to valuations and to financial statement disclosures about risks and uncertainties pertaining to financial instruments, would likely continue to prove challenging for both preparers and auditors.

4. In October 2009, the IAASB issued a Consultation Paper (CP)⁶ describing the IAASB's plans with respect to revising IAPS 1012. The CP included the IAASB's views that work completed by the UK's Auditing Practices Board (APB) on its Practice Note (PN) 23 (Revised)⁷ could be leveraged as part of the revision. Amongst other matters, the CP sought views from respondents about how a revised IAPS should deal with four main topics:
- The definition of complex financial instruments and the applicability of the proposed guidance to entities of all sizes;
 - Application of the audit risk standards;
 - Sufficient appropriate audit evidence, including relevance and reliability of fair value information; and
 - Disclosure and reporting considerations.

Responses to the CP indicated strong support for the direction being considered by the IAASB. The feedback obtained on identified topics of interest was used to inform the IAASB's development of the proposed IAPS 1000.

5. In October 2010, the IAASB exposed proposed IAPS 1000 (ED-1000).⁸ ED-1000 was released contemporaneously with the proposal, amongst others, to amend the *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (Preface) to clarify the status and authority of new IAPSs (ED-Authority).⁹ The comment period ended on February 11, 2011. Forty four¹⁰ responses were received from various respondents, including regulators and oversight authorities, national auditing standard setters, IFAC member bodies, firms, public sector organizations, other professional organizations, and individuals.
6. The Basis for Conclusions for the amended Preface¹¹ summarizes the comments received on ED-Authority, and the IAASB's reasoning for its decisions to withdraw the category of IAPSs and create instead the category of IAPNs. The revised Preface states:

⁶ The Consultation Paper, *Auditing Complex Financial Instruments*, can be downloaded at www.ifac.org/Guidance/EXD-Details.php?EDID=0131.

⁷ PN 23 (Revised), *Auditing Complex Financial Instruments*. When the APB's PN was originally issued, it was based on existing IAPS 1012.

⁸ Exposure Draft of IAPS 1000, *Special Considerations in Auditing Complex Financial Instruments*

⁹ Exposure Draft of Proposals Relating to International Auditing Practice Statements (IAPSs)

¹⁰ Forty four responses were variously received on ED-Authority and ED-1000. Forty three respondents commented on ED-1000 and forty commented on ED-Authority.

¹¹ Available at: www.ifac.org/publications-resources/amended-preface-international-quality-control-auditing-review-other-assurances.

International Auditing Practices 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.

7. This Basis for Conclusions explains the more significant issues raised by respondents on ED-1000, and how the IAASB has addressed them.
8. The IAASB has discussed this project with its Consultative Advisory Group (CAG) on four separate occasions.

Scope

9. The scope of ED-1000 included two elements: the types of entities that may hold financial instruments and the types of financial instruments the IAPS is intended to address.

Types of Entities Addressed

10. ED-1000 sought to present material in a manner intended to be helpful to auditors of both financial sector and non-financial sector entities with varying level of financial instrument transactions. Respondents were asked for their views on whether the balance of material included in the IAPS is appropriate in light of its purpose of assisting a wide range of auditors on an international basis.
11. Respondents were broadly of the view that ED-1000 achieved an appropriate balance of material. However, there were some strongly held views that the IAPS should focus more on material relevant to considerations in audits of large and complex entities. In particular, a few respondents recommended that the IAPS should address considerations relevant to large financial institutions and those who actively trade complex financial instruments, including banks, insurance companies, investment funds or systemically important financial institutions. This was considered important by these respondents given the degree to which these entities are exposed to complex financial instruments.
12. On the other hand, there were equally strong views suggesting a greater focus in the IAPS on matters relevant to audits of smaller entities and auditors with less extensive experience with financial instruments. In this regard, it was noted that overall readability and, in turn, applicability to these constituencies is essential. Various suggestions were made to emphasize SMP considerations, including the view that the IAPS should explain the intended audience of the IAPS, including specific mention of SMPs and other auditors who may have less extensive experience with financial instruments, and should have sections on "Considerations Specific to Smaller Entities." Matters noted included how risk management is to be approached if no risk management function exists and in entities where dealing with financial instruments are not routine transactions.

