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Organización Internacional de Comisiones de Valores  
International Organisation of Securities Commissions  
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Organizaçào Internacional das Comissões de Valore

February 12, 2010

Mr. James Gunn  
Technical Director  
International Auditing and Assurance Standards Board  
International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
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Email address: [Edcomments@ifac.org](mailto:Edcomments@ifac.org)

***Re: IAASB Consultation Paper "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 Consultation Paper on Auditing Complex Financial Instruments (CP). 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 in this important subject area. We believe it is reasonable to use work that has been done in one jurisdiction as a starting point and we have provided a number of comments in this letter that we believe will be helpful in revising and expanding the guidance for international use. At this early stage of the project, we have not answered all questions in the Consultation Paper, but rather have focused our comments to those areas where we believe we could be most helpful in providing input for the work ahead. For ease of reference, all questions in the CP are reproduced

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in this letter, including those on which we have no comments to provide at this time. Also, please note that our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1 and do not include all comments that might be provided by individual members on behalf of their respective jurisdictions, now or later.

We look forward to the outcome of the Board's deliberations and issuance of an Exposure Draft.

### **General Observations**

We have read the Consultation Paper and draft Practice Note from two perspectives. The first was considering the content in terms of identifying the relevant audit risks and concerns of investors. The second was considering the style of the document in terms of its use internationally and within the context of the existing International Standards on Auditing (ISA) framework.

With regard to the content, generally the U.K. Auditing Practices Board's Practice Note appears to identify the relevant audit risks and we look forward to how the IAASB will develop the International Auditing Practice Statement (IAPS) to address those risks in light of an international environment and aligning it with the ISA provisions.

With regard to the style and layout of the paper, we have some suggestions regarding the development of the proposed guidance.

- We think the U.K Auditing Practices Board's Practice Note provides a good start for this project but will require significant revision and expansion for international use. For example, we noted a number of useful factual and informational statements in the current IAPS 1012 that we could not find in the Practice Note, including such matters as the explanation of linear and non-linear contracts in paragraph 4 of IAPS 1012, and the comprehensive glossary of terms at the end of the IAPS. We also noticed that some of the content in the IAPS section "Need for Skills and Knowledge", for example, the coverage of an auditor's use of an expert in paragraph 15 of the IAPS, was not discussed as extensively in the Practice Note. We have not done a full comparison of the IAPS content to the Practice Note content, but would expect that the IAASB would perform such a comparison and would ensure that no useful information in the IAPS is lost during its update.
- The proposed IAASB document should not mix language that is associated with requirements with language that is typical of guidance. Further, the final IAPS should clearly state within the document the authoritative status of the guidance. For example, will the resulting IAPS have an equivalent status to Application Guidance in an ISA? Or is it intended to have a more general, informational status that is not as authoritative? We are aware that the Preface to International Standards provides general statements in paragraphs 18 and 19 regarding the authority of International Auditing Practice Statements and states that the IAPS "are issued to provide interpretive guidance and practical assistance to accountants in implementing ISAs"; however, the Preface is not located in close proximity with ISAs and IAPSs and is not always easy to find, and

furthermore, the Preface contains statements regarding the Application Guidance in ISAs in paragraphs 12-14 under the heading "Other Standards" that can be viewed as similar to what is said about IAPS authority. So we believe it would be helpful to clarify this in general, and address it directly in the IAPS as well.

- It is important for the IAPS to have a clear linkage to ISAs and to include references to ISAs where needed. The IAPS should not paraphrase or summarize requirements of an ISA, as the different language that would then be involved could cause some confusion about the actual requirements.

Our answers to the questions that follow in this letter will indicate a number of additional revisions that we observe would be needed to update and improve IAPS 1012.

