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IFAC
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Ref.: AUD/HvD/HB/SH

Dear Mr. Gunn,

Re: FEE Comments on the IAASB Consultation Paper on Auditing Complex Financial Instruments

FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the IAASB Consultation Paper on Auditing Complex Financial Instruments (the Consultation Paper).

The current guidance in International Audit Practice Statement (IAPS) 1012 needs reconsideration taking note of the lessons learned from the financial crisis and following the finalisation of the IAASB Clarity project. We believe that the UK Audit Practice Board (APB) Practice Note 23 on "Auditing Complex Financial Instruments – Interim Guidance" forms a good starting point for revised guidance on this issue at international level.

However, FEE would recommend that the use and status of IAPSs should be reassessed before finalising this and other "IAPS type" guidance relevant to auditing historical financial statements.

Generally, FEE considers that guidance on auditing financial instruments is also useful and relevant, for small and medium practitioners (SMPs) auditing predominantly small and medium-sized entities (SMEs).

Responses to the specific questions raised in the Consultation Paper are set out below.

Question 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?

FEE appreciates the existing guidance on auditing derivative financial instruments in current IAPS 1012 but supports the IAASB project to revise it in light of the increased attention to financial instruments following the financial crisis.

FEE welcomes the work done by APB in revising its guidance on auditing complex financial instruments and appreciates that IAASB uses material of others to be able to respond on a timely basis to the needs of auditors. FEE sees the APB guidance as very helpful and supports the initiative to 'internationalise' the APB guidance. FEE is though of the view that some additional considerations are needed to ensure that the guidance is consistent with the IAASB framework and the clarified ISAs at international level.

FEE is of the view that the scope of the guidance should be auditing financial instruments as a whole and should not be limited to auditing *complex* financial instruments. When considering APB Practice Note 23 it appears that it implicitly and rightly covers *simpler* financial instruments as per paragraph 8. FEE is therefore of the view that the scope of the revised guidance should be and is "Auditing Financial Instruments" which should be reflected in the title of the document and requires only minor amendments in the guidance itself. If there are simple instruments covered by other IAASB standards and pronouncements, like cash, receivables or payables, these might be excluded by explicit scope exemption.

FEE supports the observations made in the Consultation Paper regarding the applicability of guidance for auditing financial instruments for entities of *all* sizes including SMEs. FEE believes that it is important that this point is conveyed in the introduction of any future guidance on auditing financial instruments.

The APB Practice Note is currently issued as Interim Guidance. The APB has chosen to do so mainly because the accounting requirements are currently under review. FEE supports this approach at this point in time. However, FEE would recommend that any future guidance at international level is framework-neutral and as such the guidance related to auditing financial instruments should not be dependant on possible future changes in the accounting requirements under any framework.

The status and authority of guidance and other material issued by the IAASB and of IAPSs in particular needs to be clarified. As far as the IAPSs are concerned, the IAASB should also reflect on whether auditors should be required to read and understand the text of the IAPS in order to apply the requirements of ISAs properly as we are not convinced that this should be the case. The IAASB could carefully consider the status of IAPSs as compared to the clarified ISAs before issuing this revised guidance on auditing financial instruments. FEE would strongly recommend that the IAASB consults its constituents separately on this issue of the hierarchy, authority, subject matters and status of IAPSs and other guidance like for instance IAASB Staff Alerts and Staff Questions and Answers in accordance with its due process.

As far as the status of guidance on auditing financial instruments is concerned, FEE does not believe that it could become Application and Other Explanatory Material to an ISA as Application and Other Explanatory Material explains what a requirement means or is intended to cover and not all topics are fit for becoming a requirement in an ISA expressed by the phrase "the auditor shall". Therefore, guidance on such topics should remain truly guidance, whether in the form of an IAPS or otherwise.

Question 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.

FEE is of the view that the UK APB Practice Note forms a good starting point for IAASB guidance on auditing financial instruments. However, the latter needs to be applicable at the international level. For example, the guidance should be framework-neutral when referring to accounting standards.

Users of this guidance will range from practitioners auditing mainly SMEs and other entities with few (often simple) financial instruments to practitioners from large firms auditing listed entities, complex financial institutions, other larger entities and SMEs which use extensively both simpler and complex financial instruments. Therefore, some users may find this guidance too lengthy, whilst others might be looking for more detailed guidance. However, when assessing the current overall level of detail in the APB Practice Note, FEE considers that it is balanced and appropriate for international guidance on auditing financial instruments.

For clarity the Introduction to the eventual IAASB guidance should explicitly refer to its application of, and consistency with, the general principles of the ISAs.

