1999

Comment letters on proposed Statement on Auditing Standards, Auditing Financial Instruments

American Institute of Certified Public Accountants. Auditing Standards Board

AICPA
ISO9001

September 17, 1999

File Ref. Nos. 1120
2405 ✓

To the Auditing Standards Board:

Here are the comment letters received to date on the proposed Statement on Auditing Standards, *Auditing Financial Instruments*.

Name/Affiliation	Location
1. Janice Mueller State of Wisconsin	Madison, WI
2. Kevin Wilson	Tivoli, NY
3. Joy L. Gibson, CPA, Chairman Florida Institute of Certified Public Accountants	Tallahassee, FL
4. Walter J. Kucharski Commonwealth of Virginia	Richmond, VA
5. Vincent J. Love, CPA New York State Society of Certified Public Accountants	New York, NY
6. Jacob A. Azar, CPA, Chairman Massachusetts Society of Certified Public Accountants	Boston, MA
7. Alex L. Suffrin, CPA Society of Louisiana CPAs	Kenner, LA
8. David Dufendach, CPA/ABV Brueggeman & Johnson	Seattle, WA
9. Dr. Douglas E. Ziegenfuss, CPA, Chair Virginia Society of Certified Public Accountants	Virginia Beach, VA
10. Vickie Rauser Legislative Audit Division State of Montana	Helena, MT

11. Debra Hopkins
    Illinois CPA Society — Chicago, IL

12. Claire C. McCaskill
    Missouri State Auditor — Jefferson City, MO

13. Thomas H. McTavish, CPA
    Auditor General, Michigan
    National State Auditors Association — Lansing, MI

14. Richard D. Johnson
    Office of Auditor of State
    State of Iowa — Des Moines, IA

If you have any questions, please call me at 212/596-6032.

Sincerely,

Sherry Boothe
Administrative Secretary
Audit and Attest Standards

Enclosures

cc: Financial Instruments Task Force

#1

State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

JANICE MUELLER
STATE AUDITOR
131 W. WILSON ST., STE. 402
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August 13, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Sherinsky:

We appreciate the opportunity to respond to the exposure draft of the proposed statement on auditing financial instruments. Overall, we believe the draft provides clarification and guidance to the auditor. We believe the additional guidance on the impact of service organizations on auditing financial instruments will be especially helpful for auditors. In our audits, we have found that an understanding of a service organization's internal controls has been critical in performing our audits within acceptable risk levels considering management's increasing reliance on service organizations. We also believe the examples of substantive testing by assertion and the inherent risk considerations provide needed guidance in auditing financial instruments.

We did note two areas in which additional guidance may be helpful to the auditor. First, paragraph 15 discusses the auditor's responsibility in gathering evidential matter to support management's designation of a financial instrument as a hedge. Given the complexities involved with hedge accounting, we believe additional clarification in this area, through the use of examples, may assist auditors in devising effective audit procedures. We also suggest a further interpretation of what auditing procedures would be recommended for inspecting agreements for embedded financial instruments, as noted in paragraph 18. Further guidance or examples of what the inspection of these agreements should encompass would be beneficial.

We appreciate the opportunity to respond. If you have any questions about our comments, feel free to contact Carolyn Stittleburg at (608) 266 –2818, who coordinated our response.

Sincerely,

Janice Mueller

Janice Mueller
State Auditor

JM/ao

Kevin Wilson
26 Pine Street
Tivoli, N.Y 1258
August 22, 1999

#2

AICPA, 1211 Avenue of the Americas
Fele 2405, NYC 10036
Judith M. Sherinsky
RE: SAS 81

Dear Ms. Sherinsky

Thank you for the exposure Draft regarding auditing Financial Instruments. My understanding is that you are addressing options (stock), futures, derivatives, and interest rate swaps, and hedging. I am no expert in these areas and feel some may have some off-Balance sheet risk; I.e; not reflected in the financial Statements. This appears to give the investment an intangible value and may be risky to the entity owning them. A derivative is an investment that derives its value from some other investment. A person should be experienced in auditing these investments as it may be difficult to ascertain the values at certain points in time; such as for quarterly, semi-annual or annual reports. One should have experience with brokerage firms, in my opinion, and with the various markets. This would include the New York Stock Exchange, the American Stock Exchange, the Nasdaq, which is the Over the Counter Market, and also the Chicago Mercantile Exchange and the Chicago Board of Trade. Also, a knowledge of the Mutual Fund, Insurance, and Real Estate Industries. Thanks Again

Sincerely
Kevin Wilson

#3

FLORIDA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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August 19, 1999

Judith M. Sherinsky
Technical Manager, Audit and Attest Standards – File 2405
AICPA, 1211 Avenue of the Americas
New York, NY 10036-8775

RE: Proposed Statement on Auditing Standards
Auditing Financial Instruments

Dear Ms. Sherinsky:

The Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants (the Committee) has reviewed and discussed the referenced "Exposure Draft". In general, the Committee agrees with the Exposure Draft as written and also agrees that because of the wide variety of financial instruments, the expanding accounting requirements to provide fair value information and the increasing tendency for entities to use service organizations, this guidance is needed. The Committee however does have one specific area of concern, and would like to comment as follows:

> The committee is concerned with the use of the terms "Special Skill or Knowledge", "Special Skill" and "Special Knowledge" as discussed in the section entitled THE NEED FOR SPECIAL SKILL OR KNOWLEDGE TO PLAN AND PERFORM AUDITING PROCEDURES. Traditionally the accounting industry has used these terms when defining a specialist[1] and defining an expert[2] and the Committee believes the use of these terms can be construed as expanding the first general standard.
>
> The Committee believes that there are and always have been many areas in which industry or other specialized knowledge is necessary for an auditor to be proficient and that this specialized knowledge is contemplated by the first general standard. Additionally, the Committee believes that the use of the proposed terminology in the Exposure Draft can lead to the preclusion of anyone other than someone deemed to be a "specialist" or an "expert" in a given field from performing the audit function in certain areas. That is, this exposure draft can be interpreted to exclude an otherwise proficient auditor with seasoned judgment in a given industry from performing audit functions relating to areas such as internal controls, service organization functions, computer applications, measurement, etc.

