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11 February 2011

Technical Director, International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017 USA

Our reference: 2011/JE/TCSC1/IAASB/26

Subject Line: IAASB Exposure Draft “Special Considerations in Auditing Complex Financial Instruments”

Dear Mr. Gunn:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the Proposed International Auditing Practice Statement, IAPS 1000, *Special Considerations in Auditing Complex Financial Instruments* (IAPS 1000). As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing and professional standards. Members of SC 1 seek to further IOSCO’s mission through thoughtful consideration of accounting, auditing and disclosure concerns, and pursuit of improved global financial reporting and auditing.

SC 1 is pleased to see that the IAASB has undertaken a project to provide updated guidance on this important subject to assist auditors in conducting their work in an important and challenging area. We have provided comments in this letter that we believe would improve IAPS 1000. These comments reflect those matters on which we have achieved a consensus among the members of SC 1, and thus do not include all comments that might be provided by individual members on behalf of their respective jurisdictions.

We look forward to the outcome of the Board’s deliberations and issuance of a final IAPS.



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General Observations

We have read the document from two perspectives. The first was considering the content in terms of identifying the relevant audit risks. The second was considering the style of the document in terms of its use internationally and within the context of ISAs. With regard to the content, the Proposed IAPS 1000 appears generally to identify the relevant audit risks and to provide guidance to address those risks in an international environment. We have some specific suggestions for improvement that are noted later in this letter. With respect to style of the document, we offer our comments in the responses to the questions below.

Responses to Questions in the IAPS 1000 Exposure Draft:

1. Whether the material included in the proposed IAPS is appropriate in light of the proposed status and authority of new IAPSs. We believe the combination of educational and background material and audit procedures guidance included in the IAPS is appropriate for a document that is required to be understood by an auditor if relevant to an entity's audit. In regard to the proposed status and authority of the IAPSs, SC 1 members have raised some questions that we are communicating in a separate letter on the ED regarding withdrawal of existing IAPSs and status and authority of new IAPSs.

2. Whether the balance of material included in the proposed IAPS is appropriate in light of its purpose of assisting a wide range of auditors on an international basis. We support the work that has been done to address the types of risks that can arise with complex financial instruments and the auditor's consideration thereof. We believe that, overall, the balance of material included in the IAPS is appropriate and that it will assist a wide range of auditors in their work to audit complex financial instruments. We do, however, believe there are a few aspects of auditing complex financial instruments where the IAPS should go further in addressing key areas of audit judgment. These are discussed later in this letter.

3. Whether the proposed form of the IAPS, including the use of two separate sections and shaded tables, enhances its readability. We appreciate the efforts by the IAASB to enhance the readability of the IAPS. With regard to the use of two sections, we believe that it is logical to have a section on background, which is more educational in nature and may serve a broader audience, and a section focusing more specifically on audit considerations and guidance. The presence of having two clearly and prominently separated sections, however, might cause some readers to wonder if



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there is any difference in the intended authority or auditor's responsibilities associated with each section. We suggest that the purpose and authority of the two sections could be clarified for the reader/user with an explicit statement that addresses the auditor's responsibilities regarding the two different sections.

With regard to the shaded tables, we had some mixed reactions among our members regarding the helpfulness of the approach. We do not object to the shaded tables, but some members observed that when a shaded portion of text is several pages long, the shading loses some of its ability to differentiate the text from other text for readability purposes.

4. Whether respondents believe an effective date should be established for the proposed IAPS and, if so, what an appropriate date would be. We support the inclusion of an effective date with early adoption and application encouraged. We believe the lead time allowed should be reasonable in light of what users need to do to adopt the guidance but it should not be overly long. It should allow jurisdictions sufficient time to translate the IAPS and audit firms and other constituents to consider the guidance relevant to their training materials and audit methodologies.

Explanatory Memorandum Requested Comments on Other Matters - Special Considerations in the Audit of Smaller Entities—Respondents are asked to comment whether, in their opinion, material addressing considerations in the audit of smaller entities is sufficient and appropriate in the IAPS. Since it is possible that an entity of any size may have complex financial instrument transactions and the guidance provided in the IAPS appears to be sufficiently flexible and scalable to the circumstances of an entity under audit, we believe that it is sufficient and appropriate for addressing considerations in the audit of smaller entities.

