



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

January 21, 2010

Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017
United States

Dear Sir

Re: **IAA comments on the IAASB Consultation Paper on *Auditing Complex Financial Instruments***

In response to the request for comments on the Consultation Paper on *Auditing Complex Financial Instruments*, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by the IAA's Committee on Insurance Accounting. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the chairperson of that Committee, Sam Gutterman, or any of the other members of the Committee. The IAA will be pleased to develop these ideas further with you.

Yours sincerely

Yves Guérard
Secretary General

[Attachment:](#) IAA comments

**A Commentary on the
CONSULTATION PAPER ON AUDITING COMPLEX FINANCIAL INSTRUMENTS
Released by the International Auditing and Assurance Standards Board: October 2009**

International Actuarial Association

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty-two Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The Full Member associations of the IAA are listed in an Appendix to this statement. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries. The IAA appreciates the opportunity to provide comments on this IAASB exposure draft.

IAA Due Process

These comments have been prepared by the IAA's Committee on Insurance Accounting. Our comments are written from the perspective of actuaries involved in financial reporting for insurers around the world, with an emphasis on measurement of insurance liabilities and reinsurance assets. Our members are involved in both the preparation of financial statements and the auditing of financial statements. The members of the committee are listed in an Appendix to this statement. It has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA's official web site.

Overall Comments

We support the development of guidance on auditing financial instruments. We believe that such guidance will enhance the effectiveness of audits of many entities, including insurers that invest in many types of, often complex, financial instruments. We also believe that the paper will prove to be useful in developing guidance for auditing of insurance contracts when a uniform standard for financial reporting of insurance contracts is adopted. In fact, much of the guidance included could be adapted to guidance in areas other than the audit of complex financial instruments.

Our specific comments on the consultation paper are found below in our responses to the specific questions raised.

Comments regarding specific exposure draft questions

Question 1: *Do you agree with the IAASB's overall approach for revising IAPS 1012, in particular the usefulness of the APB's work as a starting point for the revision of an international auditing practice statement?*

IAA Comment: We applaud the Board for taking advantage of existing national guidance. We find the APB is useful as a starting point for the revising IAPS 1012 and, in fact, we believe the modification to the Practice Note will not be extensive.

Question 2: *What are respondents' views as to the overall structure and content of the Practice Note? In considering this question, respondents are asked for views about the level of detail of the APB's Practice Note, including the length and flow of the document, and its suitability in an international context.*

IAA Comment: We find the Practice Note generally to be appropriate in structure and content and suitable in an international context. We have some suggestions for improvement, which we provide in our responses to the specific relevant questions.

Question 3: *If respondents think the Practice Note is insufficient, in what areas should the IAASB consider including additional guidance in revising IAPS 1012? Specific examples as well as the rationale for a particular suggestion would be helpful.*

IAA Comment: We have several suggestions for your consideration in the development of a revised standard. Our suggestions are based on how the revised standard might be an improvement to the Practice Note and are not based on a review and critique of IAPS 1012.

The Practice Note relates only to the fair value measurement of financial instruments. However, the revised standard could be expanded somewhat relatively easily to apply to all measurement attributes including, for example, amortised cost. Some additional attention would need to be made, including where appropriate,

- identification and separation of embedded derivatives;
- documentation as to whether embedded derivatives are, or are not, closely related to the host instrument;
- impairments; and
- if the IASB adopts an accrued loss model for amortised cost, estimation of the effective yield after accounting for expected losses, with proper controls.

We found only one mention of embedded derivatives in the Practice Note, and none in the Concepts Paper. We believe that special note should be made of controls around the identification and valuation of embedded derivatives, especially when the host contract is not a financial instrument.

The practice note refers to IAS 1 and disclosure of “other major sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment in the carrying amount of assets and liabilities within the next financial year.” We hope that reporting entities and auditors would not limit their disclosures only to uncertainty that can cause material adjustment within the following year. There should also be assessment and disclosure of possible adjustment beyond the next year.

