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Dear Mr. Gunn

Proposals relating to IAPSs - Withdrawal of existing IAPSs and Clarification of the Status and Authority of New IAPSs; Proposed IAPS 1000, Special Considerations in Auditing Complex Financial Instruments

The European Banking Authority (EBA)[1] welcomes the opportunity to comment on the exposure draft containing the above proposals relating to International Auditing Practice Statements (IAPSs). The heads of banking supervisory authorities and high level representatives of central banks of the European Union are represented in EBAs Board of Supervisors.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality audit practices supporting high quality corporate reporting which is a crucial element of market confidence and discipline. This is particularly relevant to financial instruments – a pervasive feature of banks' activities, risks and reporting. Accordingly, our review of the exposure drafts is from this perspective.

We support the objectives underlying the proposals relating to the withdrawal of existing IAPSs and the clarification of the status and authority of new IAPSs. However, we have concerns about the lack of clarity provided by the proposed amendments to the Preface as set out in the exposure draft.

In our view, the content of the draft IAPS 1000 will provide important guidance to auditors of entities that transact in complex financial instruments. We in particular welcome a clear separation of IAPS 1000 into the educational material and the audit guidance, so that it is clear which parts of IAPS 100 have authoritative status.

[1] The EBA has officially come into being as of 1 January 2011 and has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS).

However, we believe there should be a greater focus in the guidance on providing practical assistance to the auditor rather than extensive explanatory material covering management activities. We also have concerns about potential gaps in its scope as well as some suggestions regarding specific content. These are set out in the Appendix.

Our comments were coordinated by our Expert Group on Financial Information (EGFI), and especially by its Subgroup on Auditing, which is chaired by Patricia Sucher, from the UK FSA. If you have any questions regarding our comments, please feel free to contact the chairman of EGFI, Mr. Didier Elbaum from the French Autorité de Contrôle Prudentiel (+33 1 4292 5801) or Ms. Sucher (+44 20 7066 5644).

Yours sincerely

Thomas Huertas

Alternate Chair, European Banking Authority

Appendix

Withdrawal of existing IAPSs and clarification of the status of new IAPSs

With respect to certain existing IAPSs, we agree that the practice statement on derivative financial instruments needs a comprehensive re-work, and we provide detailed feedback on this in the section below. Furthermore, in the wake of the financial crisis, the interaction between the auditor and banking supervisory authorities has become a focal point, so we welcome any efforts to refresh the guidance in this respect, alongside various initiatives in place by national regulators.

As a banking supervisory authority, our primary concern in the context of this IAPS is the quality of bank audits, and in particular the audits of those banks that are seen to be systemically important. In this context, we would encourage the IAASB to further develop its consideration of future replacement of IAPS 1006 – *Audits of the financial statements of banks*.

With respect to the criteria for the development of new IAPSs, we consider the objective of promoting high quality audit practice to be primary, and therefore agree that Practice Statements should be developed based on the need to address divergent audit practice (for example in complex areas such as impairment), when this has the potential to put the quality of financial reporting at risk. The EBA encourages the IAASB to continue to consider the need for new IAPSs in the context of a clearly articulated hierarchy of auditing literature it promulgates ranging from authoritative standards and application guidance, to Practice Statements, and staff publications.

We note the approach taken with respect of the obligation attached to an IAPS is that the auditor has to (1) determine whether the IAPS is relevant and then (2) obtain an understanding of the IAPS. Though we see a need for auditors to read and understand ISAs and IAPSs as part of their professional training, we therefore note that, as laid out in the exposure draft, auditors may determine that specific IAPS may not be relevant to the performance of particular audits. On the other hand, as banking supervisors, we would expect that IAPS 1000 would always be relevant to the performance of bank audits. If auditors of financial institutions would deem IAPS 1000 as not relevant, they should be required to document and explain this.

We agree that the status and authority of IAPSs needs to be clarified and that this should appear in the Preface which explains the hierarchy as just described (although our longer term preference is for inclusion in ISA 200 for the reasons specified in the explanatory memorandum on page 11). We also agree that Practice Statements should not impose additional requirements on auditors beyond those mandated by ISAs. Notwithstanding this, we feel the proposed amended wording addressing the authority attaching to Practice Statements (in paragraph 23 of the proposed amendments) remains unclear. In particular, there seems to be an obligation imposed on the auditor by the statement that "Auditors *should* determine whether any IAPS is relevant….", but then once this determination has been made there is merely the suggestion that "an IAPS *may assist* the auditor…." (emphasis added).