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[1] See AU § 336, USING THE WORK OF A SPECIALIST. Paragraph .01
[2] See AU § 8110, GLOSSARY OF TERMS - Expert

There is consensus by majority vote within the Committee that paragraph number 2 of the Exposure Draft under the section entitled THE NEED FOR SPECIAL SKILL OR KNOWLEDGE TO PLAN AND PERFORM AUDITING PROCEDURES be modified for the reasons stated.

The Committee would also like to point out that paragraph number 3 is redundant with other general industry literature and is not necessary. The Committee, however, does not object to the inclusion of this paragraph as drafted.

As always, the Committee appreciates the opportunity to share our views and concerns and to comment on exposure drafts. Members of the committee are available to discuss any questions you may have about this communication.

Sincerely,

Joy Gibson

Joy L. Gibson, CPA, Chairman
FICPA Accounting Principles and Auditing Standards Committee
P.O. Box 5437
Tallahassee, FL 32314

Task force member coordinating this response
Patrick F. Gannon
Jeff Walraven

#4

COMMONWEALTH of VIRGINIA

Auditor of Public Accounts

WALTER J. KUCHARSKI
AUDITOR

POST OFFICE BOX 1295
RICHMOND, VIRGINIA 23218
(804) 225-3350

August 31, 1999

Ms. Judith M. Sherinsky
Technical Manager, Audit and Attest Standards
File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Sherinsky:

The Auditor of Public Accounts appreciates the opportunity to respond to your exposure draft entitled, Auditing Financial Instruments. We concur with the concept of issuing this statement on auditing standards. This proposed statement expands on the auditing of financial instruments of its predecessor, SAS 81, and provides a more detailed auditing framework for financial instruments covered in FASB 133.

Currently, many of the issues, considerations, and audit procedures identified in the proposed SAS are in use by the Office of the Auditor of Public Accounts. We agree with the emphasis on the following issues in the proposed statement and recommend that the following issues also be addressed in the practice aid and updated as necessary:

- The need for a specialist for purposes of auditing financial instruments, as indicated in SAS 22 and 73.
- Planning and assessing of the risk environment, as well as the importance of auditor judgement.
- The use of a service organization's services and possible audit test work.
- Investments in hedges and hedge accounting as described in FASB 133, since auditing these instruments has not been previously addressed.
- Guidance for auditors without experience in investments to include areas of inherent risk, control risk, and possible test work through the five assertions.

However, we are concerned that the examples provided as recommended test work (in paragraphs 17 to 19 and 29 to 35) could lead to the auditor not performing appropriate test work or overauditing. It would be beneficial for the final statement to note that the examples and recommendations of considerations and test work are not an exhaustive list of requirements. Since the auditor should plan test work considering materiality and the risk of misstatement, simply following the examples provided may result in an inappropriate audit plan.

This proposed statement and the related practice aid address the need for the audit community to keep current with financial instrument accounting and auditing and contains many improvements over SAS 81.

We appreciate the opportunity to provide these comments to you. Should you wish to discuss these items further, please do not hesitate to contact us.

Sincerely,

Walter J. Kucharski
Auditor of Public Accounts

WJK:kva

#5

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new york state society of
NYSSCPA
certified public accountants

September 9, 1999

RE: Proposed Statement on Auditing Standards: ***Auditing Financial Instruments*****--**
File 2405

Judith M. Sherinsky, Technical Manager
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York NY 10036-8775

Dear Ms. Sherinsky,

The New York State Society of Certified Public Accountants is pleased to submit the attached comments on the proposed statement on auditing standards. The Society's Auditing Standards and Procedures Committee developed the comments. We would be pleased to respond to questions you may have about the comments.

Very truly yours,

Vincent J. Love

Vincent J. Love, CPA
Chair
Auditing Standards and Procedures Committee

cc: James L. Craig, Jr., Technical Services
Auditing Standards and Procedures Committee
Accounting and Auditing Committee Chairs

NYSSCPA Committee on Auditing Standards and Procedures

Comments on the Exposure Draft

Proposed Statement on Auditing Standards

Auditing Financial Instruments

The Auditing Standards and Procedures Committee of the New York State Society of Certified Public Accountants (the "Committee") would like to thank the AICPA Auditing Standards Board (the "Board") for this opportunity to comment on the Proposed Statement of Auditing Standards, *Auditing Financial Instruments*.

Overall we believe the Proposed Statement on Auditing Standards, *Auditing Financial Statements* (the "Exposure Draft") is timely and informative.

