Chairman

Via email: Edcomments@ifac.org

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Combined Exposure Drafts, "*Proposals Relating to International Auditing Practice Statements (IAPS)" and "Proposed IAPS 1000, Special Considerations in Auditing Complex Financial Instruments*"

Dear Mr Gunn

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the IAASB's Exposure Drafts (i) Proposals Relating to International Auditing Practice Statements (IAPS) and (ii) Proposed IAPS 1000, Special Considerations in Auditing Complex Financial Instruments. The Committee has a strong interest in high quality auditing standards for banking organisations because for many banks complex financial instruments represent a material part of the balance sheet. We generally support the objective of providing guidance to auditors in this important area as this initiative complements the April 2009 call by the G20 Leaders to "*take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector which will support sustainable global growth and serve the needs of business and citizens*".[1] Having consistent international auditing practices contributes to a sound financial sector and would be in the public interest.

The Committee believes that the proposals relating to the status and authority of IAPS would benefit from more clarity. Specifically, this relates to the status of IAPS within the context of auditing and assurance standards and other pronouncements published by the IAASB. The Committee recommends that the purpose of IAPS should be to provide additional explanatory material complementing the International Standards on Auditing (ISAs).[2] The Committee also recommends

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1 G20 Communiqué, *Declaration on strengthening the financial system,* London, 2 April 2009 – http://www.g20.org/Documents/final-communique.pdf.

2 The Committee acknowledges that the legal status and authority of explanatory material can vary in accordance with how auditing standards are given the "force of law" in a jurisdiction. In some jurisdictions the entire auditing standard is given the force of law under the applicable legislative framework. However, in other jurisdictions it is only the basic principles and essential procedures in an auditing standard that are given the force of law.

that auditors' documentation requirements related to their compliance with the provisions of these IAPS should be strengthened.

Although we support the objectives set out in the auditing of complex financial instruments ED, we believe it should contain more extensive and practical guidance for auditors dealing with complex financial instruments. This is explained in Annex B of this letter.

Our specific comments and responses to some of the key questions raised in the EDs are included in the following Annexes:

- Annex A: Withdrawal of Existing IAPS, Clarification of the Status and Authority of New IAPS; and
- Annex B: Special Considerations in Auditing Complex Financial Instruments.

This letter has been prepared by the Committee's Accounting Task Force, chaired by Mrs Sylvie Mathérat, Deputy Director General at the Banque of France, and has been approved by the Committee. If you have any questions regarding this letter, please feel free to contact Mrs Mathérat (+33 1 4292 6579), Marc Pickeur who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely

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Annex A

Withdrawal of Existing IAPS,
Clarification of the Status and Authority of New IAPS

The Committee supports the development and publication of IAPS. The rationale for the IAASB's project to review the status and authority of its IAPS is to clarify the level of authority that attaches to IAPS. The current description of this authority in the *"Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"* (the Preface) is subject to differing interpretations.

The Committee's view is that IAPS should provide additional explanatory material complementing one or more International Standards on Auditing (ISA). The Committee is in favour of more authority for several reasons:

- IAPS follow the same due process that has to be followed for an ISA;
- IAPS should promote high-quality auditing practice. As noted on page 9 of the ED, the IAASB's research has indicated that, "*There is divergent practice in the application of the ISAs internationally, or a need to raise awareness of issues being encountered in practice in particular areas, and therefore promulgating an IAPS would promote high-quality auditing practice, contributing to improved financial reporting*"; and
- IAPS should promote consistent application of ISAs. As noted on page 9 of the ED, the IAASB's research has indicated that, "*Such guidance would provide practical assistance to auditors in particular circumstances or industries, and would be expected to be applicable internationally*."

We are also of the view that the documentation requirements would benefit from more clarity. Page 11 of the ED indicates that "*it is not the IAASB's intent to establish a specific documentation (or suggest that documentation may be appropriate) requirement addressing the auditor's determination as to whether any IAPS was relevant to the audit and, if so, the required understanding of its content*". The ED indicates that "*The IAASB believes that documenting this determination and the required understanding of the IAPS is not meaningful and might imply the existence of requirements in the IAPS when none exists*". We disagree with this view as we believe that an auditor should obtain an understanding of the IAPS and should consider the IAPS that are relevant to a particular audit. When an auditor decides not to consider the guidance in an IAPS, the auditor should be required to document how the requirements in the ISAs have been properly applied without considering the guidance in the IAPS. We would expect that there is a presumption that IAPS 1000 is always relevant to the audit of a bank.