IAASB Decision

13. The IAASB reaffirmed its view that the most utility of the IAPN would be achieved by providing guidance to a broad audience, comprised of auditors with different levels of familiarity with financial instruments. Accordingly, IAPN 1000 focuses primarily on the

needs of those auditors who have less frequent contact with financial instruments as they would benefit the most from the IAPN. This is not necessarily the same group as SMEs and their auditors, as some SMEs may be heavy users of financial instruments (for example, small banks and hedge funds).

14. In this regard, the IAASB acknowledged that to address fully the needs of the auditors of large financial institutions that often use sophisticated financial instruments, the IAPN would reduce the broad applicability of the IAPN. This is because the IAPN, in order to be fully relevant to audits of such entities, would need to address the most sophisticated and complex instruments. Such instruments are unlikely to be encountered by an auditor in the majority of circumstances, and the resultant length and detail of the IAPN would impair the ability for it to be used effectively by a broader audience. The IAASB also noted the difficulty in maintaining the IAPN's relevance by adapting to new products and practices in the financial sector.
15. Nevertheless, the IAASB agreed that it is important to acknowledge the role larger financial institutions play and their importance to economies. Accordingly, the IAASB included further elaboration on issues relevant to entities of all sizes, including:
 - The use of models, including educational material, testing strategies and related audit considerations (see paragraphs 26–28 below); and
 - Further material on third-party pricing sources, particularly explanations of the different types of third-party pricing sources, and further elaboration of the audit considerations (see paragraphs 29–32 below).

The IAASB also maintained the material on internal controls in entities that have a high volume of financial instrument transactions.

Nature of Financial Instruments Addressed

16. ED-1000 applied to “complex financial instruments” but did not define what is meant by the term. Instead, ED-1000 focused the auditor on the many considerations, some of them subjective, that need to be taken into account in assessing complexity. The IAPS also incorporated the concept of “estimation uncertainty” as defined in ISA 540 as a factor affecting the complexity of the measurement of financial instruments.
17. Respondents varied widely in their comments on ED-1000's coverage of financial instruments. A few recommended coverage of all but the simplest financial instruments. However, a few other respondents recommended that the IAPS should have more material on the most complex and structured financial instruments, and one suggested that the IAPS should also take into account the standards developed by parties such as the accounting standard-setters, banking supervisors and other recognized stakeholders.

IAASB Decision

18. Consistent with the decision regarding the audience of the IAPN, the IAASB decided that the IAPN should address all but the simplest financial instruments. Accordingly, paragraph 5 of IAPN 1000 states: “This IAPN does not deal with instruments such as the simplest financial instruments such as cash, simple loans, trade accounts receivable and trade accounts

payable.” Also, the IAASB agreed that the IAPN should not specifically cover the most complex instruments that auditors with less frequent contact with financial instruments are unlikely to come into contact with. A consequence of this decision is that IAPN 1000, and its title, no longer refers exclusively to “complex” financial instruments.

19. The IAASB recognized that expanding IAPN 1000 to cover the most complex financial instruments would make the IAPN unsuitable for a broad audience, due to the length and complexity of discussion needed to deal with such matters. The IAASB agreed with respondents who noted that material on the most complex financial instruments would mostly be of value to large financial institutions who use complex financial instruments as a core element of their business models. This does not preclude future IAASB pronouncements on such matters, and may be considered by the IAASB in the context of its *Strategy and Work Program for 2012-2014*.¹²