Whilst we are not of the view that IAPSs should carry the same weight as the ISAs, we believe that if the intention of IAPSs is to provide practical assistance to the auditor in complying with ISAs, an onus should be placed on the auditor to consider and act upon such guidance. We would see IAPSs as having the same authority as the application material in the ISAs. When auditors apply the ISA requirements in the area of complex financial instruments, they should use the IAPS to 'apply the requirements properly' (para 19, ISA 200). To emphasize that the use of the relevant IAPS should be the norm, and that if auditors do not apply the relevant IAPS, they should explain why, a comply or explain rule should be stated. We believe this could be achieved by adding some language to the description of the status and authority of the IAPSs such as, 'An auditor who does not consider and apply the audit guidance included in a relevant IAPS should be prepared to explain their rationale including how, nonetheless, the requirements in the ISAs have been properly applied.'

IAPS 1000, Special Considerations in Auditing Complex Financial Instruments

Scope

Complexity of financial instruments is a fluid concept which is often reflective of the economic environment as well as the inherent characteristics of the instrument. Given this, we agree that the IAPS should not attempt to define complex financial instruments, thereby limiting its applicability. Nor do we believe that any attempt should be made to 'catalogue' the types of financial instruments that could fall within the scope of this practice statement, for the same reason. We are supportive of the framework adopted in paragraph 7 of the proposed amendments which describes characteristics which could make the accounting for and audit of financial instruments complex.

As a minor point, the description in paragraph 12 of the purposes of using complex financial instruments is incomplete and somewhat inaccurate. Specifically, the description of 'trading' includes reference to long term investment returns, which is more akin to investment, which could be a third listed purpose. Also, while trading often is for the purpose of benefitting from short term market movements, it can sometimes be to facilitate client order flow.

We see merit in maintaining a degree of industry neutrality in the IAPS, in order to ensure broad and consistent application. We also agree with the separation of audit guidance from guidance on the application of accounting standards (as noted in the explanatory memorandum, page 24), and thereby focusing on the former in the IAPS. The reference to ISA 540 requirements in respect of auditing estimates, specifically the requirement to consider the applicable accounting framework, provides a useful linkage between accounting requirements and the consequences on auditing approaches.

However, certain accounting requirements give rise to particular challenges in the audit of fair values and revenue recognition for financial instruments, and should therefore be considered in more detail in the IAPS. For example, the accounting requirements for the recognition of 'day 1' profit require an analysis of the observability of inputs to valuation models, which then drives revenue recognition. Entities have varying levels of internal controls in place to address this financial reporting risk and as a result, the audit approach requires judgment and such approaches may diverge. Consequently, the IAPS should address how the auditor should go about assessing whether or not these complex accounting requirements have been met. Further guidance in this area should not be viewed as guidance on interpreting and applying the accounting standards, but rather, assistance in auditing the outcome of the application of an accounting standard to promote consistent application of auditing standards. A similar argument can be made regarding the audit of analyses supporting derecognition decisions.

Effective date

The effective date for application of this IAPS must allow auditors enough time to adequately understand its contents, determine its relevance, and build into their audit planning process as necessary, for a given audit cycle. Since this is a complex audit area which may require change to existing audit approaches as a result of implementing this Practice Statement, we would support a set future date for its application with the option to adopt early.

Content

In general, we believe that the balance of material in the IAPS is too heavily weighted towards descriptions of the processes that management have in place for managing their transactions in financial instruments, rather than the provision of specific guidance on what procedures an auditor should consider performing. We set out below some specific areas where we feel the IAPS could elaborate more. This is aligned to areas where auditors are likely to spend a significant amount of time in auditing an entity with complex financial instrument transactions.

ISA 540

Auditors may face challenges when applying the requirements of (clarified) ISA 540 to evaluate estimates in light of the outcomes of previous estimates. This requirement may be straightforward for large, discreet positions in instruments where sale proceeds can be compared to a previous fair value estimate (for example, a private equity holding or commercial real estate whole-loan), but are much more challenging in the context of a more 'fluid' and voluminous trading book comprised of exotic instruments with complex fair value calculations. Guidance in this area would be useful.

Models

The use of valuation models by an entity often poses a significant audit risk, and therefore receives a commensurate level of attention in the IAPS (including the background material in Table 6 which broadly reflects market practices and the list of audit considerations on page 74). However, in the interest of ensuring applicability across entities of varying levels of complexity and sophistication as well as promoting sound and consistent audit judgments, more guidance could be provided on the development of the auditor's approach to performing audit procedures on models. The aforementioned list of audit considerations applies after the auditor has ascertained the circumstances under which models are employed and determined which models are material enough to test. However, a risk-based judgment needs to be made on determining which models to test. This judgment should take into account an assessment of which models pose the highest level of risk of inappropriate valuations (often expressed by banks in their valuation methodology as 'model-risk'), and areas of a firm where there is potentially over-reliance on models to produce financial statement valuations.

