



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email: edcomments@ifac.org

Mr Jim Sylph
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Standards Board (IAASB)
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Consultation Paper– Auditing Complex Financial Instruments

Dear Mr Sylph

The Basel Committee welcomes the opportunity to comment on the IAASB's October 2009 consultation paper *Auditing Complex Financial Instruments*.

The Committee has a strong interest in the accounting and auditing of complex financial instruments because these instruments often represent a material part of an international banks balance sheet. We therefore support the IAASB's efforts to revise the Auditing Practice Statement (IAPS) 1012, "Auditing Derivative Financial Instruments" that was issued in 2001.

The Committee recognises that there are presently several accounting projects potentially relating to financial instruments and disclosure practices that could affect the development of IAASB's consultative paper. We recommend that the development of this consultative paper be coordinated carefully with related accounting developments.

Our specific responses to 9 of your 26 questions are included in the attached Appendix.

This letter has been prepared by the Committee's Accounting Task Force, chaired by Mrs Sylvie Mathérat, Director of the Banque de France, and has been approved by the Committee. If you have any questions regarding this letter, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Marc Pickeur who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253) or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely

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Specific answers to questions

Q 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.

The consultative paper (CP) repeats several requirements that are already in International Standards on Auditing (ISAs). For example, the section "Types of entity" (paragraphs 9 -12) notes that the CP applies to all entities. The section also notes that the auditor needs to plan the engagement, having regard to the nature of the entity, the entity's environment and the auditor's knowledge of the business. Generally, these requirements apply to all audits.

Structuring the content of the CP in this manner makes it long and repetitive. We would recommend that any revised International Auditing Practice Statement (IAPS) emphasises specific aspects relating to auditing complex financial instruments. When the CP intends to remind auditors of requirements contained in other ISAs we would suggest that cross referencing be used to make it more relevant to an international audience.

Q 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 financial reporting for complex financial instruments there are likely to be several quantitative and qualitative disclosures that are made. These disclosures might relate to financial instruments that have significant measurement uncertainty. We believe that in such circumstances, an auditor should evaluate whether appropriate and meaningful disclosures are made to enable the intended users to understand these matters. That is, the auditors need to ensure that the disclosures are comprehensive, meaningful, consistent, comparable and not overly complex.

The recent crisis has shown that the completeness, accuracy and valuation of complex financial instruments can impact management's use of the going concern assumption. Given this can be a significant risk for those entities which are substantially engaged in trading complex financial instruments, we believe that the CP should emphasise the relationship between the audit of complex financial instruments and the going concern assumption when systemic issues arise (eg when markets are dislocated or are illiquid).

We believe that the ED would benefit from expanding paragraphs 115 and 117 to provide more specific guidance when markets become illiquid or dislocated. For example, when markets become illiquid or dislocated and valuations become more judgmental, less verifiable and as a result less reliable the auditor needs to modify or conduct additional procedures to collect sufficient and appropriate audit evidence. In addition, when external pricing services are used there would be a need for additional audit procedures to verify

external prices. The audit approach might also include more rigorous testing of the assumptions used in determining valuations associated with such instruments.

The auditing of complex financial instruments requires consideration of management's own expertise within the control and governance framework, the use of management experts, and capable expertise within the audit team. The use of experts is addressed in paragraphs 128 to 132 of the CP. We believe that the relationship, roles and responsibilities associated with management and experts should be more fully articulated within the ED when markets are illiquid or dislocated, and when models are used.

Finally, the guidance should better explain the relationship with supervisors. The Committee's views on this matter are further explained in question 21 and 22 below.

Q 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 believe that the CP needs to define “complex financial instruments” (as part of paragraph 5). Complex financial instruments can be defined by having regard to the following attributes:

- *The characteristics of the instrument* – The characteristics of the instrument define complexity in terms of whether it is actively traded, it is a compound financial instrument, or has an embedded derivative. We believe that compound instruments and instruments with embedded derivatives tend to be more complex whereas instruments that use fair value based on observable prices in actively traded markets are less so. For example, some derivative instruments, such as futures and forwards, are actively traded in markets. These derivatives are relatively less complex in nature as the prices are less difficult to verify in normal market conditions. However, other derivatives are more complex and typically not actively traded (eg credit derivatives) and prices for such instrument are more difficult to verify.
- *The variability associated with the cash flows of such instruments* – The higher the variability of cash flows with an instrument to changes in market conditions the more complex the instrument is likely to be.
- *Complexity of fair value measurements* – A key consideration is how fair value is determined when applying the accounting requirements for fair value measurements. When instruments use market based inputs from active markets these instruments are generally less complex as the values are generally less difficult to verify in normal market conditions. However, when instruments use entity specific or model based inputs these instruments tend to be more complex notably because their fair value may be highly sensitive to changes in valuation assumptions. That is, the fair values are generally more difficult to verify.