Other Comments Regarding Clarifications and/or Improvements Needed in the IAPS

In the beginning of the IAPS, in the boxed paragraph below Contents: We believe that the Board needs to clarify further the authority and relationship between the IAPS 1000 and ISA requirements and ISA application material. Some of our members read and understand the status and authority of the guidance in this IAPS to be the same as application guidance in ISAs, in that an auditor is obligated to understand the content in each if relevant to an entity being audited. Others see an IAPS as having a somewhat lesser status or a different purpose than application material in an ISA, in that an ISA's application material is supporting



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particular audit requirements of the ISA, while an IAPS may contain a greater amount of background information and span the subject matter of several ISAs.

For further discussion of this matter, please see our separate comment letter on Proposals Relating to International Practice Statements - Withdrawal of Existing IAPSs, Clarification of the Status and Authority of New IAPSs, and Proposed Amendments to the Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements.

Scope of this IAPS

Nature of Financial Instruments Addressed by this IAPS

Paragraph 7: We suggest adding “or illiquid” along side “inactive” in describing characteristics of a financial instrument that may cause valuation of the instrument to be considered complex and therefore subject to this IAPS. It should be noted that the existence of or return to active or liquid market conditions does not preclude a financial instrument from being considered complex.

Section I – Background Information about Complex Financial Instruments

Purpose of Using Complex Financial Instruments

Paragraph 12: We suggest that mention be added about the complexity that can arise in accounting frameworks with respect to hedge accounting for financial instruments, including issues of hedge effectiveness, consolidated entity versus segments and other issues.

Risks of Using Complex Financial Instruments

Table 5 following Paragraph 15: We suggest that “including fraud risk” be added at the end of the bullet point item (v) so that it would read “The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events, including fraud risk”.

Controls Relating to Complex Financial Instruments

Paragraphs 16 – 17: We suggest adding more discussion about the relevance and importance of segregation of duties to Table 2 in paragraph 17. As noted in the general comments to this letter, we also suggest the IAASB consider whether a 5 page “table” may be confusing to readers and users of the IAPS. Consideration should be given to an alternative format for this



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area of the guidance given its length. One alternative would be to put all tables into an appendix, however, we do not feel strongly that this is a better solution to the current draft IAPS nor do we have other alternatives to suggest to you at this time. However, we do not want to cause the IAASB any delay in issuing this important guidance in their consideration of this concern.

We suggest adding more background about what an auditor can expect a company to have in place within the company's routine protocols and internal controls relating to complex financial instruments.

Section II – Audit Considerations Relating to Complex Financial Instruments **Planning the Engagement**

Professional Skepticism

Paragraph 24: We suggest adding a new second bullet “Understanding the systems of internal control relating to use of complex financial instruments” (similar to the information systems bullet point in this list). We also note that the content of paragraph 31 regarding attributes of the complex financial instruments used by the entity and the capabilities and competence of the engagement team are especially important considerations in audit planning and wonder if some of this content should not also be captured in paragraph 24.

Using Those with Specialized Skills and Knowledge in the Audit

Paragraph 30: The considerations in paragraph 30 are very relevant in understanding and auditing of complex financial instruments. We believe the Board should consider placing some of this material earlier in the IAPS, perhaps in the section “Understanding Complex Financial Instruments” that now begins with paragraph 25.

Paragraph 31: We suggest highlighting the need to involve more senior audit staff in the auditing of complex financial instruments in this paragraph.

Assessing and Responding to the Risks of Material Misstatement

Overall Considerations Relating to Complex Financial Instruments



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Paragraph 32: We suggest indicating a need for the auditor to understand the rights and obligations of the complex financial instruments involved, and to consider estimation uncertainty and other risk factors as noted in ISA 540.

Factors in Determining Whether to Test Controls

Paragraphs 35 to 39: We suggest highlighting the need to assess the extent of information system dependent controls over complex financial instruments.

Dual Purpose Tests

Paragraph 41: We believe that the IAASB should include more robust examples of dual purpose tests in addition to or in place of the examples included in this paragraph (e.g., testing independent price verification controls at the same time as testing period end values, or testing processing and approval of manual journal adjustments at the same time as substantiating the adjustments themselves). We believe the development of dual purpose tests can be a particularly challenging area for an auditor and that more robust examples could be instrumental in assisting the auditor.

