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Mr James Gunn  
Technical Director  
International Auditing and Assurance Standards Board  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, NY 10017  
USA  
Dear James

**Proposals Relating to International Auditing Practice Statements (IAPSs):**

**Withdrawal of Existing IAPSs and Clarification of the Status and Authority of New IAPSs**

**Proposed Amendments to the *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements***

**Proposed International Auditing Practice Statement  
IAPS 1000, *Special Considerations in Auditing Complex Financial Instruments*.**

The ICAEW welcomes the opportunity to comment on the proposals relating to IAPSs and IAPS 1000 published by IAASB in October 2010.

The ICAEW 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, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

We are pleased that IAASB is addressing the issue of IAPSs. IAPS 1000 will be of great benefit to firms with less extensive experience in this area and the extended consultation period properly reflects the importance of IAPSs in general and complex financial instruments in particular.

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

Yours sincerely

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## MAIN COMMENTS

### A. Proposals Relating to IAPSs

#### Withdrawal of Existing IAPSs

We agree with the withdrawal all six extant IAPSs. We also agree that IAPSs 1004 on the relationship between banking supervisors and external auditors, and 1006 on the audit of banks, are worthy of revision. IAASB should nevertheless give further consideration to updating IAPSs 1010 on the audit of environmental matters in a financial statement audit and 1013 on e-commerce. Both are relatively short documents at 11 and 25 pages respectively and while the audit of banks is clearly of paramount importance in the current economic conditions, both IAPSs 1010 and 1013 are of much wider application. IAPS 1010 notes that

*Environmental matters are becoming significant to an increasing number of entities and may, in certain circumstances, have a material impact on their financial statements.*

This is more true now than it was in 1998 when the IAPS was issued. There is greater public concern about such matters and legislation has developed reflecting that concern. IAPS 1013 was issued in 2002 and its contents, while fairly basic in the context of mature economies, remain very relevant to developing nations and transition economies. We are pleased to note that reference is made to this in IAASB's recent consultation on its Strategy 2012-14.

We suggest that strong consideration be given to including IAPS 1004 material in the guidance for banks proposed in the IAASB's proposed strategy and work programme. IAPS 1004 is a joint document of the International Auditing Practices Committee (the predecessor of the IAASB) and the Basel Committee on Banking Supervision. Both have approved and published the document and the relationship between banking supervisors and external auditors has clearly not become a non-issue.

#### Development of New IAPSs and Staff Publications

We share IAASB's concerns about the possible proliferation of IAPSs, and in particular their development when non-authoritative staff publications would suffice, although we are also concerned about the possible proliferation of non-authoritative staff publications, many of which have appeared without advance notice. Given that such publications are not accorded full due process, we hope that IAASB will be clearer going forward on the timetable for the production of such material.

Staff publications to date have consisted largely of re-iterations of material in ISAs. These are helpful, but we should be mindful of the fact that more guidance is not necessarily better guidance and we do not believe that staff publications should necessarily be restricted to of re-iterations of ISA material. An appropriate home for *background and educational* material, such as much of the material in proposed IAPS 1000, might be in non-authoritative staff publications, or in an appendix. We suggest that paragraph 6 of the proposed amendments to the *Preface* reflect this.

We agree with most of IAASB's criteria for the development of new IAPSs: that there should be divergent practice internationally, that such guidance should provide practical assistance to auditors, that the need for guidance should be widely acknowledged and that guidance is likely to be useful for the foreseeable future. We think it might be more appropriate however, where *background and informational material is needed, or where the issue extends across a number of ISAs but does not necessitate the development of new requirements*, for consideration to be given to the development of a non-authoritative staff publication, rather than an authoritative IAPS. It is difficult to see why background and informational material needs to be authoritative, and virtually all of the staff publications recently issued consist of material covering issues that extend across a number of ISAs, those ISAs not requiring new requirements.

## Clarification of the Status of New IAPSS

We agree that the status of IAPSS is in need of clarification and with IAASB's proposal that auditors should be *aware of the existence of the IAPSS and have an understanding of IAPSS that may be relevant to the circumstances of the audit*. It is important that readers of IAPSS clearly understand that the status of IAPSS derives from the due process applied to their development. We also agree that IAPSS are not intended to establish new requirements but that auditors are nevertheless expected to determine whether any individual IAPSS is relevant and, if so, obtain an understanding of its content.

It would be very helpful indeed, however, for IAASB to consider the need for, ability of, and mechanisms available to national standard-setters to incorporate IAPSS into national regimes. This is a tricky area as IAPSS are not part of the corpus of ISAs that are being considered for adoption in many jurisdictions where the adoption or adaptation of IAPSS to the national environment on a piecemeal basis - possibly replacing extant national second tier guidance, as in the UK – is likely. An IAASB position on the need for adoption of IAPSS where ISAs are to be adopted and possible methods for achieving this might help in national deliberations on the subject. The proposed status of IAPSS is likely to result in a significant amount of new guidance needing to be read and understood.