One aspect with regard to the level of detail contained in the APB Practice Note could be considered. Reproducing selected paragraphs from the ISAs would result in duplication of material between the ISAs and the guidance. Replacing these paragraphs with cross references to the relevant paragraphs in the ISAs avoids duplication. One relevant example is paragraph 38 in the APB Practice Note on materiality. A reference to the relevant paragraphs of ISA 320 "Materiality in Planning and Performing an Audit" would be sufficient and underline that the level of materiality in auditing financial instruments follows the same principles as included in the ISAs. However, guidance specific to auditing financial instruments as included in the Sections on 'Control Environment', starting at paragraph 53, and on 'Entity's risk assessment process', starting at paragraph 58, are very helpful and are examples of the types of guidance most useful in this APB Practice Note.

In the Consultation Paper the IAASB has highlighted that the revised APB Practice Note also incorporates guidance from the IAASBs Staff Audit Practice Alert which presumably refers especially to IAASB Staff Audit Practice Alert on "Challenges in Auditing Fair value accounting estimates in the current market environment" from October 2008. FEE would emphasise that it is essential that any future guidance on auditing financial instruments issued by the IAASB incorporates the issues referred to in the Staff Audit Practice Alert on "Challenges in Auditing Fair Value Accounting

Estimates in the current market environment". In addition any other lessons that may have been learned from the recent financial crisis after October 2008 related to auditing financial instruments should be carefully considered when developing the IAASB guidance.

Question 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.

In FEE's opinion the issues included in the APB Practice Note are sufficient and form a good starting point for the development of internationally applicable guidance on auditing financial instruments. We refer to our responses to Question 1 and 2 relating to the scope of the guidance covering all financial instruments.

Question 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?

FEE has not been made aware of any national guidance on auditing financial instruments in any of the countries covered by FEE Member Bodies or at European level, apart from the APB Practice Note 23 (Revised).

Question 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?

As mentioned in the response to Question 1 FEE is of the view that any future IAASB guidance should cover all financial instruments and not restrict its scope to complex financial instruments only. The IAASB should however consider to exclude financial instruments as cash, receivables and payables from the guidance, ideally by explicit scope exclusion.

It would be helpful were the guidance, when explaining the term "complex financial instruments", compare it to "financial instruments" as a whole, including derivatives. The explanations regarding complex financial instruments in the APB Practice Note, Paragraphs 4 to 8, are appropriate as a basis for the definitions in the international guidance.

As already indicated, the APB Practice Note refers to International Financial Reporting Standards (IFRS) and to national UK accounting standards. Any international guidance needs to be framework-neutral, especially in relation to the definition of financial instruments which can vary from one accounting framework to another. The guidance in this IAPS should, be applicable for financial instruments measured both at fair value and at amortised cost. Also, the guidance should theoretically be applicable under a fair presentation framework only, as it does not

appear to make much sense for it to apply to tax or cash-based accounts nor to compliance-only frameworks.

Question 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; if so, how?

The guidance included in paragraphs 9 to 12 of the APB Practice Note is helpful. However, FEE recommends that specific sections on “Considerations Specific to Small Entities”, similar to such insertions in the clarified ISAs, are included in the future international guidance. Furthermore, examples of the applicability of this guidance to SMEs would be helpful for practitioners when, for example, considering the need to balance the work performed over internal controls and the extent of substantive procedures.

Question 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?

Financial instruments, especially the more complex ones, present significant threats and opportunities, including threats to the financial statements in general. The APB guidance necessarily focuses on more complex financial instruments because greater complexity means greater risks. Considerations as well as examples, as mentioned in the response to Question 6, related to auditing simpler and less complex financial instruments could also be relevant.

Question 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?

The IFRS definition of financial instruments is included in paragraphs 4 to 8 in the APB Practice Note. At international level a *description* rather than a definition of financial instruments would be more relevant as international guidance should be framework-neutral, as mentioned in the response to Question 5. Together with our response to Question 6 referring to the applicability to all entities the guidance should also cover simpler financial instruments, such as spot foreign exchange transactions.

The definition of financial instruments, complex or simpler, should not include “bright lines” as new types of financial instruments will continue to be developed. The relevance and practical application of this guidance to these new instruments should be a matter of professional judgement of the practitioner.

Question 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 consider that the risks described in paragraph 59 of the APB Practice Note are commonly understood and accepted. The guidance is expected to be very useful for practitioners. One point to be mentioned related to APB paragraph 59 is however that the term “valuation risk” would be more appropriately named “measurement risk”. In practice valuation risk normally means “model risk”.

It is important that the definitions of the risks mentioned are generic enough to be framework neutral and precise enough to be applied consistently. However, FEE strongly recommends that the IAASB ensures that the descriptions or definitions of the risks mentioned are not contradicting similar definitions in IFRS, i.e. in IFRS 7 Financial Instruments: Disclosures. For instance, the APB Practice Note definition of “liquidity risk” is different from the equivalent definition in IFRS 7.

In the context of risks relating to financial instruments it should be borne in mind that management and those charged with governance have the responsibility for managing those risks.

Question 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?