### **Responses to Questions in the CP**

**1. Do you agree with the IAASB's overall approach for revising IAPS 1012, in particular the usefulness of the APB's work as a starting point for the revision of an international auditing practice statement?** We agree that starting with recent work done in one jurisdiction is a reasonable way to begin this project. We also encourage the Board to consider the content of any other work that has been carried out on this subject in other jurisdictions and is made known to the Board, particularly those jurisdictions that provide Board members and Observers to participate in the work of the IAASB.

We encourage the IAASB to consider providing further explanation of its rationale as to why it chose to issue an updated interpretative IAPS rather than, for example, amending ISA 540 and other ISAs to provide additional application guidance as needed.

We also note that the Practice Note issued by the U.K. uses a lot of present tense verbs when describing various auditor considerations – these could be read as implying requirements on auditors that may not be requirements in the relevant ISAs. Although not all inclusive, some examples of these potentially implied requirements are contained in paragraphs 19, 45, 53, 55, and 70. Consistent with the general comments above, we would encourage the IAASB to avoid the use of present tense in revising the IAPS and to characterize the potential auditor actions as actions that the auditor "may," "might," or "could" take, and utilize other terminology that would be consistent with the status of the document as guidance.

**2. What are respondents' views as to the overall structure and content of the Practice Note? In considering this question, respondents are asked for views about the level of detail of the APB's Practice Note, including the length and flow of the document, and its suitability in an international context.** We believe the Practice Note provides a very useful beginning for an international auditing practice statement but would like to see more detail in an IAASB-prepared document that would include and expand upon the content now in IAPS 1012. We would encourage greater coverage of the types of risks that can arise with complex financial instruments (e.g., price risk, default risk, liquidity risk, reputational risk, etc.) and a more comprehensive discussion of auditor considerations in assessing risk, including determining significant risks, and designing audit procedures. A discussion of how leverage can multiply the

risk exposure involved would be helpful. We believe this additional coverage can be accomplished and still retain an overall approach of focusing on the principles involved, with which we agree. Please see also our response to Question 9 regarding types of risk.

As to overall flow of the document, we note that the Practice Note document is quite lengthy and heavily text-oriented. We recognize that it contains a large amount of helpful information, and that we have suggested some additions. As a result, we would encourage the IAASB to explore ways that it might be possible to format and present the information in ways that could enhance broad readability, similar to what is done in the application guidance sections of some ISAs with headings and bullet points and other information formatting techniques.

Additionally, throughout the Practice Note, we observed that there are a variety of statements that appear definitive and conclusive when in fact the circumstances for which an apparent conclusion is based may not always warrant such a conclusion. Examples include, but are not limited to, the use of the adjective "very" in paragraphs 21 and 33, an indication in paragraph 32 that accounting requirements and related risks and uncertainties "are themselves complex," and the statement in paragraph 71 that reconciliations are a "key control." While these circumstances may generally or usually be the case, there could be circumstances where these statements would not be appropriate and therefore we encourage the IAASB to evaluate where it should use a more neutral and less definitive tone in the development of the revised IAPS.

**3. If respondents think the Practice Note is insufficient, in what areas should the IAASB consider including additional guidance in revising IAPS 1012? Specific examples as well as the rationale for a particular suggestion would be helpful.** Please see our comment in response to Question 2 above. We believe that more specific practical guidance (e.g., greater coverage of the types of risks that can arise with complex financial instruments and a more comprehensive discussion of auditor consideration in assessing risk) can make the subject area more understandable and meaningful to a diverse international audience.

**4. Are there currently any national standards or guidance in your particular jurisdiction that should also be considered by the IAASB in revising IAPS 1012?** IOSCO SC 1 is a committee composed of many jurisdictions. We have already commented earlier in this letter (see our response to Question 1) that the IAASB should consider whatever work that is made known to the Board.

**5. Is the Practice Note clear on what is meant by the term "complex financial instruments"? If it is not, how could the definition and illustrative examples be improved, bearing in mind the evolving nature of these instruments?** We think the definitions and criteria in paragraphs 4 and 5 are helpful and give a clear overall view. The examples in paragraph 6 are useful, and would be more useful if some additional names and types of the more commonly-used instruments were noted. We agree that the market is constantly evolving and a comprehensive list cannot be maintained, but providing several additional examples with the caution that the list is illustrative and not all-inclusive would be helpful.