The following are our comments on the Exposure Draft:

Titles of Existing and Proposed Statement on Auditing Standards (SAS)

The title of SAS 81, *Auditing Investments*, the existing standard that the proposed standard will supercede, clearly states that investments are the subject matter of the standard. "Investment" is a basic accounting term understood by all practitioners. The subject matter of the exposure draft, however, is financial instruments. "Financial instrument" is not a well-known term and practitioners may misunderstand it.

A clearer title for the standard is needed. The proposed SAS uses the definition of a financial instrument from Financial Accounting Standard (FAS) No. 133, which states that a financial instrument is cash, an ownership interest in an entity, or a contract, that is *an obligation* to one party and *a right* to the second party. A financial instrument can be an asset (ownership interest or right) or a liability (obligation).

The proposed SAS should make clear in its title that the standard applies to assets or liabilities that have the characteristics of a financial instrument. A better title would be *Auditing Assets and Liabilities That Meet the Definition of a Financial Instrument.*

The Proposed Practice Aid

In the past when the Board recognized the need for extensive audit and accounting guidance, it issued the guidance in the form of an Audit and Accounting Guide. Accounting for and auditing financial instruments can be complex. The Exposure Drafts guidance on assertions, audit risk, materiality and control risk are essentially the same as in other SASs with little new guidance. Additional and more specific guidance should be included in an Audit and Accounting Guide.

The Need for Special Skill or Knowledge to Plan and Perform Auditing Procedures

¶2. and ¶3. are unnecessary because their subject matter is already included in the authoritative literature. Consider including specific examples and more guidance on this subject in the Practice Aid/Audit and Accounting Guide.

Audit Risk and Materiality

Inherent Risk Considerations

Consider adding a section on the inherent risk relating to the use of estimates in recording many different financial instruments.

Control Risk Consideration

¶8.c. Consider including a reference to the Internet as an electronic means used to transmit, process, maintain, and access information.

¶12. Discusses obtaining evidential matter about a service organization's controls through tests performed by an auditor engaged as part of an examination under SAS 70.

The Board should consider amending AU§ 324 (SAS 70) to reference financial instrument transactions by service organizations as an example of an applicable service since auditors of financial instruments may need to rely on a SAS 70 report.

The Board should consider mentioning in this paragraph the use of tests to evaluate the effectiveness of internal controls, with additional guidance on the timing and types of tests that can be conducted included in the Practice Aid/Audit and Accounting Guide.

Performing Substantive Tests

¶14. states "…valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or on assumptions about conditions expected to exist over a long period. *Accordingly, competent persons could reach different conclusion about estimates of fair values or estimates of ranges of fair values."* (Emphasis added.)

This is an extremely problematic paragraph because it may open the door to justify earnings, ratio, and reserve management. Whether financial instruments are material to the financial statements or not, different justifiable point estimates or ranges for the same future economic events allows management to adjust earnings, ratios, and reserves up or down to whichever estimate best suits their needs. Consider including extensive guidance in this area for the auditor (and financial management) in the Practice Aid/Audit and Accounting Guide. In the alternative, the section of ¶14 referred to above should be stricken.

Existence or Occurrence

¶17. Consider giving examples of analytical review procedures that may be used in auditing financial instruments in the Practice Aid/Audit and Accounting Guide.

Consider adding "reperformance" to the bullet point on "inquiry and observation."

¶18. See comments above under ¶17.

¶24 For investee financial results, consider including a refernce to AU§508.12 when the auditor is relying on the audit work and report(s) of other auditor(s) and the amount involved is material individually or in the aggregate.

There is no mention of auditing the *Presentation and Disclosure* assertion. Consider addressing the audit of management's representation that they have the ability to hold the financial instrument to maturity or for any extended period of time. Currently, this guidance is included in ¶21 for the *Valuation* assertion. Also, consider mentioning (and updating if necessary) the Industry Audit and Accounting Guide for Not-for-Profit entities.

***

The Committee greatly appreciates this opportunity to comment on the proposed interpretations and rulings, and hopes that its recommendations are helpful to the Board.

Massachusetts Society of
Certified Public Accountants, Inc.

#6

105 Chauncy Street • Boston, Massachusetts 02111

August 27, 1999

Judith M. Sherinsky, Technical Manager
Audit and Attest Standards, File 2405
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Exposure Draft - Proposed Statement on Auditing Standards - Auditing Financial Instruments

Dear Ms. Sherinsky:

The Accounting Principles and Auditing Procedures Committee is the senior technical committee of the Massachusetts Society of Certified Public Accountants. The Committee consists of over 30 members who are affiliated with public accounting firms of various sizes, from sole practitioners to international "big five" firms, as well as members in both industry and academia. The Committee has reviewed and discussed the exposure draft on Proposed Statement on Auditing Standards - Auditing Financial Instruments. The views expressed in this comment letter are solely those of the Committee and do not reflect the views of the organizations with which the Committee members are affiliated.

The Committee members would like to express their overall support for the above-mentioned exposure draft.

We appreciate the opportunity to present our comments and thank you for your consideration.

Very truly yours,

Jacob A. Azar

Jacob A. Azar, CPA, Chairman
Accounting Principles and Auditing Procedures Committee
Massachusetts Society of Certified Public Accountants

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COMMENT LETTER #7

Judith:

The attached file contains a response from our Accounting and Auditing Standards Committee on the following exposure draft: Proposed Statement on Auditing Standards, Auditing Financial Instruments.

If you need additional information or have any questions, please feel free to contact me.