Possible alternative wording for paragraph 23 of the Preface could be as follows:

"23. International Auditing Practice Statements (IAPS) are issued to provide practical assistance to auditors in implementing ISAs and to support good practice and consistent application. IAPS do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with the requirements of all ISAs relevant to that audit. Auditors should read and understand all IAPS, should determine which IAPS are relevant to a particular audit and, when an IAPS is relevant to the audit, the auditor should consider it. However, an auditor may decide not to consider the guidance in an IAPS that is relevant to the audit. When such a situation arises, the auditor is

required to document how the requirements in the ISAs have been properly applied without considering the guidance in the IAPS."

As noted in the ED, the IAASB discussed a range of options that could be considered regarding where the wording of the auditor's obligation with respect to the IAPS should be placed. We support the option of incorporating the auditor's obligation in ISA 200 and recommend that this option be explored more fully in due course. The ED indicates that this option was not pursued because, "*[…] it would be inappropriate to adopt this approach at this time given the implications to jurisdictions that are currently adopting, or planning to adopt, the clarified ISAs into law or regulation and the possible confusion that might arise between the guidance in the IAPS and the application material in the ISAs.*" In our view a transitional phase should not affect the IAPS indefinitely. As such, we can accept the option to change the Preface at this time as a short-term action. However, the Board should indicate within what timeframe it could modify the approach taken and revise ISA 200.

We would also encourage the Board to contact IFAC and propose a redraft of the Statement of Membership Obligations (SMO) to include that IAPS should also be incorporated in national standards.

Annex B

Special Considerations in Auditing Complex Financial Instruments

The Committee observes that this ED is a much more readable document than the previously exposed consultative document, both in terms of structure and presentation, and notably because it separates educational guidance and more detailed guidance.

Response to Questions on page 26

- Questions 1 and 3: The IAPS would become clearer and its authoritative nature would be better understood if the educational guidance is clearly separated from the audit guidance that has authoritative status (eg the Board could consider including the educational guidance in an appendix of the IAPS).
- Question 2: The Committee believes that IAPS 1000 could be expanded to focus on the kinds of complex financial instruments found in entities that actively trade such instruments. Examples of such entities include banks, insurance companies and investment funds (unit trusts), or systemically important financial institutions. These entities have complex financial instruments that are routinely subject to audit. In developing its own standards, the IAASB should take into account the various standards that are currently being developed by accounting standard-setters, banking supervisors and other recognised stakeholders in relation to such organizations. The Committee remains available to provide updates and information on standards development in those areas where it has competence.
- Question 4: Since IAPS do not create new audit requirements but rather provide practical audit assistance, their effective dates should be close to the date of their issuance. However, sufficient but reasonable time should be given, for example, to adapt the audit methodologies of those involved in their operational application.

Complex financial instruments

Paragraphs 4, 5, 7, 8 and 9 address the main characteristics of complex financial instruments without defining them. The guidance as drafted may be interpreted to exclude certain financial instruments because such instruments are not overly complex. As noted in the Committee's submission on the consultative paper (see our letter of 14 January 2010 for more details), a good starting point would be that complex financial instruments can be described by having regard to the following:

- The characteristics of the instrument: We believe this point could be more clearly addressed than it currently is (eg in paragraph 8). For example, by defining a complex financial instrument as an instrument not having amortised cost characteristics as in IFRS 9 *Financial Instruments* and having one or more characteristics associated with the variability of cash flows and complexity of fair value measurements. These aspects are further detailed below.
    - The variability associated with the cash flows of such instruments: This point is covered in the current draft;
    - Complexity of fair value measurements: This point is addressed to some extent in paragraph 9 but could be expanded. The IAPS should indicate the difference between an "estimation uncertainty" (an audit concept) and "measurement uncertainty" (an accounting concept).