Timing of the Auditor's Procedures

Paragraph 45: Manual journal adjustments could also be given as an example of a substantive procedure to be performed by the auditor at year end; the last bullet point could also be clarified to note that items such as these may be recorded after the end of the accounting period during the closing period process.

Procedures relating to completeness, accuracy and existence of complex financial instruments

Paragraph 47: We believe more discussion of the objectives and approaches to reviewing journal entries would be helpful. For example, we suggest expanding the discussion in the second to last bullet to include the review of topside and unusual end-of-period journal entries in addressing fraud risk.



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Valuation of Complex Financial Instruments

Paragraphs 50 to 52 and Table 5, Fair Value Hierarchy: We encourage the IAASB to ensure that Table 5 on the fair value hierarchy is fully in line with the language used in related accounting standards on fair value measurement insofar as possible. We also request that the IAPS provide some coverage in this section of the IAPS as to what the auditor needs to consider in developing his approach to auditing models. The auditor needs to assess which models pose the highest level of risk of inappropriate valuations and look for areas where there is potentially over-reliance on models to produce financial statement valuations. Once auditors have decided which models to test, there is a need to determine how to audit the model considering the reasonableness of inputs and outputs or the inner workings of the model. Other key areas of judgment in valuation that we believe should be discussed or at least mentioned include the following:

Own credit risk – This can be a highly material and volatile number that has a significant impact on earnings. There are various ways of valuing one’s own credit risk and it is an area prone to error.

Fair value hierarchy – There can be substantial issues in assessing whether to place an instrument into level 2 and 3 of the hierarchy. This area can involve substantial management judgment and therefore auditor judgment as well.

Accounting for gain or loss on recognition of a complex financial instrument, also called “day one profit/loss” – This is an area of significant judgment where there may be issues regarding internal controls and audit procedures need to be designed accordingly.

Understanding management’s methodology for valuing complex financial instruments

Table 7, Effects of Inactive Markets: We note that alongside the reference to current or recent transactions in the second to last bullet of Table 7, a discussion of “proxy pricing” might be helpful where an instrument without an observable price is valued by locating a proxy in the market.

Paragraph 67: We believe that there are some inherent limitations to consensus pricing services which are perhaps not fully reflected in this paragraph: for example, the process can be circular if there are only a few contributors (so the preparer essentially gets its own price back), or data can be limited due to the exclusion of outliers. We suggest the IAASB consider expanding the discussion here to caution the auditor about what some of the



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limitations may be and why these limitations may exist. We believe this would be highly valuable guidance for auditors that is particularly relevant to auditing complex financial instruments in today's highly integrated financial markets.

Paragraph 70 – 71: We believe these paragraphs could be enhanced to provide the auditor with a greater understanding of the complexities and/or operational difficulties inherent in credit valuation adjustments or a company's own credit risk (e.g., for credit risk, noting examples of various methodologies that could be used to measure it, such as bond spreads or credit default spreads).

Procedures relating to understanding and testing the valuation of complex financial instruments

Paragraph 82 to 104: We believe the discussion could be further developed in certain areas. For example, consideration of "who developed the models" could include mention of the need to consider where an internal model development or control team sits, whether within the front office group pricing and negotiating deals or in a separate technical and control group. There could be a discussion of different audit approaches, for example, depending on volume and/or complexity, a controls-based approach could be used, or a more substantive reperformance approach, or a "deep dive" into details of one or more specific material models. Also, the discussion could address the extent to which models are rejected or re-designed and/or incorporate model risk reserves. We also believe the guidance could elaborate on the use of models and associated controls throughout the product life cycle.

Paragraph 106: We believe that paragraph 106 should include "existence" in the first paragraph preceding "recognition, measurement ...etc" and should be added to bullet point a or b, in the discussion about assertions that are encompassed in presentation and disclosure.

Procedures relating to the presentation and disclosure of complex financial instruments

Paragraph 107: We believe the second bullet could also mention the need for audit work on the underlying systems used to generate disclosures, as well as on the process for deriving disclosures.



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Thank you for the opportunity to comment on this ED. If you have any questions or need additional information regarding this comment letter, you may contact me, Jane Poulin, or Susan Koski-Grafer at 202-551-5300.

Sincerely,

Julie A. Erhardt

Chair

IOSCO Standing Committee No. 1

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