Sincerely,

Society of Louisiana CPAs

Alex L. Suffrin, CPA
Committee Staff Liaison

Judith M. Sherinsky
Technical Manager
Audit and Attest Standards
File 2405
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Comments to Exposure Draft

Proposed Statement on Auditing Standards. Auditing Financial Instruments (To Supersede Statement on Auditing Standards No. 81, Auditing Instruments).

Comments submitted by: Accounting and Auditing Standards Committee - Society of Louisiana CPAs.

One committee member submitted the following comments.

1. On pages 12-13, several examples of considerations that might affect the auditor's assessment of inherent risk are given. I have comments about two of these:

a. I fail to see how management's objectives (example one) with respect to the use of a particular financial instrument can affect the inherent risk associated with that instrument. For example, it seems to me that the inherent risk associated with a derivative would be the same whether management engaged in the transaction as a hedge or for speculative reasons.

b. In example three, it seems that the underlying reason for the increased inherent risk is that the financial instrument was not recorded at inception, which just happens to be because no cash was exchanged. I would suggest changing the wording to state that inherent risk may be greater if a financial instrument is not initially recorded.

2. On page 15, paragraph ten excludes the execution by a securities broker of trades initiated by the entity from the entity's information system. However, paragraph nine includes as part of the entity's information system the service of receiving payments from purchasers and disbursing proceeds to sellers for security purchase and sale transactions. In my experience, it is customary to settle all trades through the broker (perhaps very large trades are an exception). My interpretation of paragraph nine is that the entity's auditor would be required to evaluate controls of every broker that simply executed a trade (at management's direction) and facilitated settlement. I am not convinced that this effort is necessary.

3. I noticed that there is somewhat less guidance in the proposed statement regarding investments accounted for using the equity method than in existing standards (SAS 81), although there have been no recent pronouncements related to the equity method. Has the ASB decided that this guidance is unnecessary, or will it be incorporated in the Practice Aid? I don't really object to excluding it, but I am curious about why it was changed.

#8

PROPOSED S.A.S.: AUDITING FINANCIAL INSTRUMENTS

Comments by: David Dufendach, CPA/ABV

Paragraph 14. In situations where "competent persons could reach different conclusions about estimates of fair values" due to the need for subjective judgment, expanded disclosures regarding the valuation process and key assumptions should be required.

Paragraph 30. "Fair value" is a relatively imprecise term. The valuation profession has developed a series of terms that more accurately describe the premises, standards and levels of value. Adoption of this terminology would significantly enhance both auditing procedures and financial statement disclosures.

Paragraph 31. When estimates of fair value are "obtained from third-party sources based on proprietary models or from the entity based on internally developed or acquired models," expanded disclosures regarding such models should be required (see comment re: paragraph 14 above).

Paragraph 34. With respect to valuation models, same comment as paragraph 31.

#9

September 10, 1999

Virginia Society of
Certified Public Accountants
Accounting and Auditing Procedures Committee
5813 Hamlet Road
Virginia Beach, Virginia 23464

Office 757.683.3514
FAX 757-683-5639
E-Mail dziegenf@odu.edu

Judith M. Sherinsky,
Technical Manager
Audit and Attest Standards
File 2405
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Judith:

The Accounting and Auditing Committee of the Virginia Society of Certified Public Accountants would offers the following comments concerning the AICPA Exposure Draft – Proposed Statement on Auditing Standards, "Auditing Financial Instruments."

In general, we believe that this exposure draft is an excellent and comprehensive revision of SAS No. 81, "Auditing Investments." We like the overall organization of the SAS and the additional guidance should prove helpful to practitioners in the field. We anticipate reviewing the practice aid that will be developed to complement this SAS and our endorsement of this exposure draft is predicated on the completeness and clarity of that practice aid.

Our only concern is the use of a nonauthoritative practice aid with an authoritative standard. We feel that some practitioners may not accept the guidance contained in the practice aid. We urge the ASB to consider converting the practice aid into an Accounting and Auditing Guide to give it more authority and clear up a possible source of confusion.

Thank you for this opportunity to comment on this exposure draft and we await the final version of the standard.

Sincerely,

Dr. Douglas E. Ziegenfuss, CPA
Chair

COMMENT LETTER # 10

Subject: Proposed Statement on Auditing Standards, Auditing Financial
Author: MIME:Vrauser@state.mt.us at INTERNET
Date: 9/9/99 7:19 PM

September 9, 1999

Ms. Judith M Sherinsky, Technical Manager
Audit and Attest Standards
File 2405
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Sherinsky,

We appreciate the opportunity to participate in due process for the proposed statement on auditing standards, "Auditing Financial Instruments." Based on our reading of the proposed statement, we believe it provides an adequate, basic framework for auditing the assertions related to financial instruments. We agree with the Auditing Standards Board's belief that combining a SAS with a Practice Aid will enhance its ability to be more timely with audit guidance in an area experiencing constant change.

Sincerely,

Vickie Rauser, Audit Manager
Legislative Audit Division
State of Montana

ILLINOIS CPA SOCIETY & FOUNDATION

#11

September 10, 1999

Ms. Judith M Sherinsky, Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Sherinsky:

The Committee on Auditing Services of the Illinois CPA Society ("Committee") is pleased to have the opportunity to comment on the exposure draft of the "Proposed Statement on Auditing Standards (SAS) titled *Auditing Financial Instruments*. The following comments and considerations represent the collective views of the members of the Committee. The organization and operating procedures of the Committee are reflected in the Appendix to this letter.