Coverage of Complex Accounting Issues

20. ED-1000 explicitly excluded loan-loss provisioning and was silent on other accounting issues such as hedge accounting, recognition of day 1 profits or losses, offsetting and risk transfers. It also touched on, but did not explain in any detail, certain specific issues such as own credit risk. The explanatory memorandum of ED-1000 explained the IAASB’s view that it would not be possible or appropriate to develop comprehensive guidance on the other matters without significantly limiting the general applicability and usefulness of the IAPS.
21. Some respondents were of the view that accounting and auditing issues related to matters such as hedge accounting, day 1 profits or losses, derecognition, and loan loss provisioning should be covered in ED-1000, as well as further elaboration of issues regarding own credit risk. It was noted that these matters give rise to particular challenges in the audit of fair value measurements and income recognition for financial instruments and, therefore, should be considered in more detail in the IAPS. Others supported the exclusion of issues such as hedge accounting and de-recognition as they noted that these are matters for the accounting standard setters to address. Respondents also noted that the material on the fair value hierarchies used in some financial reporting frameworks needed to be clarified, and relevant audit considerations highlighted.

IAASB Decision

22. The IAASB deliberated these comments and resolved that, consistent with ED-1000, IAPN 1000 should continue to exclude these issues (see paragraph 6 of IAPN 1000), and focus on more pervasive issues regardless of the financial reporting framework. The IAASB agreed with the observation by respondents that further material on specific accounting issues may be viewed as interpreting accounting standards. In its deliberations, the IAASB noted that some of the requests for auditing guidance on these matters may reflect a lack of clarity in

¹² In 2012, given the spotlight on banks in the global financial crisis and their continuing vulnerabilities in the ensuing sovereign debt crisis, the IAASB plans to work with the Basel Committee and other stakeholders to stimulate discussion on issues relating to the audit of banks.

financial reporting frameworks, and, therefore, are unlikely to be resolved by further material in IAPN 1000. The IAASB also agreed with respondents who noted that these accounting issues may differ significantly depending upon the jurisdiction and the financial reporting framework.

23. Further, the IAASB noted that respondents had noted that the IAPN was already lengthy and detailed, and that dealing with all such topics in this IAPN would significantly increase the length and complexity of the document. Consequently, the IAASB noted that inclusion of such material may make the document less useful to the intended audience.
24. However, in recognition of the challenges that these issues may pose at the planning stage of an audit, the IAASB highlighted that the requirements of some financial reporting frameworks regarding financial instruments may themselves be complex and require extensive disclosures, and that reading the IAPN is not a substitute for obtaining a full understanding of all the requirements of the applicable financial reporting framework (see paragraph 74 of IAPN 1000).
25. The IAASB also agreed with respondents who sought additional material on the use of the fair value hierarchy, and the relevant considerations for the auditor in assessing management's categorization of inputs in the hierarchy. The IAASB clarified the background and educational material on the fair value hierarchy (see paragraph 36 of IAPN 1000), highlighted the importance of management's policies for identifying when inputs move to a different level of the hierarchy (see paragraph 41 of IAPN 1000), and indicated when the categorization of the inputs in the hierarchy may be a useful tool in assessing measurement uncertainty (see paragraph 107 of IAPN 1000).

Models

26. ED-1000 included material on:
 - (a) The entity's considerations when using models;
 - (b) Considerations when adjustments for valuation uncertainty may be needed to model outputs;
 - (c) The nature of inputs used in models; and
 - (d) Factors considered by the auditor in evaluating whether models used by the entity, including related controls, are appropriate.
27. Broadly, respondents supported the proposed material on models. However, respondents, including some regulators, recommended that further material on the topic be developed, particularly regarding the use of models, testing strategies, and the auditor's approach to performing audit procedures on models. Other respondents suggested that an example of a common model, and how the auditor may approach such a model, would be useful to auditors with less familiarity in this area.

