THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Our ref: ICAEW Rep 36/09

Jon Grant, Executive Director
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By email

Dear Jon

APB CONSULTATION DRAFT: PRACTICE NOTE 23 (REVISED) *AUDITING COMPLEX FINANCIAL INSTRUMENTS*

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on Draft PN 23 (Revised) *Auditing Complex Financial Instruments* (PN 23) published by the Auditing Practices Board in December 2008.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.

We welcome this revision to PN 23. Complex financial instruments are now ubiquitous and while the current economic climate renders challenges to the audit thereof acute, such instruments are likely remain important regardless of the economic climate. The effort involved in improving draft PN 23 along the lines suggested below is worthwhile in terms of improved audit quality; the document risks failing to meet its objective of providing useful guidance to auditors otherwise.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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Consultation Draft: PN 23 (Revised)

1. **Title and scope**

   We note above that complex financial instruments are now ubiquitous, which means that this document will be more relevant than ever to smaller firms and their clients. An instrument does not have to be very complex or large for this guidance to be relevant. Many smaller firms might, erroneously read the title of the document as meaning irrelevant to them, and only relevant to larger entities such as banks and financial institutions; some very small pension funds for example may be exposed to some very complex instruments. Some mechanism needs to be found - a clear highlighted statement in the introductory material perhaps - to make it clear that the value of some complex instruments may be very low indeed (fixed rate interest rate swaps, for example).

   It is arguable that virtually all financial instruments now display some degree of complexity and that the document should therefore cover all financial instruments (and the word ‘complex’ be taken out of the title) and include a definition or description of financial instruments that excludes simple instruments that function as and have simple characteristics such that they closely resemble cash, debtors or creditors.

   At the every least, the press release accompanying the final publication of the PN should highlight the issue.

2. **Mark to model in illiquid markets**

   To counter the practice in some jurisdictions of the blanket use of emphases of matter where assets that are material to the financial statements are marked to model in illiquid markets, the PN should note that emphases of matter

   - should not be used as a matter of course
   - are only likely to be appropriate in unusual circumstances, where valuations are exceptional in the context of the market as a whole, for example, and that
   - professional judgement should be applied in each case.

   The PN should also point out that while illiquid markets may be an indicator of significant uncertainty, illiquidity is a relative term; in shipping, for example, under normal circumstances there may be just a handful of transactions for a given category in a given year and this does not, of itself, necessarily represent illiquidity.

3. **Going concern issues in illiquid markets**

   While the general existence of illiquidity in the marketplace has in practice been the factor most relevant to going concern uncertainties to date, more could be made of the possible link between the use of complex financial instruments and the adequacy of disclosures relating to liquidity and going concern uncertainties. The possibility of large future losses in respect of complex financial instruments needs to be considered as part of the auditor’s review of liquidity and going concern disclosures. It would be helpful to note that when an entity’s trading strategy uses such instruments or an entity is otherwise unusually exposed to large losses, auditors need to consider the effect of inadequate cash reserves, lines of credit or parental support on the liquidity and going concern status and disclosures of the entity. This is particularly relevant where financial markets are difficult.

4. **Duplication and omission of material**

There is extensive duplication of material between the draft PN and relevant ISAs. The draft PN is lengthy and while it is always possible to justify the inclusion of more material rather than less, for the avoidance of doubt, this document would benefit from an edit with the specific purpose of eliminating inessential duplication of material. More use might be made of cross-referencing. If this leads to the impression of a paucity of coverage in some areas (as it might), consideration needs to be given to the need for additional material explaining the ISA rather than simply repeating the ISA material. Specifically, there might be more material on:

- the complexity of accounting judgements and consideration of the need to engage experts where necessary
- materiality and estimation uncertainty
- professional skepticism
- the special inherent limitations involved in auditing financial instruments.

5. **Considerations when financial markets are difficult and when they are not**

On balance, a separate section on considerations when financial markets are difficult is helpful. However, much of the material in this section might well be incorporated into the main body of the material in order to avoid its loss when the financial markets become ‘slightly difficult’ or when, if current conditions persist, the label ‘difficult’ loses its potency.