



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

150 York Street, Suite 200, Box 90, Toronto, Ontario M5H 3S5
Tel 416.913.8260 Fax 416.850.9235 www.cpab-ccrc.ca

January 31, 2011

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017
USA

Dear Sir:

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

The Canadian Public Accountability Board (CPAB) is pleased to comment on the International Auditing and Assurance Standards Board's (IAASB's) exposure draft, Proposals Relating to International Auditing Practice Statements.

CPAB is Canada's independent audit regulator responsible for overseeing audit firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into the application of auditing standards and how they might be improved.

Withdrawal of Existing IAPSs

CPAB agrees with the IAASB proposal to withdraw the six existing IAPSs to create a clean slate approach to the development of new IAPSs. The clean slate approach is necessary to clarify the status and authority of the IAPSs going forward and remove guidance that is out of date or inconsistent with the text of the clarified International Standards on Auditing (ISAs).

While CPAB supports the withdrawal of the extant IAPSs, we believe the material in IAPS 1006, *Audits of the Financial Statements of Banks* is important, although dated, guidance. Therefore, CPAB would strongly encourage the IAASB to initiate a project on this subject as soon as possible and to explore how the relevant material could be retained in some form until replacement guidance is developed.

Factors to be Considered in the Development of New IAPSs

CPAB generally supports the proposed criteria outlined in the explanatory memorandum for evaluating future proposals to develop a new IAPS. The IAASB may want to further explore how it might expedite the future issuance of authoritative guidance in response to urgent matters. CPAB believes the ever changing and complex economic and regulatory environments that entities subject to audit operate in may make it necessary to develop guidance more quickly than a project to revise a standard.

Clarification of the Status and Authority of New IAPSs

CPAB supports the proposal to clarify the IAPSs as authoritative guidance and to clearly distinguish the IAPSs from other non-authoritative guidance such as Staff Audit Practice Alerts or Staff Question and Answer publications.

CPAB believes the auditor's obligation to consider the IAPSs should be contained in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, to ensure auditors are aware of all authoritative material, in addition to the ISAs, when considering what guidance may be relevant to the conduct of the audit. The proposal to include the auditor's obligation to consider the IAPSs as a requirement in the Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements is inappropriate as the adoption of the Preface is not required for a member country to adopt the International Standards issued by the IAASB (International Standards).

In addition to the concerns with the placement of the auditor's obligations, CPAB is concerned the required response, once the auditor has determined the IAPS is relevant to the circumstances of the audit, is not sufficiently clear in simply stating the auditor should "obtain an understanding of its content". For the required response to be meaningful obtaining an understanding of the IAPS must include assessing the impact on the audit and therefore an explicit statement to that effect should be added to clarify the requirement. Given the authoritative status of the IAPSs and the extensive due process followed by the IAASB in developing IAPSs we believe there should be a substantive obligation on the auditor to consider the impact of IAPSs on the audit and if applicable to improve the audit approach.

The substantive obligation on the auditor to consider the impact of an IAPS relevant to the audit should include a requirement for an auditor who does not apply the guidance in an IAPS to document how he or she complied with the objectives and requirements of the ISAs relevant to the circumstances of the audit addressed by the IAPS. This documentation requirement would

be similar to that which currently exists in Canadian Auditing Standards for Assurance and Related Services Guidelines.

Given the clarification of the IAPSS as authoritative guidance and the clean slate approach to the development of new IAPSSs, efforts should be made to amend the IFAC Statement of Membership Obligations related to International Standards, Related Practice Statements and Other Papers Issued by the IAASB to require member bodies to use their “best endeavours” to incorporate IAPSSs into their national standards as they are required to do for International Standards. CPAB believes member bodies who have adopted International Standards should be required to adopt all of the authoritative guidance and the withdrawal of all extant IAPSSs provides a unique opportunity to incorporate such a requirement.

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

CPAB believes the adoption of the proposed IAPS will represent a significant enhancement of the existing auditing guidance. Complex financial instruments pose a significant risk to practitioners, and the potential risk of audit failure is heightened. Accordingly, CPAB supports the need for additional guidance on auditing complex financial instruments.

We have responded below to the questions posed by the IAASB:

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

Overall, we believe that the material included in the proposed IAPS is appropriate. We have provided comments for the Board’s consideration in the appendix to this letter with regard to: Issuer’s own credit risk; Controls over valuation; Substantive testing; Valuation testing; and Professional Scepticism and Fraud Risk.

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 that the balance of material included in the proposed IAPS is suitable and appropriate in an international context.

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

We believe the use of distinct sections for background information about complex financial instruments and audit considerations relating to complex financial instruments as well as the use of shaded tables to provide further background material are appropriate. The level of background material provided in the exposure draft will help promote

greater understanding and context for the guidance included in the proposed practice statement.

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.

It is important for auditors to have sufficient time to consider the guidance in the IAPS and incorporate its content into their training programs, audit methodologies and work plans. CPAB believes that the use of an effective date provides a clear timeline for auditors to complete these tasks and so should be incorporated into the proposed IAPS. Given the current timetable for finalizing the proposed IAPS is September 2011 it is probably not practicable for it to be effective for the audits of fiscal periods ending on or after December 31, 2011 but CPAB strongly encourages the IAASB to establish the earliest possible effective date thereafter while also encouraging early adoption.

CPAB appreciates the opportunity to provide input to the IAASB on the proposed IAPS. We would be pleased to discuss further any of the comments noted.

