



By e-mail < Edcomments@ifac.org >

11 February 2011

Our Ref.: C/AASC

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

Dear Sir,

[IAASB Proposed Amendments to the Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements \(Preface\) and Proposed IAPS 1000 Special Considerations in Auditing Complex Financial Instruments](#)

The Hong Kong Institute of Certified Public Accountants is the only statutory licensing body of accountants in Hong Kong responsible for the professional training, development and regulation of the accountancy profession. The HKICPA sets auditing and assurance standards, ethical standards and financial reporting standards in Hong Kong.

We welcome the opportunity to provide you with our comments on the captioned IAASB Consultation Paper for developing guidance relating to auditing complex financial instruments.

We support the proposed plan to clarify the status and authority of the IAPS in the proposed *Preface* and withdrawal of existing IAPSS. In addition, we believe the proposed IAPS 1000 provides guidance on the audit considerations as well as providing educational information. Our comments on the Exposure Drafts are set out in the attachment.

We trust that our comments are of assistance to you. If you require any clarifications on our comments, please do not hesitate to contact me at ong@hki CPA.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/SH/jn

Encl.



ATTACHMENT

**HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' COMMENTS ON
THE IAASB PROPOSED AMENDMENTS TO THE PREFACE AND
PROPOSED IAPS 1000 SPECIAL CONSIDERATIONS IN AUDITING COMPLEX
FINANCIAL INSTRUMENTS**

Comments on Proposals Relating to International Auditing Practice Statements (IAPSs)

1. In general, we support the IAASB's proposal to withdraw the six existing IAPSs.
2. We noted that in respect of the IAPS 1004 *The Relationship Between Banking Supervisors and Banks' External Auditors* and IAPS 1006 *Audits of the Financial Statements of Banks*, the IAASB has proposed to further explore or consider the need for a future project. Whilst we are in support for the proposal, we would encourage the IAASB to consider if the scope should be expanded to financial institutions in general (e.g. banks, insurance companies and securities companies) rather than focusing on banks alone.
3. We support the proposal to clarify the status and authority of IAPSs in the *Preface*. Below are some of our editorial comments for IAASB's consideration:
 - i. We noted the extant collective term (i.e. International Standards or IAASB's Standards) has been deleted in paragraph 1. Hence, there is no "definition" of "International Standards". However, the term is being used throughout the *Preface* (e.g. paragraphs 2, 3, 4, 5, 7, 16, 17 and sub-headers). We would encourage the IAASB to define "International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements" and also consider if "International Standards" is appropriate as "pronouncement" is now used instead of "standards" in the title of the *Preface*.
 - ii. It is not clear what "other pronouncements" in paragraph 2 means.
 - iii. IAASB's Standards in paragraph 3 is now not defined.
 - iv. Practice Statements in paragraph 4 is not defined.
 - v. We noted that in paragraphs 3 and 23 uses the word "should". It is our understanding that the drafting convention adopted for the Clarity project is to use "shall" for ISA requirements. Paragraph 20 of ISA 200 states that "The auditor shall not represent compliance with ISAs in the auditor's report unless the auditor has complied with the requirements of this ISA and all other ISAs relevant to the audit." By using "should" in the *Preface* may create confusion as to whether it is a requirement. We would propose the IAASB to clarify its intention.



Request for Specific Comments on Proposed IAPS 1000

1. Whether the material included in the proposed IAPS is appropriate in light of the proposed status and authority of new IAPSs.

We consider the material in the proposed IAPS appropriate. As currently drafted, it provides background information to enable auditors to have a deeper understanding of complex financial instruments and providing guidance on the audit procedures.

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 believe the balance of material is appropriate as auditors with different levels of knowledge can navigate through the relevant auditing guidance.

3. Whether the proposed form of the IAPS, including the use of two separate sections and shaded tables, enhances its readability.

Due to the complexity of the topic and the aim of ensuring applicability to a wide range of auditors, the level of information could be quite voluminous. Using two separate sections and shaded tables enhances its readability.

4. Whether respondents believe an effective date should be established for the proposed IAPS and if so, what would be an appropriate date would be.

We are of the view that there should be an effective date for the proposed IAPS, say for the next financial year end reporting period, allowing for at least 1 year for translation and implementation. Individual jurisdictions should be allowed to determine a later effective date for the IAPS if they are still in the process of adopting the clarified ISAs.

Other Comments

Below are comments on the drafting of the proposed IAPS 1000 for IAASB's considerations.