Question 4: *Are there currently any national standards or guidance in your particular jurisdiction that should also be considered by the IAASB in revising IAPS 1012?*

IAA Comment: As an international organization, we do not represent any particular jurisdiction. Nonetheless, we believe that it is generally appropriate to survey applicable standards from around the world, especially those from jurisdictions that have significant capital

markets. This review can make the development of standards more efficient, since the Board will have the benefit of the insights already garnered in the development of national standards. The Board will also have the opportunity to incorporate best practices into the international standard.

We also note that the attribute that that financial statements or items are “true and fair” or “fairly stated” is not one that is globally applied. In some jurisdictions, the reference instead is to conformity with financial reporting standards.

Question 5: *Is the Practice Note clear on what is meant by the term “complex financial instruments”? If it is not, how could the definition and illustrative examples be improved, bearing in mind the evolving nature of these instruments?*

IAA Comment: We believe that, rather than being concerned about the clarity of the term, the Board should focus on audit guidance that relates to any financial instrument that is scalable to the circumstances, i.e., appropriate not only to the complexity of any particular financial instruments, but also to the variety of financial instruments, the frequency of trading and the other factors that contribute to the challenges of keeping accurate records and of proper valuation.

Question 6: *Is the guidance included in paragraphs 9-12 of the Practice Note helpful in explaining its applicability to audits of entities of all sizes? If not, should such guidance be deleted or expanded in revising IAPS 1012; if so, how?*

IAA Comment: Yes, we find this guidance helpful. In fact, it underscores the views we expressed in our response to the preceding question regarding the applicability of the standard. In other words, it is generally applicable and the nature of the extent of audit procedures is a function of the risks involved. Hence, the standard should not be written in a manner that emphasizes the size of the entity or that suggests that the standard does not apply to simple financial instruments, but rather that the audit procedures are designed to address the risks of material misstatement. In our view, the Practice Note is generally well written in this regard and requires only care with respect to phrasing to avoid leaving unintended impressions. For example, the standard should not refer to *complex* financial instruments in its title, but only to financial instruments.

Question 7: *Throughout the Practice Note, examples of how the guidance can be applied in a range of entities – from smaller entities to larger financial institutions – have been included. Do respondents believe the guidance is adequately balanced, or would a revised IAPS 1012 be more helpful if focused at a different level?*

IAA Comment: We find the guidance to be appropriate and do not have any suggestions for improvement.

Question 8: *Many of the considerations described in the Practice Note can also be applied to simpler financial instruments. Would it be more appropriate in revising IAPS 1012 for the*

guidance to be developed to apply to all financial instruments rather than limiting it to complex financial instruments?

IAA Comment: Yes, it would be more appropriate for the standard to apply to all financial instruments. See our responses to Questions 6 and 7.

Question 9: *Are the types of risks described in paragraph 59 of the Practice Note understood across a number of industries and applicable in an international context?*

IAA Comment: In our experience as actuaries involved in financial reporting for insurers all around the world, we find the types of risks are commonly understood. We would add to the list of valuation risks the category of risk commonly referred to as parameter risk, which is the risk that assumptions or inputs to models are not appropriate. Parameter risk differs from model risk in that model risk refers to the appropriateness of the model and parameter risk refers to the appropriateness of the inputs to the model.

Question 10: *Is the guidance in paragraphs 64-84 (particularly related to information systems, control activities, and monitoring of controls) helpful for auditors in obtaining an understanding of controls for a financial statement audit? Is the guidance helpful for audits of entities that have smaller portfolios of complex financial instruments?*

IAA Comment: Yes, the guidance is helpful. We would add some items to the controls that should exist around the use of models. For example, there should be standard procedures for the development, review and approval of inputs, whether inputs are based on market observable information or not. There should also be analytical reviews and reasonability tests of results of models to corroborate the reasonableness of results.

Question 11: *Is the guidance on substantive procedures in paragraphs 105-108 of the Practice Note helpful to auditors? Are there other procedures that should be considered in revising IAPS 1012?*

IAA Comment: We suggest that the standard should discuss the possibility of substantive testing as a means of benchmarking valuation methods. Even in an environment that is demonstrably tightly controlled, a certain amount of substantive testing in the form of calculations to reproduce prices can help the auditor understand the valuation models and how they change from time to time in way that cannot always be achieved from review of documentation alone. In our experience, benchmarking testing sometimes reveals systemic errors in models.