Yours very truly,



Brian Hunt, FCA

Chief Executive Officer

cc. Mr. Greg Shields, CA
Director, Auditing and Assurance Standards
The Canadian Institute of Chartered Accountants

Appendix: Further comments on the material included in the proposed IAPS

Issuer's own credit risk

We note the discussion in paragraphs 12, 71 and 72 regarding consideration of credit risk. Although the accounting model for the issuer's own credit risk is the subject of an IASB exposure draft, we believe the proposed IAPS should consider guidance to practitioners in this area. CPAB notes that the accounting and hence auditing considerations with respect to the incorporation of the issuer's own credit risk in the valuation of financial instruments are often complex. The incorporation of the issuer's own credit risk is often a significant management estimate that, under many common approaches, requires the application of management judgment in the determination of the exposure profiles of instruments subject to the issuer's own credit risk, as well as the credit risk profile of the issuer itself.

We believe that the inclusion of background information including factors to consider for both the exposure profiles of the financial instruments and the issuer's credit risk profile would be beneficial for practitioners. Such matters may include a discussion of the simulation models often used by management to determine the exposure profiles for financial instruments as well as the impact of factors such as collateral, margin arrangements or credit rating triggers on those profiles. In addition, the background discussion of the issuer's own credit risk profile should consider issuers that do not have actively traded credit default swaps.

Further guidance on appropriate auditing procedures that may be applied should be included in the proposed IAPS. This area is complex, and in many jurisdictions, relatively new. It would be beneficial for practitioners to have specific auditing guidance in this area, in particular as practitioners may not encounter exposure profiles of financial instruments in other areas. Such guidance should consider the use of experts when testing management's exposure profile models and in assessing the appropriateness of the entity's own credit profile. Guidance should also consider testing trade data input into the exposure models, testing of collateral, margin or other factors that affect the exposure profiles.

Controls over valuation

We note table 2 includes discussion of management controls and specific issues that may arise with regard to valuation. We also note the reference to segregation of duties regarding monitoring positions and valuing complex financial instruments.

We believe that further background discussion on management controls related to valuation would be beneficial to practitioners. Such information may include a discussion of an independent model vetting function, an independent price or input vetting function, and controls

related to resolution of collateral or margin disputes. In addition, further guidance should consider the practitioner's assessment and testing of controls including the assessment of management's own experts, sources of management inputs, and considerations relevant to determining whether it is appropriate to place reliance on internal audit in testing these controls.

Substantive testing

We note paragraphs 41, 42 and 45 refer to substantive testing performed with respect to complex financial instruments, discussing dual-purpose testing and timing of substantive tests.

We note that the proposed IAPS does not discuss considerations for practitioners with respect to the selection of items for the testing described in the above paragraphs. The selection of items for substantive testing is an area of significant practitioner judgment and is often complex when an issuer's financial instrument population contains instruments with widely varying complexity, nature and level of inputs, and risk profiles. In certain circumstances, the application of a monetary sampling framework to populations of complex financial instruments would be impractical. We believe that further guidance would be helpful to practitioners. Such guidance should consider the instruments' risk profiles when selecting complex financial instruments for substantive or dual-purpose testing. For example, if sampling primarily considered a characteristic such as notional amount or fair value, the selection for testing may not sufficiently address the valuation risk for the population.

We also note that it is frequently impractical for practitioners to conduct detailed vetting of models used by management. In such circumstances and where practitioners are also unable to independently revalue a transaction due to the lack of the practitioner's own models, the practitioner may need to conduct other substantive tests to determine the appropriateness of the valuations determined by management's models. Further guidance to practitioners in this area would be appropriate, and should consider procedures such as developing expectations of the valuation from management's model based on changes in inputs to the model, or analyzing management's model into components and conducting procedures on the components thereof.

Valuation testing

We note paragraphs 68 and 70 discuss the necessity to understand the source of broker quotes and quotes obtained from pricing services. The proposed IAPS and the explanatory memorandum accompanying the proposed IAPS discuss management's evaluation of whether the prices are derived in a manner that is consistent with the financial reporting framework, and explains how the investigation of pricing disparities between different providers can help management determine which price is the most reasonable.

We agree that an understanding of the valuation technique, whether determined internally or provided by an external pricing service, is important in testing valuation of complex financial instruments. However, in practice, it may be difficult to obtain this level of detail from these brokers and pricing services, especially for smaller entities or entities with fewer of these instruments. Models and other detailed information used to compile these quotes are often proprietary. In addition, while it is true that a price based on a recent transaction that is a forced sale likely does not meet the definition of fair market value, in practice it can be difficult to identify a forced sale (see paragraph 70 first bullet). This level of transparency can be difficult to obtain. While we note the IASB Expert Advisory Panel has previously issued guidance, we believe that guidance to practitioners to address these circumstances should be incorporated into the proposed IAPS and should consider corroboration of quotes used with other information available including analysis of the quotes received against available indices.

We also note the discussion in table 7 with regard to level 3 inputs. The discussion refers to current or recent transactions in similar instruments. We note that in certain circumstances, the availability of current or recent transactions in similar instruments would permit the use of a level 2 measurement classification.

Professional Scepticism and Fraud risk

We believe the discussion on professional scepticism included in paragraphs 22 to 24 would be enhanced by also discussing management bias. Further, in the discussion on fraud risk in paragraph 27, where a meaningful portion of an entity's net income is derived from the use of complex financial instruments, fraud risk incentives may extend beyond the traders to senior management. Particular fraud risk factors may exist around certain trigger levels within individual financial instruments or limit levels, regulatory or otherwise, on portfolios of financial instruments. It would be appropriate to include a discussion of these additional factors.