The general nature of the content of the IAPS on complex financial instruments addresses audit considerations for all financial instruments – not just complex financial instruments. The challenges in auditing financial instruments often arise not necessarily because of the complexity of the instrument itself but due to the nature of market conditions. For example, when markets become illiquid or dislocated auditing a product with 'vanilla' characteristics could also pose significant practical challenges. The IAPS notes this in paragraph 7, *"…sometimes financial instruments that ordinarily are relatively easy to value become complex to value because of particular circumstances…"* We believe that the auditor should be aware of and recognise these instances, and the IAPS should provide guidance in this regard.

Furthermore, many areas dealing with complex financial instruments are not adequately considered (e.g. accounting for day 1 profits and losses; recognition and derecognition of financial instrument transactions; own credit risk; and risk transfer for originators of financial instruments). Although the IAASB has avoided providing guidance on the application of accounting standards in the past, the recent financial crisis has demonstrated that these accounting complexities pose significant challenges for auditors when they arise. We believe that more extensive guidance in the areas mentioned above would promote more consistent application of auditing standards in practice.

Linkage to Accounting Framework

We believe that the ED would benefit from a clearer linkage with accounting frameworks as significant changes are taking place in these frameworks, notably in relation to requirements for the accounting treatment of impairment and hedging. These requirements are likely to be more forward looking and principles based, particularly under (the new) IFRS 9 *Financial Instruments*, and the ED should provide guidance to auditors in these areas.

We note that the International Accounting Standards Board (IASB) has acknowledged that further work is needed in the area of fair value measurement and related uncertainty. This is particularly important for the measurement of financial instruments when markets are dislocated or illiquid, as pointed in the October 2008 report of the IASB's Expert Advisory Panel. This is part of the IASB's ongoing work, and there is a need for the IAASB to leverage off this work. Furthermore, instruments that have embedded derivatives tend to be more complex than other instruments. The ED should provide guidance to auditors to address these practical challenges as this potentially impacts all types of entities.

We acknowledge that it is in the public interest to publish this IAPS as soon as possible. However, we strongly recommend that this IAPS be updated when IFRS 9 is completed as it is particularly relevant to this IAPS.

Professional scepticism and management bias

We believe that the concepts of professional scepticism in paragraphs 22 to 24 need to be strengthened and specifically tied into areas of management bias (eg paragraphs 81 and 88). For example, paragraph 23 could also mention the existence of management bias as follows: "*Application of professional scepticism by the auditor also increases when indicators of management bias are present*." Furthermore, additional guidance is required to stress the need to specifically challenge management when gathering audit evidence. For example, paragraph 22 could be amended as follows: "*This includes questioning and challenging contradictory audit evidence and the reliability of documents and responses to inquiries and other information from management and those charged with governance. Further, the auditor needs to pay particular attention to indicators of management bias and undertake additional audit work as appropriate*."

Compensation policies may impact the risk appetite of traders as well as management and, therefore, create a management bias that auditors should be cognisant of. In this regard, we propose that paragraph 27 be edited to read "*the incentives that this may create for management and its traders".*

To further emphasise the impact of management bias, we believe that paragraph 28 would benefit from the following revision: "*Difficult financial market conditions may give rise to increased incentives for management or employees to engage in fraudulent financial reporting: to protect personal bonuses, to hide management error, to avoid breaching borrowing limits, to avoid breaching regulatory limits or to avoid reporting losses*".

ISA 540 – Auditing Estimates

This revised auditing standard requires auditors to evaluate management's estimates in light of the outcomes of previous periods' estimates. Depending on the nature of financial instrument usage (eg volume, complexity, price transparency), this will pose an audit challenge requiring guidance in the IAPS.

Using the work of the internal auditor

Paragraph 111 of the ED refers to the external auditor using the work of an internal auditor. Our comment letter on the Board's July 2010 ED on ISA 610, *"Using the work of the internal auditor"* (see our letter dated 15 November 2010) encouraged the Board to be more direct regarding when it is appropriate for external auditors to use the work of the internal auditor and we suggested including specific criteria such as those described in the Committee's August 2001 document entitled, "*Internal audit in banks and the supervisor's relationship with auditors"*.[3] We believe that the IAPS would benefit from the inclusion of concrete examples of when the external auditor should not use the work of the internal auditor. For example, in auditing the fair values of financial instruments that have been estimated using measurement inputs that are unobservable (ie Level 3), the external auditor should not use the work of the internal auditor.