Question 12: *Are there additional issues or best practices relating to the auditor's application of the audit risk standards that have been noted that should be included in revising IAPS 1012?*

IAA Comment: Our suggestions for improvements are in our responses to the preceding questions.

Question 13: *Is the additional guidance included in the Practice Note helpful for auditors in obtaining sufficient appropriate audit evidence in relation to complex financial instruments?*

IAA Comment: Yes, the additional guidance is helpful. We appreciate the inclusion of guidance on auditing the selection of the model. Too often in the past, measurement standards and audit standards have bypassed the design or selection of models and have focused almost entirely on setting and auditing inputs to the models.

Question 14: *Is the additional guidance relating to the valuation assertion applicable to most complex financial instruments? Are the concepts in this section easily understood and relevant in an international context?*

IAA Comment: We believe the guidance is applicable to most financial instruments, whether complex or not. We also believe that the concepts in this section are sufficiently understandable and that they are relevant in an international context.

We are somewhat concerned with the language in paragraph 110 of the Practice Note that relates to residual uncertainties. This paragraph suggests that adjustment to valuation results may be needed to reflect residual uncertainties. We believe that this is a legitimate concern, and we have already noted parameter risk as an uncertainty that may contribute to these considerations. At the same time, we encourage the Board to draft the auditing standard in a way that does not allow the reader to infer that an adjustment for prudence or conservatism in the estimate is appropriate *per se*. The adjustment, if any, should be one that the entity believes that market participants would make. In certain market conditions, market participants are not as wary of the residual uncertainties and the amount of adjustment for these uncertainties may in fact be small or nil.

Question 15: *Would it be helpful to include more generic guidance describing concepts such as broker quotes, the different types of pricing services that may be used, and other forms of evidence and cite examples of how this information is typically gathered and in what particular circumstances?*

IAA Comment: Since we are primarily concerned with valuation by the use of models, we do not comment on broker quotes or pricing services.

Question 16: *Is the guidance on the use of models, from both a preparer and auditor perspective, sufficient? If not, what further guidance could be added and why?*

IAA Comment: We believe the revised standard would benefit from discussion on the development and audit of non-observable inputs. Non-observable inputs may rely, in part, on observable prices or other data, in which case guidance on the appropriateness of this data and the relating auditing should be similar to the guidance on observable inputs. Because inputs that are non-observable often require significant judgment on the part of the preparer, there should be guidance on the documentation of the process for making, reviewing and approving the judgmental decisions. In particular, there should be guidance on changes in non-observable inputs and the strength of evidence that must be produced by the entity to support its decision to change the inputs.

Question 17: *Is the Practice Note sufficiently clear that the issues relating to valuation and the types of risks involved in financial instruments apply equally to financial assets and financial liabilities or should more guidance be added about financial liabilities?*

IAA Comment: We do not see that valuation issues between financial assets and financial liabilities are different. However, the guidance should mention that if financial reporting standards on the measurement of financial assets, are in some ways, different from those for financial liabilities, that the accounting policies should be appropriate to the instrument and its characterization as an asset or as a liability.

Question 18: *Are there additional issues or best practices relating to the auditor's need to obtain sufficient appropriate audit evidence that have been noted that should be included in revising IAPS 1012?*

IAA Comment: As we suggest in our response to Question 11, we believe that some substantive testing of valuation models is helpful even in a strong control environment. The testing enhances the auditors' understanding of the models. It can also be a part of the testing of the effectiveness of controls.

Question 19: *Is the guidance included in the Practice Note on disclosures helpful?*

IAA Comment: The guidance is helpful. We make a suggestion for improvement in our response to Question 20.

Question 20: *Is more guidance needed on the audit of disclosures? For example, is more guidance needed to address how the auditor would obtain sufficient appropriate audit evidence when the disclosures about risks and uncertainties are qualitative in nature or the information is derived from information systems that are not otherwise used to generate information for inclusion in the financial statements? How should the IAASB deal with these areas in revising IAPS 1012, while ensuring the framework neutrality?*

IAA Comment: We recommend that the guidance regarding disclosures be more integrated into the standard, so that presentation and disclosure is not seen as an adjunct to records and valuations, but rather as an integral part of the financial reporting process and of the audit. The control environment should include presentation and disclosure on an equal footing with other aspects of financial reporting.