SUMMARY

We are in general support of the issuance of the proposed SAS, with suggested considerations.

GENERAL CONSIDERATIONS

Practice Aid Guidance

The Auditing Standards Board (ASB) has indicated that it plans to issue the SAS and the Practice Aid at *approximately* the same time. Although the Practice Aid is nonauthoritative, we believe that the Practice Aid should be issued at *exactly* the same time as the SAS. It is understood that the Practice Aid will be periodically updated to address new pronouncements and new types of investments and related practice issues. However, the ASB has acknowledged that some financial instruments may have extremely complex features (ie. embedded derivatives) that may require similarly complex accounting and auditing considerations. As such, thorough and *timely* practical guidance would be most beneficial to practitioners when implementing this new auditing standard.

Appropriateness of Accounting Policy

SAS 81 states that the auditor should ascertain whether the accounting policies adopted by the entity for investments are in conformity with GAAP. Certain investments require the application of Financial Accounting Standards Board Statements (ie. Nos. 115 and 124), other investments may require the application of the cost or equity method of accounting, and certain entities (ie. employee benefit plans) follow specialized accounting policies. However, this concept of appropriateness of accounting policy is no longer highlighted in the proposed SAS. Perhaps the appropriateness of accounting policy should be clearly spelled out as in SAS 81.

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SPECIFIC CONSIDERATIONS

Presentation and Disclosure

Paragraph 1 presents five broad categories for assertions about financial instruments. The first four assertions are further discussed in detail in paragraphs 17 through 36. However, the fifth assertion, presentation and disclosure, is not address at all. Perhaps direct references should be made to presentation and disclosure guidance, including the nonauthoritative Practice Aid.

Control Risk Considerations

Paragraph 7 presents four examples of considerations that might affect the auditor's assessment of control risk for assertions about financial instruments. The fourth example considers how management *assures* itself that controls over financial instruments are operating as designed. Perhaps a more appropriate consideration would be how management *monitors* itself regarding the design and operating effectiveness of those controls.

Valuation

Paragraph 30 states that assertions about the fair value of financial instruments should be considered in the context of specific accounting requirements, that is, as specified by GAAP, nature of entity, industry in which the entity operates, type of asset or liability, etc. Perhaps a helpful logical link at the end of this paragraph would be a subnote reference to discussions on the general accounting for such, similar to the technique utilized by subnote 10 of paragraph 21.

Sincerely,

Debra R. Hopkins

Debra Hopkins
Chair, Auditing Services Committee, Illinois CPA Society

APPENDIX A

ILLINOIS CPA SOCIETY
AUDITING SERVICES COMMITTEE
ORGANIZATIONAL AND OPERATING PROCEDURES
1999

The Auditing Services Committee of the Illinois CPA Society (the Committee) is composed of nineteen technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to fifteen years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of auditing standards.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of auditing standards. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint.

#12

CLAIRE C. McCASKILL
Missouri State Auditor

September 7, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified
Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Sherinsky:

Enclosed are comments on the proposed Statement on Auditing Standards titled *Auditing Financial Instruments.*

The comments were prepared by Myrana Gibler, Audit Manager, of my office. Please feel free to call Myrana at (573) 751-4213 if you have any related questions.

Sincerely,

Claire C. McCaskill
State Auditor

CCM/bh
Enclosures

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COMMENTS - PROPOSED STATEMENT ON AUDITING STANDARDS,
AUDITING FINANCIAL INSTRUMENTS

We appreciate the opportunity to comment on the proposed Statement on Auditing Standards (SAS) titled *Auditing Financial Instruments*, which will supersede SAS No. 81, *Auditing Investments*. We generally agree that the expanded guidance in the proposed SAS is needed because of the increase in the number and complexity of financial instruments, changes in the accounting and reporting requirements for the instruments, and entities' growing use of service organizations to assist with the management of financial instruments.

Auditors should find the additional guidance on such topics as inherent risk considerations (paragraph 5), determination of whether a service organization's services are part of an entity's information system for financial instruments (paragraphs 8 through 10), and valuation of certain investments (paragraphs 24 through 29) to be very helpful. During our review, we did note that the proposed SAS (e.g., all or parts of paragraphs 6 through 8 and 11 through 13) repeats considerable information from SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit,* as amended by SAS No. 78, and SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*. However, we do not object to this information's inclusion since it may help the auditor relate the audit work on financial instruments to the requirements of the other SASs.

Although we have no major improvements to suggest, we have noted below or on the enclosed draft several suggestions related to the consistency, conciseness, clarity, and editorial quality of the proposed SAS.

paragraph 3 - We suggest the third sentence be deleted. The first sentence, which refers to others outside the firm with the necessary skill or knowledge, is a sufficient introduction to the reference to SAS No. 73, *Using the Work of a Specialist*, in the last sentence.

paragraph 9, second bullet - We suggest the second phrase listed, "Receiving notification of corporate actions," be clarified through one or more examples.

paragraph 30 - We suggest this paragraph be made more concise. For example, the first sentence may not be necessary since the last sentence clearly refers to corroborating assertions about fair value. Also, the second sentence's reference to generally accepted accounting principles specifying the method of determining fair value may not be needed; the fourth sentence on this subject would suffice.

Additional editorial comments were submitted and distributed to the Financial Instruments Task Force members.