Models

The ED dedicates several paragraphs to models and related controls (eg paragraphs 52, 66, 68 and 104) given their prominent usage in pricing and valuing instruments. However we believe the guidance should be expanded to address the auditor's understanding of where models are used in the organization and which models are material enough to warrant testing, taking into account the risks posed by valuation uncertainty. The guidance should then be expanded to elaborate on potential approaches to auditing models, including controls, testing of inputs and outputs, and a more substantive 're-performance' approach.

Information technology controls

Entities that make extensive use of financial instruments are often dependent on complex information systems to process transactions and ensure that internal controls are adequate and effective. Given the importance of these information systems to an audit of such an entity, we believe the IAPS should devote more attention to the provision of guidance in this area. This could include discussion of information technology general controls, automated controls and application controls.

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3 This document is available from the BIS website.

Own credit risk

We believe that paragraphs 71 and 72, while highlighting the correct issues, should be expanded to address specific auditor considerations in relation to own credit risk (OCR). The auditors should be alerted that computations of the effects of changes in OCR can be complex and subjective. The auditor should be advised to seek the involvement of a specialist to evaluate the entity's methodology and assumptions used. There are several valuation approaches currently used in this area in practice and the process of developing an estimate is highly error prone due to the multiple sources of information involved. While we recognise the challenges associated with developing specific audit procedures in an area where measurement approaches are continually evolving, the document, as currently written, does not sufficiently communicate audit risks inherent in the OCR estimation.

Communication with Regulators

Paragraph 115 regarding communications with regulators is unclear. In particular, it is unclear why such communications will only be relevant at the start of the audit. We are of the view that in order to provide feedback and improve the quality of the audit on an ongoing basis communication would be relevant throughout the audit, and especially at the end. Therefore we propose deleting the sentence stating that "*Such communication may be most useful in the early stages of the audit*". A replacement sentence could be "*Such communication may be useful on an ongoing basis throughout the audit*." The proposed approach is not only in line with ISA 250 as mentioned in footnote 46 of the ED, but also with IAPS 1004, *The Relationship Between Banking Supervisors and Banks' External Auditors.*

Independent price verification function

The IAPS would benefit from making reference to *Independent price verification* (IPV) functions and how auditors could verify their work and make use of their inputs in relation to valuation uncertainty and fair value hierarchy practices. Whilst varying in quality, IPV is a well established function in banks and other financial services organisations using complex financial instruments. Input from IPV functions is essential in the internal control framework in relation to management's financial reporting processes.

Other comments

- Table 2: As Table 2 (starting on page 36) is not an exhaustive list of internal controls that may exist, we believe this should be clearly articulated at the start of the table. This can be achieved by moving the last sentence in paragraph 16 to the end of paragraph 17 and amending it as follows, "*Table 2 describes some internal controls that may exist in an entity that deals win a high volume of financial instrument transactions. This list is not exhaustive*." Also, we believe that the section entitled "Human Resource Policies and Practices" on page 39 would benefit from more clarity because the concept of a "key employee" is subject to considerable judgment. We are of the view that it is equally important for back office staff as well as traders to take mandatory time off from their duties. Further, we believe that the section entitled "The Entity's Control Activities" on page 42 would benefit from noting that the use of process flow charts aids in identifying an entity's controls and lack of controls.

- Paragraph 21: We believe the IAPS would benefit from the addition of the following words to reflect ISA 540, paragraph 8(a), more fully, "*ISA 540 requires the auditor to obtain an understanding of the requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures and any regulatory requirements*".

- The example about OTC transactions given in Table 6 on “An Entity’s Considerations when Using Models in a Valuation Methodology” would benefit from the addition of further details for the purpose of an illustration.
- The completeness, accuracy and existence assertions referred to in paragraphs 46 and 47 should refer to paragraphs 108 and 109 with regard to Master Netting Agreements. Rights and obligations associated with such agreements are critical assertions as there needs to be legal certainty to ensure enforceability. Paragraph 109 should clearly indicate that legal certainty is a requirement for netting.