Question 21: *Is the guidance included on communication with those charged with governance helpful? Is there scope for adding additional guidance on the auditor's communications with those charged with governance with respect to valuation and control issues that come to the auditor's attention?*

IAA Comment: Overall, we are satisfied with the guidance on communication with those charged with governance. Emphasis on the need for early communications with those charged with governance, for any significant difficulties in the audit, may be appropriate. In addition, we note that observations regarding the entity's use of appropriate risk management expertise would be useful.

Question 22: *Are there best practices relating to auditor's communications with regulators, prudential supervisors and others, for example, where such communication or reporting is required by law or regulation, that should be acknowledged in revising IAPS 1012?*

IAA Comment: We recommend that the Board become familiar with auditors' communications with insurance regulators in the various states of the United States. Some of the practices in the United States related to audits of insurance companies may be helpful to the development of a standard.

Question 23: *Would further guidance on the possible implications for the auditor's report when auditing complex financial instruments be helpful? For example, this could include guidance on the use of Emphasis of Matter paragraphs, Other Matter paragraphs and limitations on the scope of the audit.*

IAA Comment: We believe the focus of the audit should include the adequacy of disclosures, and that the auditor should be expected to bring matters to the attention of the users of financial statements if material to the financial statement that are not sufficiently addressed in the financial statements or in management's discussion and analysis. If there are particular difficulties in the audit, the auditor must decide whether they should lead, for example, to expanded disclosures about uncertainty in estimates or to a qualification of the auditor's report.

Question 24: *Is the use of an Overview section helpful or is such a section duplicative?*

IAA Comment: The Practice Note is fairly lengthy and we expect that the revised standard will be lengthy as well. We believe that an overview section, while not necessary, would be helpful to the auditor. We also believe that drafting an overview section will be useful in reviewing the appropriateness of the organization and flow of the standard.

Question 25: *For the areas noted above, is the level of guidance included in the Practice Note helpful?*

IAA Comment: Generally speaking, it is, although, as noted in our responses to other questions, we believe there are areas for improvement.

Question 26. *Are there any issues that may arise with the Practice Note from a translation perspective?*

IAA Comment: Although we feel certain that issues will arise in connection with translation, we are unable to identify them in advance.

Appendix A

Members of the IAA Committee on Insurance Accounting

Sam Gutterman	Chairperson
David Congram	Co-Vice-Chairperson
Francis Ruygt	Co-Vice-Chairperson
Gunn Albertsen	Den Norske Aktuarforening
Victor Hugo Cesar Bagnati	Instituto Brasileiro de Atuária
Daniel N. Barron	Israel Association of Actuaries
Ralph Sumner Blanchard III	Casualty Actuarial Society
Guy Castagnoli	Association Suisse des Actuaires
Antonella Chiricosta	Istituto Italiano degli Attuari
Alexander Dollhopf	Svenska Aktuarieföreningen
Guillermo Ezcurra Lopez De La Garma	Instituto de Actuarios Españoles
David John Finnis	Institute of Actuaries of Australia
Mark J Freedman	Society of Actuaries
Kavassery S. Gopalakrishnan	Institute of Actuaries of India
Rokas Gyls	Lietuvos aktuariju draugija
William C. Hines	American Academy of Actuaries
Armand Maurice Ibo	Institut des Actuaires de Côte d'Ivoire
Dragica Jankovic	Udru enje Aktuara Srbije
Burton D Jay	Conference of Consulting Actuaries
Jelica Klucovska	Slovenska Spolocnost Aktuarov
Ad Kok	Het Actuarieel Genootschap
Christoph Krischanitz	Aktuarvereinigung Österreichs
Kurt Lambrechts	Association Royale des Actuaires Belges
Yin Lawn	Actuarial Institute of Chinese Taipei
Kristine Lomanovska	Latvijas Aktuaru Asociacija
Brian Joseph Morrissey	Society of Actuaries in Ireland
Yoshio Nakamura	Institute of Actuaries of Japan
Andreja Radic	Hrvatsko Aktuarsko Drustvo
Nithiarani Rajasingham	Singapore Actuarial Society
Thomas Ringsted	Den Danske Aktuarforening
Matthew Christopher Saker	Faculty of Actuaries
Jaanus Sibul	Eesti Aktuaaride Liit
Dieter Silbernagel	Deutsche Aktuarvereinigung e.V.
Pentti Soininen	Suomen Aktuaariyhdistys
Bjarni Thórdarson	Félag Islenskra Tryggingastærðfræðinga
Arseny Timakov	Russian Guild of Actuaries
Charles Vincensini	Institut des Actuaires
Peter Andrew Withey	Actuarial Society of South Africa
Derek John Wright	Institute of Actuaries
Jana Zelinkova	Ceská Spolecnost Aktuárù
Jesús Alfonso Zúñiga San Martin	Colegio Nacional de Actuarios A.C.