FEE finds the guidance in paragraphs 64 to 84 helpful and would not reduce it. It is also relevant when considering smaller portfolios of complex financial instruments.

Question 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?

When auditing financial instruments the main issue of concern is that the audit documentation obtained from the entity draws on judgement (of ratings agencies, etc) formed by an entity which is usually outside the control of the audited entity. Guidance in relation to substantive procedures is therefore very useful for practitioners.

FEE recommends that the guidance on substantive procedures in the APB Practice Note be expanded upon in the IAASB guidance. For instance, examples of how analytical procedures might be used and guidance on information produced by systems not used to produce the financial statements (see hereafter in relation to Question 20) would be helpful.

Question 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?

Although guidance on risk assessments is included in the APB Practice Note, the financial crisis has shown that risk assessment of financial instruments is crucial when auditing financial statements. Therefore, additional guidance related to this could be useful for practitioners, especially in the form of examples of material risks and on liabilities arising from financial instruments.

Question 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?

Guidance included in the Practice Note for ensuring that the audit evidence obtained is sufficient to document the conclusions of the work done would be helpful for practitioners in any international guidance.

Question 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?

Financial instruments are, generally, traded internationally and those that are not often bear a resemblance to those that are. Therefore, most practitioners have some experience with financial instruments. The guidance in paragraphs 110 to 135 of the APB Practice Note is helpful and should aid understanding of the relevant issues when auditing financial instruments.

Question 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?

Notwithstanding practitioners' experience with financial instruments, additional guidance describing concepts such as broker quotes and pricing services supplemented with examples of forms of evidence would probably be helpful. Also the risk connected with the use of "indicative quotes" from brokers might be prominently highlighted.

Question 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?

The guidance on the use of models included in the APB Practice Note is helpful. Additional examples, for instance, more commentary on some of the more common generic models in an appendix to the guidance could be helpful to practitioners.

Question 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?

As noted in the response to Question 12 more guidance on liabilities could be relevant.

Liabilities are an issue of concern in many financial instruments, especially complex financial instruments and debt instruments. More guidance on the relevant risks would be helpful in practice.

Question 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?

FEE has not identified any additional issues relating to audit evidence. However, it is important that the guidance refers to the requirements for quality control and engagement documentation as set out in ISQC 1 "Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements" when auditing financial instruments. Therefore, some details in the APB Practice Note, like certain parts of paragraph 36, need to be replaced by a reference to the relevant parts of ISQC 1.

Question 19: Is the guidance included in the Practice Note on disclosures helpful?

Yes. However, disclosures are mainly driven by the relevant accounting framework and not by auditing guidance. One issue that could be considered is creating a link between the use of complex financial instruments and the adequacy of disclosures on liquidity and going concern uncertainties.

Question 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 is 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?

Yes. As it is important to pay sufficient attention to disclosures outside the financial statements, further guidance on information systems that are not otherwise used to generate financial statements, would be helpful.

The guidance on disclosures as included in the APB Practice Note should be made framework-neutral for the international guidance on financial instruments.

Question 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?

FEE suggests the guidance included in paragraphs 151 and 152 in the APB Practice Note be supplemental by commentary on the differences between the responsibilities of management and those charged with governance as compared to the responsibilities of auditors. The guidance could propose communication with those charged with governance is dealt with earlier than at the end of the audit.

Question 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?

Some additional guidance in situations where practitioners may be required to or may need to report to regulators could be helpful. However, the requirement for practitioners to report to regulators is highly dependant on national legislation which will impact on the nature and extent of such guidance.

Question 23: Would further guidance on the possible implications for the 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.

FEE is of the view that the guidance in ISA 700 on Forming an Opinion and Reporting on Financial Statements and ISA 706 on Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report suffices in this respect. Therefore, FEE does not see a need for additional guidance specific to reporting on auditing financial instruments.

Question 24: Is the use of an Overview section helpful or is such a section duplicative?

An Overview section would be helpful for the readability of the guidance, notwithstanding possible duplication with the detailed guidance. Such a section could replace the repetitive ISA requirements, and this would reduce length and duplication.

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

It may be appropriate to include more material on professional scepticism and judgement as complexity usually entails a heightened level of risk. Paragraph 98 of the APB Practice Note refers to the relationship between risk and complexity which could be developed further.

The guidance related to the use of experts appears useful and appropriate, whether in-house experts or outside experts are used. To illustrate the guidance on these issue examples could be added and would be helpful in practice.

Question 26: Are there any issues that may arise with the Practice Note from a translation perspective?

Translation issues might arise when the revised guidance is translated into local languages. As is the situation with the current translation process of clarified ISAs into the various languages in the European Union, FEE Member Bodies will need to address such issues in due course.

For further information on letter, please contact Ms. Hilde Blomme from the FEE Secretariat at +32 2 285 40 77 or hilde.blomme@fee.be.

Yours sincerely,



Hans van Damme
President