Finally, we are of the view that the CP would benefit from articulating that seemingly “simple” financial instruments can become “complex” when markets become illiquid or dislocated.

Q 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?

We believe that the CP would be improved by the inclusion of more generic guidance describing concepts such as broker quotes, the different types of pricing services that may be used, and other forms of evidence. In particular the guidance in paragraph 117 could be expanded to more fully consider the audit implications when there is valuation uncertainty.

For financial instruments there can be valuation uncertainty in situations when they are not actively traded, there is insufficient market depth or there is reliance on valuation models using unobservable inputs to a significant extent. There is a possibility of inappropriate recognition of both initial and subsequent gains and losses when there is significant valuation uncertainty. Valuation uncertainty considerations and the size of any necessary valuation adjustment to arrive at fair value would be based on the factors market participants would consider in setting a price, for example the degree of uncertainty created by weaknesses in the data or the underlying modelling approach.

We believe that the CP should draw more extensively from the existing guidance on valuation adjustments included in the report of the IASB Expert Advisory Panel (EAP), published in October 2008. In particular, auditors should draw upon their market knowledge and the EAP guidance to challenge management's valuations to ensure that, where there is significant valuation uncertainty, the valuations are reasonable. The IASB EAP includes for example:

- Guidance on using broker quotes and/or pricing services (paragraphs 53-57);
- Guidance on identifying forced transactions, including the effect of supply and demand imbalances (paragraph 23) and the analysis of sales to meet regulatory requirements (paragraph 25); and
- Specific examples of valuation adjustments used to arrive at fair value (paragraphs 99 and 100).

The guidance should remind the auditor of these requirements when there is valuation uncertainty. Furthermore, the auditor should ensure that valuation uncertainty is adequately dealt with by management.

In addition, as noted in question 3 above, the auditor should consider extending the procedures performed whenever pricing services and broker quotes are used.

Q 19. Is the guidance included in the Practice Note on disclosures helpful?

Q 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?

As a general point, we encourage the IAASB to strengthen the auditor's work in the area of auditing disclosures.

Furthermore, as noted in question 3 above, we are of the view that auditors need to ensure that disclosures made by management are comprehensive, meaningful, consistent and comparable and not overly complex. Disclosures need to be in accordance with the accounting framework and other applicable guidance.

Auditors need to ensure that quantitative and qualitative disclosures relating to complex financial instruments are clearly articulated. For example, the disclosures should clearly inform the reader whether the information is being presented on a gross or net basis. Also, whenever a sensitivity analysis is performed as part of the financial statements, the reasonableness of the assumptions used and the effects of changes in assumptions should be evaluated carefully by the auditor.

Disclosures are likely to be more meaningful when they integrate information in financial statements, Management Discussion and Analysis, and other parts of a bank's public reporting package. The auditor should examine the disclosures for internal consistency, and look to remove redundancies and unnecessary complexity where possible.

It is our understanding that the Financial Accounting Standards Board and the International Accounting Standard Board are looking to establish a Comprehensive Disclosure Framework. This Framework might provide auditors with a set of criteria to evaluate whether disclosures are meaningful. Furthermore, we also note that prudential supervisors such as the UK Financial Services Authority have issued guidance to enhance the comparability and reduce complexity associated with financial disclosures made by banks¹. These frameworks might provide auditors with a useful tool when evaluating complex financial instrument disclosures.

Q 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?

Q 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 believe the guidance should recognise the importance of effective two way communication in the audit of financial statements and consider the relationship between those charged with governance at the bank, the external auditor, and the prudential supervisor. The relationship between the external auditor and the prudential supervisor has been explained in our 2002 paper, *The relationship between banking supervisors and banks' external auditors*.

We believe that in communications with prudential supervisors and others, the higher of national requirements and existing guidance in *IAPS 1004 The Relationship between Banking Supervisors and Banks' External Auditors* (paragraphs 52, 54) should apply.

¹ See for example, "Enhancing Financial Reporting Disclosures by UK Credit Institutions" (FSA), October 2009.

Q.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.

We believe the guidance on auditing complex financial instruments should address estimation uncertainty with fair value measurements and the implications for the auditor's report. ISA 701 "Modifications to the Independent Auditor's Report" does not specifically address estimation uncertainty associated with fair value measurements that could arise from complex financial instruments.

During the crisis, the October 2008 IAASB Staff Audit Practice Alert *"Challenges in Auditing Fair Value Accounting Estimates in the Current Environment"* provided guidance that reminded auditors of their responsibilities when preparing auditor reports (p.8, 3rd paragraph).

This guidance could apply to valuations of complex financial instruments in any environment and should be included in the new IAPS.

The guidance should also remind the auditor of the distinction between an emphasis of matter paragraph and a modified opinion. The IAASB Staff Audit Practice Alert included such a reminder that states *"such emphasis is not an alternative to modification of the auditor's opinion if the auditor is not able to obtain sufficient appropriate audit evidence or disagrees with the treatment of fair values of the financial instruments"*.