**6. Is the guidance included in paragraphs 9-12 of the Practice Note helpful in explaining its applicability to audits of entities of all sizes? If not, should such guidance be deleted or**

**expanded in revising IAPS 1012; is so, how?** We note that the discussion in paragraphs 9-12 of the Practice Note appears to focus on the volume of transactions as the primary driver of the risks associated with complex financial instruments and therefore the applicability of guidance in the Practice Note. While we agree that the volume of transactions is one factor to consider when thinking about the complexity of auditing an entity's financial instruments, other factors, such as the complexity of any individual financial instrument, the competency of management, and the strength of the entity's internal controls over financial reporting for both isolated and recurring financial instrument transactions may be more relevant. We also note that the statement in paragraph 12 that "[t]he larger and more complex the operations, and the better the control environment, the more likely that the entity will have effective controls over its complex instruments" is another statement that appears to equate size and volume of transactions with the likelihood of good controls. Since the recent years' financial crises demonstrated that a lack of adequate knowledge could occur in entities of all sizes and with all levels of use of complex financial instruments, we suggest that the IAPS make a clear statement to communicate this risk. For example, the IAASB could revise the "Types of entity" discussion to include a more robust discussion about the various drivers of complexity associated with an entity's use of financial instruments and stress the broad applicability of the guidance to all entities.

We have these additional comments regarding paragraphs 9-12: First, paragraph 10 seems to have a slightly negative tone as to the range of choices and judgments of the auditor – we don't think that words like "only needs to understand" and "if it exists at all" and "may be possible to limit testing" are appropriately neutral and helpful. We would suggest discussing the range of possibilities with equal coverage of what may or may not be needed in a neutral fashion. Second, paragraph 11 puts forth a view that the auditor of an entity with relatively few complex financial instrument transactions may have problems not faced in auditing an entity with high levels of such transactions, such as "management may have less understanding." As noted above, the recent years' financial crises demonstrated that a lack of adequate knowledge could occur in organizations of all sizes and with all levels of use of complex financial instruments. We would suggest revising this guidance to present neutrally the possibilities that may be presented to an auditor in entities of all sizes and types. We believe that presenting a full list of considerations that the auditor should evaluate would be most helpful in guiding what will always need to be an individual, entity-specific risk assessment by the auditor, and that the list should be comprehensive and neutral. As one additional comment, it was not clear to us why the last sentence of paragraph 11 begins with "In these circumstances", which we interpret to be when auditing an entity with relatively few transactions, because we would think the auditor needs to consider whether an expert needs to be involved in any circumstance where complex financial instruments are involved.

**7. Throughout the Practice Note, examples of how the guidance can be applied in a range of entities – from smaller entities to larger financial institutions – have been included. Do respondents believe the guidance is adequately balanced, or would a revised IAPS 1012 be more helpful if focused at a different level?** In some cases, as noted elsewhere in this letter, we thought that comments about smaller versus larger entities reflected views that were arguable and/or seemed negative – we would encourage the Board to present neutral discussions about the full ranges of possibilities that can occur in any entity, regardless of size and frequency of use of complex financial instruments.

**8. Many of the considerations described in the Practice Note can also be applied to simpler financial instruments. Would it be more appropriate in revising IAPS 1012 for the guidance to be developed to apply to all financial instruments rather than limiting it to complex financial instruments?** We believe the guidance can be most direct and helpful if developed to apply to complex financial instruments. However, as much of the guidance could also be applicable to other types of financial instruments, the IAPS could include a “scope” statement in the beginning, noting that, while the guidance in the IAPS has been developed to focus on issues arising with auditing complex financial instruments, the guidance therein may also be helpful in the audit of simpler financial instruments.