5. Paragraph 32 of the proposed IAPS states that "There are likely to be areas of significant risks of material misstatement related to these assertions." While this may hold true in many such cases, it may be useful for the IAPS to include a reminder here that this would only be the case where the auditor believed that the impact of the complex financial statements is material (to avoid creating a misperception that these assertions would always be associated with significant risks where complex financial instruments exist).
6. Paragraph 35 of the proposed IAPS indicates that it may be more "common" to take a controls reliance approach in a financial institution-type environment. It may be helpful to add here that in many financial institution environments or other entities that have trading rooms, it may not be possible to obtain sufficient appropriate audit evidence from substantive procedures alone (for instance due to the volumes of the contracts encountered, or the difficulties associated with instruments not being recorded in the accounting records).
7. With reference to paragraphs 42 to 45, the proposed IAPS states that the auditor may seek to test controls or models around the valuation of financial instruments at an interim date. It may be helpful to include a reminder that even in sophisticated entities, the effectiveness of controls in such areas at an interim date is not always as robust as at the end of the



financial reporting period (when management may be more focused on ensuring the valuations are appropriate).

8. As previously communicated in our submission dated 28 January 2010 on the proposed IAPS at the Consultation stage, we are of the view that there should be more synergy between the International Accounting Standards Board (IASB) and the IAASB, in particular, making references to IASB Expert Advisory Panel's publication on fair value of financial instruments. We would like to highlight some examples where references could be made.
 - Paragraph 77 of the proposed IAPS states that broker or pricing services would likely be considered as management's experts. Despite the qualifying language in the paragraph that when such services are provided on a contractual basis to provide routine pricing data for use in an entity's models they may not necessarily be considered to be a management's expert, we are concerned that this is not sufficiently clear. We believe that this paragraph could be interpreted as stating that when an entity uses a market standard source, such as TOTEM consensus pricing service, or receives a broker quote, then the ISA 500 requirements would apply. Furthermore, there are situations where we believe it is clear that a market data quote using a market standard model, e.g., pricing of a simple cross currency swap using broker quotes on FX and interest rates, or securities with multiple broker quotations with prices in an acceptable range, would not be considered as experts. In our experience, entities in the banking sector obtain multiple broker quotes, wherever possible, and either uses them to validate their own models or to extrapolate a value from the data supplied.

In our view such services are often used as one source of 'data', and the provider of that data is not an expert. However, we do recognise that for other services it may be less clear, for example, where pricing services use complex pricing models in addition to market data to calculate prices of derivatives and some structured products. In a situation where an entity commissioned a third party to provide a unique valuation of an instrument, such as a property valuation, then we would agree that this would fall within the scope of ISA 500.

Further to the above, many pricing services might not actually be experts in this field and there is currently no 'designation' for financial instrument valuation providers to identify those that are considered to be experts.

We would also draw parallels with the guidance issued by the IASB Expert Advisory Panel in its publication "*Measuring and disclosing the fair value of financial instruments in markets that are no longer active*". This guidance, in paragraphs 60-61 and 65-66, tends to support the view that broker quotes and pricing services would not generally be considered management's experts and that the entity can perform an assessment of whether the price is a representationally faithful measure of fair value.

We therefore believe that it would be helpful to clarify, with a cross-reference to the content in paragraphs 66-67, that in the circumstances when broker quotes and consensus pricing services are being used solely to obtain data for input into an entity's own pricing models then such services would not be considered management's experts.

- In paragraphs 86 and 90 of the proposed IAPS there is a reference to testing of inputs and assumptions in scenarios where management or the auditor has used an expert. We believe that independent auditor testing of inputs and assumptions to broker or pricing services is not always practicable or achievable.



Related to our comments on paragraph 77, we note that paragraphs 52, 61-63 and 65-67 of the IASB Expert Advisory Panel guidance states that the entity is required to understand how the valuation has been arrived at and whether it meets the objective of a fair value measurement. Although obtaining information and responses from brokers may prove difficult in some cases, for example, where brokers publish their prices in certain markets free of charge, we nevertheless believe this represents a sensible starting point. Furthermore, as noted in paragraph 65 of the guidance, pricing services may be more willing to share information about its models, when they are engaged on a fee paying basis by clients.

Based on the evidence obtained from such procedures the auditor can then make an informed assessment about the necessity of performing additional procedures to validate specific inputs and assumptions used by such broker or pricing services. Alternatively the auditor may consider performing their own valuation using their own inputs and assumptions and determining whether any discrepancies between the two valuations are within tolerable ranges.

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