National State Auditors Association

#13

September 8, 1999

Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Sherinsky:

On behalf of the National State Auditors Association, we appreciate the opportunity to respond to the exposure draft (ED) of the proposed Statement on Auditing Standards (SAS) entitled, *Auditing Financial Instruments*. Overall, we agree in principle with the proposed guidance and appreciate the AICPA's plan to issue a Practice Aid to provide additional guidance and examples.

This proposed Statement and the related Practice Aid address the need for the audit community to keep current with financial instrument accounting and auditing and contain many improvements over SAS No. 81. The guidance contained in the ED is more comprehensive than SAS No. 81 and will provide more guidance for auditing financial instruments. For example, the specific inherent and control risk considerations provided in paragraphs 5 through 12 will help ensure that auditors consider these important factors when assessing risks. Additionally, the proposed statement's language on the use of service organizations and their impact on the nature, timing and extent of the auditor's substantive tests addresses the increasingly common practice of using service organizations to manage investment activities.

However, we offer the following comments (listed in paragraph order) for the Auditing Standards Board's consideration as it completes this project:

1. Paragraph 9 provides examples of services provided by a service organization that would be part of an entity's information system. Specifically, the second example in paragraph 9 is "Services that are ancillary to holding an entity's investment in debt and equity securities..." The five services listed under this example include "Receiving notification of corporate actions," "Receiving notification of security purchase and sale transactions," and "Maintaining records of financial instrument transactions for the entity."

   We have two concerns with this listing. First, "Receiving notification of corporate actions" is ambiguous. Does the Board intend this to include only actions taken by the financial management staff? Or, would this include

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actions by the entity's board and/or its audit committee? Could this include certain non-financial actions? Second, because "Maintaining records of financial instrument transactions for the entity" is such a comprehensive service, we believe that "Receiving notification of security purchase and sale transactions" is merely part of maintaining those records, and not a separate and distinct service. Therefore, in the final document, we suggest that the Board clarify and, if appropriate, condense the specific services listed in the second example in paragraph 9.

2. Paragraph 15 discusses the auditor's responsibility in gathering evidential matter to support management's designation of a financial instrument as a hedge. Given the complexities involved with hedge accounting, we believe that additional clarification in this area through the use of examples may assist auditors in devising effective audit procedures. These examples may be appropriate for the Practice Aid.

3. We question listing analytical procedures as an appropriate substantive test for existence or occurrence assertions about financial instruments as stated in paragraph 17 of the ED. If there is a specific example that demonstrates an analytical procedure that provides evidence of a financial instrument's existence, we suggest it be parenthetically included. Otherwise, we believe analytical procedures should be removed from paragraph 17.

4. We believe that further guidance is needed for auditing procedures that would be appropriate for inspecting agreements for embedded financial instruments, as noted in paragraph 18. Further guidance or examples of what the inspection of these agreements should encompass would be beneficial. Again, this guidance may be appropriate for the Practice Aid.

5. Pages 18 through 23 of the ED provide guidance for four of the five categories of assertions. However the ED does not provide guidance for evaluating and testing the presentation and disclosure assertion. Therefore, we believe similar guidance should be provided in the final document for the presentation and disclosure assertion.

6. As a general comment, we are concerned that the examples provided as recommended substantive tests (in paragraphs 17 to 19 and 29 to 35) could lead to the auditor not performing appropriate test work or overauditing. It would be beneficial for the final document to note that the examples of substantive tests are not an exhaustive list of requirements; rather, they are simply suggestions. Since the auditor should plan test work considering materiality and the risk of misstatement, simply following the examples provided may result in an inappropriate audit plan.

We appreciate the efforts of the Auditing Standards Board on this project and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Kinney Poynter at (606) 276-1147 or me at (517) 334-8050.

Sincerely,

Thomas H. McTavish

Thomas H. McTavish, C.P.A.
Auditor General, Michigan
President, NSAA

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STATE OF IOWA

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Richard D. Johnson, CPA
Auditor of State

#14

September 9, 1999

Judith M. Sherinsky, Technical Manager
Audit and Attest Standards, File 2405
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

RE: AICPA Exposure Draft on Proposed SAS "Auditing Financial Instruments"

Dear Ms. Sherinsky:

We have reviewed the proposed SAS "Auditing Financial Instruments" and noted no significant issues that need to be addressed. We believe the proposed SAS provides more comprehensive guidance and clarification for auditing financial instruments than is currently available, including better defining the impact of service organizations that help manage financial activities.

If you have additional questions, please contact Marlys Gaston at 515-281-6416.

Sincerely,

Richard D. Johnson

Richard D. Johnson

October 22, 1999

File Ref. Nos. 1120
2405

To the Auditing Standards Board:

Here are the comment letters received to date on the proposed Statement on Auditing Standards, *Auditing Financial Instruments*.

Name/Affiliation	**Location**
15. Jim Petro State of Ohio Office of the Auditor and Frederick Kruse, CPA Assistant Senior Deputy Auditor	Columbus, OH
16. James S. Neubecker, CPA Deputy Auditor General Office of the Auditor General	Lansing, MI
17. Jon A. Wise, CPA, CGFM, Vice-Chair AGA Financial Standards Advisory Committee Association of Government Accountants	Alexandria, VA
18. Henry Rinder, CPA, Chairperson New Jersey Society of Certified Public Accountants	Roseland, NJ

If you have any questions, please call me at 212/596-6032.