**9. Are the types of risks described in paragraph 59 of the Practice Note understood across a number of industries and applicable in an international context?** We believe this area would benefit from content discussing risk concepts using some of the additional terminology that commonly exists around the world in the explanations provided, such as “default risk” and “reputational risk”. The guidance can be most helpful if it alerts the auditor to the various concepts and types of risk that arise in the global context.

**10. Is the guidance in paragraphs 64-84 (particularly related to information systems, control activities, and monitoring of controls) helpful for auditors in obtaining an understanding of controls for a financial statement audit? Is the guidance helpful for audits of entities that have smaller portfolios of complex financial instruments?** Recognizing that the exact form and detail of internal controls may differ from entity to entity, we believe that paragraphs 64-84 present a useful list of matters that auditors may need to address. However, we are concerned that the Practice Note (in particular paragraphs 74-78) is written in such a way that it appears to be providing direction and guidance to entity management rather than the auditor. Although the points noted in the guidance may be relevant matters that the auditor may need to address in conducting an audit under the ISAs, we do not believe the IAASB should provide direction to entity management through an interpretation of its auditing standards. Therefore, we would encourage the IAASB to modify the discussion that appears directed to entity management (e.g., paragraphs 46-50, 60, 118) in a manner that makes it directed to auditors.

**11. Is the guidance on substantive procedures in paragraphs 105-108 of the Practice Note helpful to auditors? Are there other procedures that should be considered in revising IAPS 1012?** The Practice Note states that when a risk is significant, the auditor performs procedures responsive to that risk. We believe it would be helpful to say directly that substantive procedures need to be increased in the case of significant risk. It may also be useful to provide some examples of increased substantive procedures that may be helpful in auditing complex financial instruments in conditions of significant risk.

**12. Are there additional issues or best practices relating to the auditor’s application of the audit risk standards that have been noted that should be included in revising IAPS 1012?**

**13. Is the additional guidance included in the Practice Note helpful for auditors in obtaining sufficient appropriate audit evidence in relation to complex financial instruments?**

**14. Is the additional guidance relating to the valuation assertion applicable to most complex financial instruments? Are the concepts in this section easily understood and relevant in an international context?**

**15. Would it be helpful to include more generic guidance describing concepts such as broker quotes, the different types of pricing services that may be used, and other forms of evidence and cite examples of how this information is typically gathered and in what particular circumstances?**

**16. Is the guidance on the use of models, from both a preparer and auditor perspective, sufficient? If not, what further guidance could be added and why?** In the discussion on “obtaining confirmation” from a management’s expert contained in paragraphs 128-131, we believe a reader could possibly be left with an impression that obtaining confirmation from management’s expert or a pricing service is sufficient in the audit. We believe it is important to emphasize that the auditor cannot just rely on a third party confirmation, but must obtain sufficient and appropriate audit evidence that would include obtaining an understanding of the method, model, and assumptions involved, in accordance with ISAs 500, 505 and 540.

**17. Is the Practice Note sufficiently clear that the issues relating to valuation and the types of risks involved in financial instruments apply equally to financial assets and financial liabilities or should more guidance be added about financial liabilities?**

**18. Are there additional issues or best practices relating to the auditor’s need to obtain sufficient appropriate audit evidence that have been noted that should be included in revising IAPS 1012?** We also think it would be helpful to provide some illustrations of the kinds of specific or newly-arising counterparty risk that may not have been addressed in the general valuation of a given complex financial instrument. For example, recent deteriorating business conditions in one or more entities similar to the counterparty, or other conditions that might also have an effect on the counterparty’s ability to meet its obligations. These examples would help to illustrate situations when a “possible need for an impairment provision” exists.

**19. Is the guidance included in the Practice Note on disclosures helpful?** We believe that the content in paragraphs 134 – 142 needs to be both “internationalized” and expanded. We encourage the IAASB to provide additional coverage of the audit of disclosures around complex financial instruments. Internationally, and in major jurisdictions, there has been a large increase in mandated and voluntary disclosures on financial instruments in Annual Reports. In view of the complexities and uncertainties around valuing complex financial instruments, this emphasis on disclosures is likely to continue.