Full Member Associations of the IAA

Caribbean Actuarial Association
Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires (Argentina)
Institute of Actuaries of Australia (Australia)
Aktuarvereinigung Österreichs (AVÖ) (Austria)
Association Royale des Actuaire Belges (Belgique)
Instituto Brasileiro de Atuária (IBA) (Brazil)
Bulgarian Actuarial Society (Bulgaria)
Canadian Institute of Actuaries/Institut Canadien des Actuaire (Canada)
Actuarial Institute of Chinese Taipei (Chinese Taipei)
Institut des Actuaire de Côte d'Ivoire (Côte D'Ivoire)
Hrvatsko Aktuarsko Društvo (Croatia)
Cyprus Association of Actuaries (Cyprus)
Česká Společnost Aktuárů (Czech Republic)
Den Danske Aktuarforening (Denmark)
Egyptian Society of Actuaries (Egypt)
Eesti Aktuaaride Liit (Estonia)
Suomen Aktuaariyhdistys (Finland)
Institut des Actuaire (France)
Deutsche Aktuarvereinigung e.V. (DAV) (Germany)
Hellenic Actuarial Society (Greece)
Actuarial Society of Hong Kong (Hong Kong)
Magyar Aktuárius Társaság (Hungary)
Félag Íslenskra Tryggingastærðfræðinga (Iceland)
Institute of Actuaries of India (India)
Persatuan Aktuaris Indonesia (Indonesia)
Society of Actuaries in Ireland (Ireland)
Israel Association of Actuaries (Israel)
Istituto Italiano degli Attuari (Italy)
Institute of Actuaries of Japan (Japan)
Japanese Society of Certified Pension Actuaries (Japan)
Latvijas Aktuaru Asociācija (Latvia)
Lebanese Association of Actuaries (Lebanon)
Lietuvos Aktuariju Draugija (Lithuania)
Persatuan Aktuari Malaysia (Malaysia)
Colegio Nacional de Actuarios A. C. (Mexico)
Association Marocaine des Actuaire (Morocco)
Het Actuarieel Genootschap (Netherlands)
New Zealand Society of Actuaries (New Zealand)
Den Norske Aktuarforening (Norway)
Pakistan Society of Actuaries (Pakistan)
Actuarial Society of the Philippines (Philippines)

Polskie Stowarzyszenie Aktuariuszy (Poland)
Instituto dos Actuários Portugueses (Portugal)
Academia de Actuarios de Puerto Rico (Puerto Rico)
Russian Guild of Actuaries (Russia)
Udruženje Aktuara Srbije (Serbia)
Singapore Actuarial Society (Singapore)
Slovenska Spolocnost Aktuarov (Slovakia)
Slovensko Aktuarsko Drustvo (Slovenia)
Actuarial Society of South Africa (South Africa)
Col.legi d'Actuaris de Catalunya (Spain)
Instituto de Actuarios Españoles (Spain)
Svenska Aktuarieföreningen (Sweden)
Association Suisse des Actuaires (Switzerland)
Society of Actuaries of Thailand (Thailand)
Faculty of Actuaries (United Kingdom)
Institute of Actuaries (United Kingdom)
American Academy of Actuaries (United States)
American Society of Pension Professionals & Actuaries (United States)
Casualty Actuarial Society (United States)
Conference of Consulting Actuaries (United States)
Society of Actuaries (United States)