



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

March 21, 2011

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

Subject: International Auditing and Assurance Standards Board (IAASB) October 2010 Exposure Draft for a proposed International Auditing Practice Statement (IAPS) entitled “*IAPS 1000, Special Considerations in Auditing Complex Financial Instruments.*”

This letter provides the U.S. Government Accountability Office’s (GAO) comments on the IAASB’s proposed practice statement regarding special considerations in auditing complex financial instruments.

We agree with the intent of this guidance, which is to provide background information to the auditor regarding special considerations when auditing complex or derivative-type financial instruments, and we believe that this is a positive step in establishing guidance that will help auditors understand the special considerations involved in auditing complex financial instruments. In addition, this guidance is well-timed to assist the international audit community as the use of complex or derivative-type financial instruments becomes more prevalent.

Responses to Specific Questions

The board is seeking views on the following questions related to the content of the proposed IAPS. We provide the requested comments below.

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

We agree that the material included in the proposed IAPS is appropriate in light of the proposed status and authority of new IAPSs. The proposed IAPS 1000 clarifies the purpose of the IAPS, imposes no new requirements beyond those described in the ISAs, and will assist auditors in understanding the applicability of the relevant IAPS.

2. Is the balance of material included in the proposed IAPS appropriate in light of its purpose of assisting a wide range of auditors on an international basis?

In general, we agree that the balance of the material included in the proposed IAPS is appropriate, because it is written at a sufficiently high level to provide useful clarifications for a wide range of auditors.

3. Does the proposed form of the IAPS, including the use of two separate sections and shaded tables, enhance its readability?

We agree that using two separate sections, one providing background information about complex financial instruments and the other on audit considerations related to complex financial instruments, is a practical way of addressing the needs of the broadest group of auditors and enhances the readability of the document. We have concerns, however, about the use of shaded tables in this IAPS.

Although the purpose of the shaded tables is to enhance the readability and highlight background material, the length and breadth of several of these tables interspersed within the guidance on audit considerations related to complex financial instruments may detract from the readability of the proposed IAPS. The IAASB might want to consider moving these tables to an appendix to improve the cohesion of the guidance in the body of the IAPS while separately retaining background material that many readers would find useful.

To further improve the readability of the IAPS 1000, we suggest the board consider organizing the guidance and related background material around the major audit phases such as planning, risk assessment, internal control, substantive testing, and presentation and disclosure as was done in Practice Note 23.¹ We believe audit guidance arranged in a sequence that would be familiar to most auditors would improve its usefulness.

4. Should an effective date be established for the proposed IAPS and, if so, what would be an appropriate date?

The effective date for the IAPS 1000 guidance should be immediate, because it relates to existing ISAs.

Other Comments

Controls Related to Complex Financial Instruments

Paragraph 17 of IAPS 1000 provides examples of key elements of process and internal control related to an entity's complex financial instrument transactions. In the case of complex financial instruments and agreements, we think it advisable that the guidance emphasize the need for separation of functions between front office trading and back office support. We suggest that you add to the fourth bullet of paragraph 17 under segregation of duties wording to that effect so that it would read:

¹UK's Auditing Practices Board (APB) Practice Note (PN) 23 (Revised)

- “Segregation of duties between those investing in the complex financial instruments and those responsible for valuing such instruments; as well as, in the case of larger operations, the segregation of functions between front office trading and back office processing and confirmation operations;...”

Assessing and Responding to the Risks of Material Misstatement –

Paragraphs 32 – 34 of IAPS 1000 discuss overall consideration of risks related to complex financial instruments and the auditor’s assessment of those risks. Given the high risk of fraud and material misstatements related to assertions on completeness, valuation, and presentation and disclosure,² it is important that the auditor obtain a thorough understanding of the internal control environment and assess the design and implementation of controls even if the auditor decides to take a substantive approach. Accordingly, we suggest integrating a reference to the control assessment procedures in ISA 315 in paragraph 34 so that it would read:

- “The auditor’s assessment of identified risks at the assertion level in accordance with ISA 315³ includes evaluating the design and implementation of internal control. It also provides a basis for considering the appropriate audit approach for designing and performing further audit procedures in accordance with ISA 330 ...”