***It is critical that the status, purpose and authority of IAPSS is clearly articulated. The status IAPSS derives from the due process applied in their development. The fact that they establish no new requirements is not relevant to the fact that IAASB considers it essential to understand those that are relevant when conducting an ISA audit. IAPSS as defined, like application material, need to be considered by regulators as part of the broader corpus of ISA material to be referenced or adopted in legislation or elsewhere, as an ISA audit cannot be completed without them. This is problematic in the EU and in the UK. It might be less critical if IAASB adopted a comply or explain approach, as for APB Practice Notes.***

***It is also important for a clear distinction to be made between the status, purpose and authority of application material in ISAs on the one hand, and of IAPSS on the other, if such a distinction exists. In the minds of many, there is parity of status between current grey letter ('application') material in ISAs and the content of IAPSS.***

***The proliferation of and lengthiness and complexity in IAPSS must be avoided. It would be ironic if, having clarified the ISAs, the issues of length and complexity re-appeared in other IAASB pronouncements such as IAPSS. Proliferation might be curbed if the criteria IAASB has suggested in the Explanatory Memorandum for the development of IAPSS (a need for guidance internationally, no new requirements etc.) were embedded in the Preface.***

We strongly agree that IAPSS should have no associated documentation requirements and for this reason we believe that paragraph 23 of the proposed amendments to the *Preface* should be unequivocal in making this assertion. Otherwise, there is a risk that regulators will (perhaps not unreasonably) seek to impose a documentation requirement by association, on the grounds that all other authoritative material published by IAASB has associated documentation requirements. We agree that the appropriate home for the wording regarding the status of IAPSS should be the *Preface*.

## Proposed Amendments to the Preface

We note above that paragraph 23 of the proposed amendments to the *Preface* should be unequivocal in asserting that IAPSS create no documentation requirements. We also suggest above that paragraph 6 of the proposed amendments to the *Preface* reflect our belief that one suitable category of staff publications is background and educational material. Paragraphs 23 and 24 should also be clear about the fact that the authority of IAPSS derives from the due process applied in developing them.

In the UK, auditors should be aware of and consider Practice Notes applicable to the engagement. Auditors who do not consider and apply the guidance included in a relevant Practice Note should be prepared to explain how the requirements of standards have been complied with. We consider this to be broadly equivalent to the proposed requirement for auditors to determine whether any IAPSS is relevant to the circumstances of the audit and, if so, to obtain an understanding of its content. UK Practice Notes are described as being *indicative of good practice*, rather than as promoting good practice as proposed for IAPSS, and they *assist auditors in applying standards to particular circumstances and industries* rather than constituting interpretive guidance providing practical assistance to professional accountants in implementing ISAs, as proposed for IAPSS. Given that IAPSS

are to create no new requirements, it might be appropriate for softer wording, nearer to that used in the UK, to be considered.

We note the use of the word 'should' in a number of places in this context. The word 'shall' might be better as it implies the imperative intended.

## **B. IAPS 1000 *Special Considerations in Auditing Complex Financial Instruments***

### **Placement and Description of Material**

We note in our main comments above on the withdrawal of IAPSs and the development of new IAPSs that we share IAASB's concerns about the possible proliferation of IAPSs, and in particular their development when non-authoritative staff publications would suffice. We also note that staff publications, which to date have consisted of helpful re-iterations of material in ISAs, should not necessarily be restricted to such re-iterations.

Proposed IAPS 1000 is notable for its length and, while we are pleased that all of the relevant material is in one place, it is proposed that the status and authority of IAPSs is enhanced and we are concerned that the nature and volume of the material therein, particularly background material, may be unwieldy at best and, at worst, inconsistent with its proposed status. While complex financial instruments are clearly critical to some audits, and guidance thereon requires some status, a useful home for some of the background material might be either in an accompanying non-authoritative staff publication, or an appendix. This would enable users to more clearly differentiate between authoritative and non-authoritative material. At present, there appears to be a mix of such material in both sections of the proposed IAPS.

The Explanatory Memorandum explains that section I of the document is background material, and also that the shaded tables in sections I and II are to highlight background material. The shaded material in section I thus appears to be background material to background material, and to be out of place in section II which is not supposed to contain background material. The background material is sufficiently extensive throughout to interrupt the flow of the rest of the material.

### **Complex Financial Instruments**

We noted in our response to APB when it issued PN 23, that:

- complex financial instruments are now ubiquitous, which means more relevant than ever to smaller firms and their clients and instruments do not have to be very complex or large for the 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), and that 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
- it is arguable that virtually all financial instruments now display some degree of complexity and that the definition or description should therefore cover all financial instruments, excepting simple instruments that function as or have simple characteristics such that they closely resemble cash, debtors or creditors, and that the word 'complex' be taken out of the title.