Once the auditor has determined which models to test, there are a variety of possible audit strategies available. The auditor may determine an audit strategy which heavily relies on controls and model governance and may focus on the reasonableness of inputs and outputs (and not the 'inner workings' of the model). Alternatively, the auditor may (possibly with the aid of a specialist) adopt a substantive 're-performance' approach to testing the model. An acknowledgement that different approaches are valid in different circumstances accompanied by some guidance in these audit decisions would be a welcome complement to the existing content. The proposed guidance should also clarify that auditors have the obligation, as part of their testing of an entity's valuation model, to consider the appropriateness of the validation processes, which should be performed periodically by the entity to ensure that used models are suitable for their intended use at all time.

Own credit risk

In many financial institutions, particularly those with significant issuances of structured notes, the valuation of the entity's own credit risk often has a highly material and volatile impact on reported profit or loss. Paragraphs 71 and 72 rightly point out that this is a significant area of management judgment. Given this significance, it would be useful to expand this guidance with reference to the fact that there are multiple valuation approaches in this area (for example observing the entity's own bond spreads, or comparable corporate bond or derivative spreads if the entity's instruments are not observable) and the auditor must evaluate the appropriateness of management's approach, taking the potential for management bias into account. Furthermore, given that multiple businesses and instruments in issue may give rise to this significant number, it would be useful to point out the risk associated with the compilation and mechanics behind the calculation, which make it prone to error.

Fair value hierarchy

The 'fair value hierarchy' is a relevant framework for disclosing financial instruments, but it can also be a useful tool for auditors in assessing the levels of audit risk attributed to different classes of financial instruments. Therefore, we believe its prominence in the IAPS is warranted. However, the hierarchy is articulated in the IAPS in terms of the observability of the *inputs* to instruments' fair values (as in the IASB's exposure draft on fair value measurement), but not at the level of the instrument itself (e.g. a level 2 instrument can have a combination of level 2 and 3 inputs). The categorisation of the instruments into the different levels of the hierarchy involves significant management judgment (for example, judgment in interpreting what is unobservable, and whether such inputs are significant to the overall fair value of the instrument) and drives important disclosures. However, the appropriate categorisation of the instruments into the different levels is also an important audit consideration. Therefore we believe that more guidance to assist the auditor in evaluating these judgments would be beneficial.

Information technology

The IAPSs refers to the relevance of information technology ('IT') controls to an audit of financial instruments, but we believe that this should receive more attention given the amount of focus this should receive by an auditor of an entity that has multiple systems and automated controls. This should include discussion of automated business controls (e.g. system interfaces, auto-calculations) as well as IT general controls (e.g. access and change management).

In addition to the above areas where we feel more auditor-oriented practical guidance should be provided, we set out below several other areas that are important to an audit of financial instruments, that should be more prominent in the IAPS.

Professional scepticism

We believe that the concepts of professional scepticism in paragraphs 22 to 24 should be specifically linked to the consideration of management bias (mentioned multiple times in paragraphs 81 to 88). There is likely to be a strong linkage between the level of the auditor's professional scepticism and the auditor's assessment of management bias. Currently, the document only refers to the linkage between complexity and scepticism. The requirements in respect of management bias are, of course, already set out in ISA 540, but could usefully be brought to life in this context.

Governance and the control environment

Within the control environment considerations set out in Table 2, reference is made to competence and expertise of management, as well as participation by those charged with governance. We believe this is a key issue within the governance of institutions that make extensive use of complex financial instruments and should be stressed more prominently in the IAPS. We acknowledge that ISAs already require an assessment of the control environment, making use of the COSO framework including a consideration of the competence and effectiveness of those charged with governance. However, it may be beneficial to refer to the bodies of guidance promulgated by various international bodies, including BCBS, IMF, OECD and CEBS[2], in order to put this element of the audit in the context of complex financial instruments.

Functions in the control environment

Table 2 also usefully sets out various functions an auditor should expect to see in place at an entity in the context of the control environment relevant to financial instruments. Following this, in Section II, the planning considerations could build on this and discuss the levels of management and functions the auditor should consider interacting with and making enquiries of in order to assess risk and plan the audit. This is particularly relevant in the audit of a financial institution with a front, middle and back office, where there is a risk that the auditor focuses almost exclusively on the latter, to the detriment of a solid understanding of the business and consequent audit risks in the first two.

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[2] All CEBS publications can be assessed under the following link: www.eba.europa.eu