Sincerely,

Sherry Boothe

Sherry Boothe
Administrative Secretary
Audit and Attest Standards

Enclosures

cc: Financial Instruments Task Force

#15

STATE OF OHIO
OFFICE OF THE AUDITOR

JIM PETRO, AUDITOR OF STATE

88 East Broad Street
P.O. Box 1140
Columbus, Ohio 43216-1140
Telephone 614-466-4514
800-282-0370
Facsimile 614-466-4490

September 10, 1999

Ms. Judith Sherinsky
Technical Manager,
Audit and Attest Standards
File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Sherinsky:

We are pleased to respond to the Exposure Draft, **Auditing Financial Instruments** (the ED).

The Auditor of State is responsible for auditing over 4,000 entities receiving public money in Ohio. Many of these governments follow GAAP promulgated by the GASB. The Auditor of State follows Generally Accepted Auditing Standards and Government Auditing Standards for these engagements.

We support the requirements of the ED, and concur that this guidance should cover all financial instruments, rather than only securities as were covered by SAS 81. The ED's clarification of investment activities subject to SAS 70 is also useful, since this office has committed considerable effort to complying with SAS 70, and we have previously debated some of these same issues. We also believe the practice aid will help auditors plan more effective audit procedures.

We appreciate the opportunity to comment. If you have questions or comments, please contact me at (614)728-7111.

Very truly yours,

JIM PETRO
Auditor of State of Ohio

Frederick Kruse

Frederick Kruse, CPA
Assistant Senior Deputy Auditor

#16

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

September 15, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Sherinsky:

Auditor General Thomas McTavish would normally respond to the AICPA Auditing Standards Board's (Board) Exposure Draft (ED) of a proposed Statement on Auditing Standards, *Auditing Financial Instruments*. However, because he is currently the President of the National State Auditors Association, he recently responded to this document on behalf of the Association. Therefore, he has asked me to respond on behalf of the Office of the Auditor General (OAG).

The OAG has reviewed the ED, and we agree in principle with the proposed guidance. We do, however, have the following three comments for consideration by the Board in developing the final document:

1. Paragraph 1, on Page 11 of the ED, lists the five categories of assertions and indicates that the proposed Statement "...provides guidance to auditors in planning and performing auditing procedures for assertions about financial instruments that are made in an entity's financial statements." In reviewing the ED, however, we noticed that Pages 18-23 merely provide guidance for four of the five assertions; no guidance is provided to assist the auditor in planning and performing auditing procedures for the 'presentation and disclosure' assertion. Therefore, we suggest that the Board expand the guidance in the final document to specifically address all five assertions listed in Paragraph 1.

2. Paragraph 9, on Page 15 of the ED, provides examples of services provided by a service organization that would be part of an entity's information system. Specifically, the second example in Paragraph 9

is "Services that are ancillary to holding an entity's investment in debt and equity securities..." The five services listed under this example include "Receiving notification of corporate actions," "Receiving notification of security purchase and sale transactions," and "Maintaining records of financial instrument transactions for the entity." We have two concerns with this listing. First, "Receiving notification of corporate actions" is ambiguous. Does the Board intend this to include only actions taken by the financial management staff? Or, would this include actions by the entity's board and/or its audit committee? Could this include certain non-financial actions? Second, because "Maintaining records of financial instrument transactions for the entity" is such a comprehensive service, we believe that "Receiving notification of security purchase and sale transactions" is merely part of maintaining those records, and not a separate and distinct service. Therefore, in the final document, we suggest that the Board clarify and, if appropriate, condense the specific services listed in the second example in Paragraph 9.

3. The first sentence of Paragraph 35, on Page 23 of the ED, begins "Negotiable securities, real estate, chattels, or other property is often assigned..." We suggest that the Board revise this sentence slightly to read "Negotiable securities, real estate, chattels, or other property are often assigned..."

We appreciate the opportunity to comment on the Exposure Draft. If you have any questions, or desire further details on our comments, please contact me or Jon A. Wise, C.P.A., Director of Professional Practice.

Sincerely,

James S. Neubecker

James S. Neubecker, C.P.A.
Deputy Auditor General

c: Thomas H. McTavish

#17

Advancing Government Accountability

September 14, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Sherinsky:

On behalf of the Association of Government Accountants (AGA), the Financial Standards Advisory Committee (Committee) appreciates the opportunity to comment on the AICPA Auditing Standards Board's (Board) Exposure Draft of a proposed Statement on Auditing Standards, *Auditing Financial Instruments*. The Committee, whose members are active accountants and auditors in federal, state, and local government, reviews and responds to proposed standards and regulations of interest to the AGA membership. Local AGA chapters and individual members are also encouraged to comment separately.

The Committee fully supports the provisions of the proposed Statement. It believes that the Exposure Draft is much more comprehensive than Statement on Auditing Standards No. 81 (which will be superseded), and that it will provide the auditor with more detailed guidance for auditing financial instruments.

The Committee does, however, offer the following two comments for consideration by the Board in finalizing the document:

1. Paragraph 9, on Page 15, provides examples of services provided by a service organization that would be part of an entity's information system. Specifically, the second example in Paragraph 9 is "Services that are ancillary to holding an entity's investment in debt and equity securities..." The five services listed under this example include "Receiving notification of corporate actions," "Receiving notification of security purchase and sale transactions," and "Maintaining records of financial instrument transactions for the entity." The Committee has two concerns with this listing. First, "Receiving notification of corporate actions" is ambiguous. Does the Board intend this to include only actions taken by the financial management staff? Or, would this include actions by the entity's board and/or its audit committee? Or, could this include even certain non-financial actions? Second, because "Maintaining records of financial instrument transactions for the entity" is such a comprehensive service, the Committee believes that

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"Receiving notification of security purchase and sale transactions" is merely part of maintaining those records, and not a separate and distinct service. Therefore, in the final document, the Committee suggests that the Board clarify and, if appropriate, condense the specific services listed in the second example in Paragraph 9.