IAASB Decision

28. The IAASB agreed with respondents' observations that further elaboration on particular elements of models, and auditor's consideration thereon, would be beneficial. In response, the IAASB:
- (a) Included further educational material about how models may be used (see paragraphs 47-48 of IAPN 1000). The IAASB highlighted that models can be as simple as a commonly used bond pricing formula or as complex as specifically developed software systems. To assist those with less familiarity with models understand how the models operate, IAPN 1000 also describes the components of models, i.e. methodology, assumptions and data.
 - (b) Provided an example of a common financial instrument (see paragraphs 50-51 of IAPN 1000). The IAASB agreed that an example of a model that may be used to value a common financial instrument would be a useful contribution to the background and educational material contained in Section I, and would contextualize the auditing considerations relative to models in Section II.
 - (c) Included guidance that certain financial reporting frameworks may require or permit adjustments to valuation techniques, while remaining cognizant that not all financial reporting frameworks include such requirements (see paragraph 37 of IAPN 1000).
 - (d) Agreed that material should be added regarding testing strategies, such as selecting the models with the highest risk of material misstatement (see paragraph 108 of IAPN 1000) and the considerations regarding the objectivity of an internal model development function (see paragraph 22 of IAPN 1000).

In developing the above additional material, the IAASB was cognizant of the need to ensure applicability of the IAPN across entities of varying levels of complexity and sophistication, while promoting sound and consistent audit judgments.

Third-Party Pricing Sources

29. ED-1000 included material on the use of third-party pricing sources (TPPS), such as pricing services and brokers, including explanation of how management may use information from such sources. Importantly, ED-1000 did not establish a "bright line" to determine whether TPPS are management's experts, within the scope of paragraph 8 of ISA 500.¹³
30. Several respondents, including regulators, sought clarity on the status of TPPS and noted that this was an area where auditors would benefit from some guidance.

IAASB Decision

31. The IAASB agreed that further material on TPPS was warranted. Accordingly, IAPN 1000 includes:

¹³ ISA 500, *Audit Evidence*

- (a) Additional background and educational material regarding how TPPS may be used by management, including the different types of TPPS, the need for management to understand how the TPPS arrived at the price, and how the price should be categorized in the fair value hierarchy (see paragraphs 52-62 of IAPN 1000).
 - (b) Further material on related audit considerations, such as the type of TPPS, the inputs and valuation techniques used, the reputation, experience, objectivity and controls of the TPPS, and the controls the entity has in place over the use of prices from the TPPS (see paragraph 117 of IAPN 1000). Importantly, the IAASB highlighted that, whilst obtaining prices from multiple TPPS may be useful, when considering financial instruments with inputs from levels 2 and 3 of the fair value hierarchy obtaining prices from multiple sources is unlikely to provide sufficient appropriate audit evidence on its own (see paragraph 119 of IAPN 1000).
32. The IAASB acknowledges that amendments to the ISAs may be needed relative to TPPS. In particular, there may be further clarification needed in ISA 500 and ISA 540 regarding the implications of whether a TPPS is a management's expert. Paragraph 45 below discusses potential future IAASB work.

Structure

33. ED-1000 comprised two sections, which enabled the separation of the background/educational material from the auditing considerations. It also contained shaded boxes to enable readers to quickly refer back to relevant material. Both of these were designed to help overall readability and navigation.
34. The use of two sections was supported by respondents from most stakeholder groups, although there were many other suggestions for improvement including incorporating the tables into the text, moving the tables to an appendix, moving the education material to an appendix and providing "road maps" for less familiar auditors to easily get to relevant material. Another respondent questioned whether readers will wonder if the IAASB intends the two sections to have differing levels of authority.
35. Respondents expressed mixed views on the use of shaded tables. While some respondents supported them, others expressed various concerns. These concerns included that they were too long, created uncertainty about the status of the text and impeded readability.
36. Further, some respondents made the general observation that Section II of ED-1000 contained many references to management's activities, but did not equally emphasize the auditor's considerations. It was noted that much of the material could be better placed in Section I, which would enable Section II to focus more clearly on the auditor's considerations.

IAASB Decision

37. The IAASB agreed to retain the two sections of IAPN 1000. The IAASB believes that this approach enables auditors with previous experience with financial instruments to more quickly access the material on auditing considerations in Section II, whilst those with less experience can learn from the background material in Section I. Given the lower level of

support for the shaded tables the IAASB decided to relocate the shaded tables either into the text or into an Appendix, as appropriate.