The definition in paragraph 5 of the proposals currently under consideration appears to exclude simple instruments but we continue to have reservations about the use of the term *complex* in the title for the reasons noted above. The title should properly include something like, *financial instruments other than very simple financial instruments*. While this lacks elegance, ensuring that the document is read by its intended audience, and accuracy, should trump stylistic considerations.

### **Specialists and Experts**

We noted in our comment letter on the October 2009 Consultation Draft that there might be more material on matters including consideration of the need to engage experts where necessary, professional skepticism, and the special inherent limitations involved in auditing financial instruments. While the material on management's experts in paragraph 73 *et seq.* is helpful, we remain concerned that there is insufficient material on specialists or on the need for auditors to use experts and the manner in which they should be used. There are a few scattered references to the auditor's expert (footnotes 10 and 30, and paragraphs 31, 33, 85 and 93) and no references to specialists. This is an important and difficult area in practice, not least because of the differing documentation requirements for specialists and experts, and the classification of the large number of people working with and for large firms in this area. We believe it is worthy of further consideration by IAASB.

### **Inactive Markets**

We are pleased to note that Table 7 refers to considerations when markets are inactive which is more appropriate than the October 2009 Consultation Draft which referred to considerations when markets are *difficult*, although we note the possibility of dysfunctional behaviour in markets giving rise to issues other than inactivity and would not object to the material being included in the main body of the IAPS, as we suggested in our comment letter on the Consultation Draft.

It seems likely that the UK's Auditing Practices Board will update the UK's Practice Note 23 in the light of the IAPS.

## DETAILED COMMENTS

### **IAPS 1000 *Special Considerations in Auditing Complex Financial Instruments***

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

We support the underlying objective of the proposed IAPS, which is to promote consistency in practice and to share good practice. Overall, we agree with the detailed guidance on audit considerations set out in the ED. The content provides direction in key areas and examples of common areas of risk and issues that often arise, but does not appear to impose any additional requirements. Nevertheless, there is much background material that we believe might be housed outside the IAPS, as noted elsewhere in this letter, and we believe IAASB should give serious consideration to this given its proposed requirement for auditors to determine whether any individual IAPS is relevant and, if so, to obtain an understanding of it.

SMEs increasingly use complex financial instruments we therefore strongly support the proposed scope of the ED. We agree with the exclusion of areas such as hedge accounting, recognition and de-recognition as they are matters for accounting standard-setters to address rather than IAASB.

Our few specific comments are as follows:

paragraph 37 – we do not believe that the existence of a treasury function necessarily indicates a high level of understanding of complex financial instruments

paragraphs 77 and 90 – it would be helpful if it were made clearer that broker or pricing services cannot function as management's experts and that auditors cannot always test the inputs and assumptions they use.

#### **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 note that auditor reporting issues have not been dealt with, partly on the basis that a Staff Audit Practice Alert deals with some going concern issues. Some consideration should be given to reporting issues because:

- the scope of the Staff Alert is narrow
- the Staff Alert does not have the status of an IAPS
- the description of IAPSs in proposed paragraph 23 of the Preface includes the following:

*...addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.*

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

We note the need to avoid complexity in our comments above on the status of new IAPSs. We also note above that the Explanatory Memorandum explains that section I of the document is background material, and that shaded tables in sections I and II are to highlight background material. The shaded material in section I thus appears to be background material to background material, and to be out of

place in section II which is not supposed to contain background material. The background material is sufficiently extensive throughout to interrupt the flow of the rest of the material.

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

We support the inclusion of an effective date in the interests of clarity in the current regulatory environment but time will be required for firms, including smaller firms, to integrate this extensive guidance into their audit methodologies and to provide training where appropriate..

***Special Considerations in the Audit of Smaller Entities***—Respondents are asked to comment whether, in their opinion, material addressing considerations in the audit of smaller entities is sufficient and appropriate in the IAPS.

References to smaller entities within the document can be found in Tables 2 and 4, and paragraphs 33 and 73. Some of these references are negative and point out problems but are less than helpful in resolving them. For example, the following reference in Table 2 is a non-sequitur, which would greatly benefit from some explanation as to its implications:

*Specific issues that can arise with respect to complex financial instruments include...information systems, in particular for smaller entities, not having the capability or not being appropriately configured to process financial instrument transactions, especially when the entity does not have any prior experience in dealing with complex financial instruments. This may result in an increased number of manual transactions.*

***Special Considerations in the Audit of Public Sector Entities***—Respondents are asked to comment whether, in their opinion, special considerations with respect to public sector entities have been dealt with appropriately in the proposed IAPS.

We have no comment.

***Developing Nations***—Recognizing that many developing nations have adopted or are in the process of adopting the International Standards, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in using the proposed IAPS in a developing nation environment.

We note elsewhere in this response concerns about the length of this document. This may cause particular problems for developing nations.

***Translations***—Recognizing that many respondents may intend to translate the final IAPS for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed IAPS.

We have no comment.