Procedures related to Completeness, Accuracy, and Existence of Complex Financial Instruments

Paragraph 47 of IAPS 1000 provides examples of procedures that may provide audit evidence to support the completeness, accuracy, and existence assertions. For complex instruments and agreements, asking the counterparty to also confirm the absence of any side agreements in external confirmations may provide audit evidence. ISA 505 *External Confirmations*, specifically paragraph A1, addresses the auditor’s use of external confirmation procedures “... to confirm the absence of certain conditions, such as a ‘side agreement’.” However, before undertaking confirmation procedures, auditors use professional judgment, based on risk and materiality, to determine the most effective procedures for obtaining sufficient appropriate audit evidence, including whether or not to use confirmation procedures in specific circumstances. Accordingly, we recommend adding to the second bullet of paragraph 47 a reference to ISA 505 and to the importance of professional judgment in determining whether to use confirmation procedures, as follows:

- “External confirmation of bank accounts, trades, and custodian statements and, if applicable, the existence of any side agreements.⁴ This can be done by direct confirmation with the counterparty (including the use of bank letters), where a reply is sent to the auditor directly. Alternatively this information may be obtained from the counterparty’s systems through a data feed. Where

² ISA 315, par. A111 (b) & (c)

³ ISA 315, par. 13 and A66 – A68; par 15 -17 and A79-A80

⁴ ISA 505, *External Confirmations*, paragraphs 7(a) and A1.

this is done, controls to prevent tampering with the computer systems through which the information is transmitted may be considered by the auditor in evaluating the reliability of the evidence from the confirmation. External confirmations, however, do not provide adequate audit evidence with respect to the valuation assertion, nor do they supplant auditor judgment by presuming that confirmation procedures are the most effective audit procedure to address the risk of material misstatement.”

Internal Audit Function

Internal auditors are not limited to communicating their findings to management. It may also be appropriate to communicate their findings to those charged with governance.

Paragraph 111 discusses the role of the internal audit function, and states that an area where the work of the internal audit function may be particularly relevant is in conducting regular evaluations to provide management with assurance that financial instrument activities are being properly controlled. Communicating findings to those charged with governance is another area where work of the internal audit function may be particularly relevant. Accordingly, we recommend that you add the consideration of reporting to “those charged with governance” to the first sub-bullet of the sixth bullet of paragraph 111, as follows:

- “Conducting regular evaluations to:
 - Provide management and, where applicable, those charged with governance with assurance that financial instrument activities are being properly controlled; and ...”

Considerations Specific to Public Sector Entities

During the recent worldwide financial crisis, unprecedented government intervention in private markets occurred. As a result of these interventions, governments acquired unique financial instruments that posed valuation challenges, including some with related parties or with parties in which the transactions were not at arms length. Since these unique financial instruments often have increased risk of material misstatement and the potential need for additional disclosures, we encourage the inclusion of a brief discussion of the potential challenges in auditing complex financial instruments held by public sector or governmental entities. Such a discussion could be included as a consideration specific to public sector entities, similar to those in the International Standards on Auditing (ISAs).⁵

Auditor Reporting on Significant Matters Related to Complex Financial Instruments

The recent financial crisis has highlighted the difficulty in valuing complex financial instruments in certain environments. The guidance should clarify that, in such circumstances, the auditor might determine that it would be appropriate to discuss significant information related to the valuation of complex financial instruments,

⁵ ISA 540, par. A11; ISA 330, par. A17; ISA 315, par, A21, A 35, A65, & A 113.

such as a discussion of estimation uncertainty, in the auditor's report as an emphasis of a matter paragraph or other-matter paragraph, as discussed in ISA 706. This discussion could include guidance on instances when an auditor might report on significant matters related to auditing an entity's complex financial instruments.

Suggested Additional Guidance on Testing Valuation Models

The guidance could be improved by clarifying that in assessing risk and determining the nature, timing, and extent of substantive procedures, the auditor may consider the significance or materiality of specific inputs, calculations, and assumptions in relation to the outputs of valuation models. This would include a consideration of the sensitivity of the model to changes in such inputs, calculations, and assumptions.

In addition, we recommend that you consider adding as a third sentence to paragraph 35 "where model outputs are difficult to review analytically, an expectation that controls over data inputs and data processing are operating effectively also may be more common" so that it would read:

- The nature and extent of internal control that exists at an entity influences the auditor's determination of the nature, timing and extent of tests of controls and substantive procedures. An expectation that controls are operating effectively may be more common when dealing with a financial institution with well-established internal controls, and therefore controls testing may be an effective means of obtaining audit evidence. Where model outputs are difficult to review analytically, an expectation that controls over data inputs and data processing are operating effectively also may be more common.

We appreciate the opportunity to comment, and we encourage the IAASB to develop additional guidance as conditions and stakeholder feedback warrant.

Sincerely yours,



James R. Dalkin
Director
Financial Management and Assurance

Cc: Prof. Arnold Schilder
Mr. James Gunn