The current coverage in the Practice Statement does not distinguish sufficiently between accounting frameworks' overall requirements for adequate disclosures (for fair or true and fair presentation) and those disclosures that flow from accounting standards (quantitative and

qualitative) and the different auditing procedures that might be appropriate. As a specific example of the latter, some accounting frameworks now require that the accounts include sensitivity analyses for valuations of hard-to-value financial instruments. For investors, this may be a disclosure of material interest and the Practice Statement should include guidance for auditors that the requirements of ISA 540 would require them to evaluate the reasonableness of the assumptions used and the effects of changes in assumptions. We believe that the guidance should note that there may be regulatory disclosure requirements in addition to the requirements imposed by accounting frameworks, and should also discuss the issue that materiality may be both qualitative and quantitative in a subject area that has a high level of investor interest.

**20. Is more guidance needed on the audit of disclosures? For example, is more guidance needed to address how the auditor would obtain sufficient appropriate audit evidence when the disclosures about risks and uncertainties are qualitative in nature or the information derived from information systems that are not otherwise used to generate information for inclusion in the financial statements? How should the IAASB deal with these areas in revising IAPS 1012, while ensuring the framework neutrality?** We believe additional guidance would be helpful. Please see our response to Question 19, above. We believe the issue of framework neutrality can be addressed by providing reference to “IFRS and some other accounting frameworks” and adding additional examples from other frameworks if such are suggested to the IAASB or otherwise identified.

**21. Is the guidance included on communication with those charged with governance helpful? Is there scope for adding additional guidance on the auditor’s communications with those charged with governance with respect to valuation and control issues that come to the auditor’s attention?**

**22. Are their best practices relating to auditor’s communications with regulators, prudential supervisors and others, for example, where such communication or reporting is required by law or regulation, that should be acknowledged in revising IAPS 1012?** We think there should be at least a brief section that discusses “Communications with regulators” following the section on “Communications with those charged with governance”, and that this section should acknowledge that additional reporting and/or communication requirements may exist in some jurisdictions and alert the auditor to ascertain if there are any additional regulatory and supervisory requirements that are relevant to the entity under audit. We do not think it is appropriate to describe such practices as might exist in particular jurisdictions as “best practices”, but rather believe that providing some illustrative samples of practices which might exist, drawn from experience, would be useful for illustration.

**23. Would further guidance on the possible implications for auditor’s report when auditing complex financial instruments be helpful? For example, this could include guidance on the use of Emphasis of Matter paragraphs, Other Matter paragraphs and limitations on the scope of the audit.** We think the use of special paragraphs is an area that could be explored. However, as ISA 706.A2 notes, “a widespread use of Emphasis of Matters paragraphs diminishes the effectiveness of the auditor’s communication of such matters.” Therefore, if the IAASB believes additional guidance is appropriate, we encourage the IAASB to be careful not to imply that the use of Emphasis of Matters or Other Paragraphs in auditor reports



should be more relevant or more prevalent for complex financial instruments than for other important matters.

**24. Is the use of an Overview section helpful or is such a section duplicative?** We believe the use of an "Overview" or "Summary" section at the beginning of a guidance document is helpful.

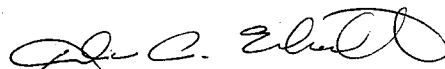
**25. For the areas noted above, is the level of guidance included in the Practice Note helpful?**

**26. Are there any issues that may arise with the Practice Note from a translation perspective?** In paragraph 53, we think the use of the term "attitude" may not be widely translatable and understandable unless it is accompanied by additional explanation and terminology. Perhaps "strategy" might be a useful supplementary term to explain the meaning intended.

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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 or Susan Koski-Grafer at 202-551-5300.

Sincerely,



Julie A. Erhardt

Chair

IOSCO Standing Committee No. 1