38. In relation to the material on management's activities in Section I, the IAASB agreed to move that material into Section I. This enabled the IAASB to streamline the IAPN by removing redundant material, and broadly improve its readability.

Other Matters

References to the Applicable Financial Reporting Framework

39. A respondent was of the view that the IAPN should make explicit references to financial reporting frameworks such as International Financial Reporting Standards (IFRS) or US generally accepted accounting principles (US GAAP). It was further suggested that the IAASB not issue the IAPS until the completion of the financial instruments accounting standards.¹⁴ The opposite view was held by other respondents, who preferred that the IAPS be more generic in its use of language and in referencing to provisions of financial reporting frameworks.

IAASB Decision

40. The IAASB reaffirmed its view that its pronouncements should remain framework neutral. Accordingly, IAPN 1000 retains the use of generic references to financial reporting concepts, such as the fair value hierarchy, rather than citing provisions that exist in specific frameworks such as IFRS and US GAAP. This enables the IAPN to continue to be applicable globally, recognizing that the applicable financial reporting framework may vary across jurisdictions. It also minimizes the risk that the IAPN inadvertently interprets, or is seen to interpret, provisions of specific financial reporting frameworks.
41. The IAASB also concluded that it would not be in the public interest to delay finalization of IAPN 1000 given the relatively urgent demand for timely guidance addressing auditing considerations relevant to financial instruments. Nevertheless, the IAASB acknowledged that, if relevant accounting standards change substantially, it may need to consider whether to revise IAPN 1000 at that time.

Competence, Professional Skepticism and Management Bias

42. Respondents variously suggested other matters for the IAASB's consideration in enhancing IAPN 1000. Amongst other suggestions, some respondents highlighted the requirement under the IESBA Code¹⁵ for auditors to be competent when accepting engagements involving financial instruments, particularly those that are more complex. Further, some regulatory respondents commented that references to professional skepticism needed to be strengthened, and further weight needed to be placed on the risks associated with management bias in several sections.

¹⁴ The final exposure drafts of elements of Phases 2 and 3 of IFRS 9, *Financial Instruments*, are not expected to be issued until Q4 2011.

¹⁵ See, for example, paragraph 210.6 of the IESBA *Code of Ethics for Professional Accountants*

IAASB Decision

43. The IAASB agreed that the IAPN could be further enhanced through some additional emphasis of these matters. Accordingly, IAPN 1000 now provides reference to the auditor's obligations under ISA 220¹⁶ regarding selection of the engagement team and relevant ethical requirements on engagement acceptance (see paragraph 78 of IAPN 1000). It also further emphasizes the importance of professional skepticism and consideration of management bias by, for example, linking the concept of professional skepticism to the risks and consequences of management bias, as well as alignment of the material with the ISAs (see paragraph 71 of IAPN 1000). Management bias is also highlighted as a concern when considering the categorization of the financial instrument in the fair value hierarchy (see paragraph 107 of IAPN 1000). Overall, the IAASB was satisfied that the entirety of the material in IAPN 100 implicitly supports further auditor consideration of the competencies necessary, and the importance of professional skepticism, in approaching the audit of financial instruments. Further, ISA 540 places an appropriate weight to considerations relative to possible management bias.

Effective Date

44. The amended Preface¹⁷ makes clear that IAPN 1000 is non-authoritative material which does not impose additional requirements on auditors. Rather, it provides practical assistance to auditors and is intended to be disseminated by those responsible for national standards, or used in developing corresponding national material, and provides material that firms can use in developing their training programs and internal guidance. Consistent with this status, the IAASB concluded that it is neither appropriate nor necessary to set an effective date.

Future Work

45. The IAASB is aware of the view that the ISAs may benefit from additional guidance relating to TPPS. It is also aware of the view that there may be merit in 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 themselves. The IAASB has agreed to explore these matters, including whether additional standard setting activities are necessary, in determining its forward strategy for 2012-2014.

¹⁶ ISA 220, *Quality Control for an Audit of Financial Statements*

¹⁷ Available at: www.ifac.org/publications-resources/amended-preface-international-quality-control-auditing-review-other-assurance