2. The first sentence in Paragraph 21.a., on Page 19, explains that "In evaluating management's intent and ability, the auditor should---Consider whether management's activities corroborate or conflict with its stated intent." Because the example focuses on documentation of management's strategies and sales and other historical activities, the Committee suggests that the Board expand the first sentence slightly to read "Consider whether management's activities corroborate or conflict with its stated intent or written policies."

Again, the Committee appreciates this opportunity to comment on the Exposure Draft. If you have any questions, or desire further details on the Committee's position, please contact me at (517) 334-8060, Ext. 500, at your convenience.

Sincerely,

Jon Wise

Jon A. Wise, CPA, CGFM, Vice-Chair
AGA Financial Standards Advisory Committee

c: Thomas Sadowski, CGFM, AGA National President

NJSCPA
VISION • VALUE • LEADERSHIP • 100 Years and Beyond
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#18

October 12, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards – File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Sherinsky:

The Auditing and Accounting Standards Committee (the "Committee") of the New Jersey Society of Certified Public Accountants ("NJSCPA") is pleased to submit its comments in connection with the proposed Statement on Auditing Standards, "Auditing Financial Instruments" (the "Proposed SAS"). The viewpoints expressed herein, represent the majority of a quorum of members of the committee but are not necessarily those of the full membership of the NJSCPAs.

We have identified below certain issues we would like to bring to your attention.

ISSUE ONE: Paragraphs 2 and 3

Is it necessary to include the section concerning the need for special skills and knowledge? Our profession already has general standards regarding skills and training. It would seem that specifically addressing this issue creates unnecessary litigation exposure. Furthermore, if adopted, additional guidance on obtaining the necessary skills is needed.

ISSUE TWO: Audit Risk and Materiality

The Committee thought this section was well addressed and provided good examples.

ISSUE THREE: Paragraphs 17 and 18

The Committee suggests the inclusion of examples regarding the use of analytical procedures.

We appreciate your consideration of our comments. We would be pleased to discuss our comments with the Board or their staff.

Sincerely,

Henry Rinder / mf.

Henry Rinder, CPA, Chairperson
Auditing & Accounting Standards Committee

HR:cb

c: Paul V. Stahlin, President
Sharon L. Lamont, President-Elect
Merryl A. Richards, Executive Director

#/19

ARTHUR ANDERSEN

Arthur Andersen LLP

33 West Monroe Street
Chicago IL 60603-5385

November 8, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File # 2405

Dear Ms. Sherinsky:

We are pleased to submit our comments on the exposure draft of the proposed auditing standard to supercede the existing Statement on Auditing Standard (SAS) No. 81, titled "Auditing Financial Instruments." We have offered both substantive as well as editorial comments; the latter appear separately in an Appendix to this letter.

Overall Comments

We strongly support the timely issuance of this proposed auditing standard. Derivative financial instruments are widely recognized as valuable tools for risk management and their use will likely continue to grow at a significant pace in the coming years. The issuance of Statement on Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, whose effective date has been deferred to the year 2000, has underscored the need for a corresponding standard on auditing, a need that the proposed SAS No. 81 seeks to fulfill.

We recognize that a non-authoritative Practice Guide will accompany the issuance of this SAS and we have received the available draft Chapters of the Practice Guide. However, we are unclear as to the basis for including guidance in the SAS versus the Practice Guide. Contributing to our confusion is that none of the draft SAS appears to establish a new auditing standard. Nevertheless, as discussed below, we are concerned about some of the guidance in the draft SAS and several omissions in the guidance. We would support a decision by the Auditing Standards Board to only issue a comprehensive Practice Guide. However, if the Auditing Standards Board believes it is appropriate to proceed with the draft SAS No. 81 and issuing the Practice Guide, we expect that revising the SAS in line with the suggestions we have made would give the SAS more substance.

Substantive Comments

ISSUE #1: Auditor's Consideration of Risks Surrounding Derivatives

The proposed SAS No. 81 needs to better describe the major types of risks pertaining to derivatives that the independent auditor needs to consider.

The risks surrounding derivatives are many and need explicit consideration by the independent auditor, for instance, credit risk, market risk, legal risk, and control risk. Moreover, as the *Derivatives—Current Accounting and Auditing Literature* (AICPA, 1994, p.5) notes, derivatives often have special features such as:

--Little or no cash outflows or inflows required at inception.
--No principal balance or other fixed amount to be paid or received.
--Potential risks and rewards substantially greater than the amounts recognized in the statement of financial position.

Derivatives' values also tend to be much more volatile than those of other financial instruments and a complex interaction may subsist between an institution's position in derivatives and that institution's other on- or off-balance sheet positions. These features increase the risk that derivatives in general, and embedded derivatives in particular, may fail to be recognized properly in accordance with SFAS No. 133.

Additional risks in the auditing of derivatives may arise from (1) inaccurate or incomplete confirmations; (2) the auditor's consideration of fraud risk in the context of unauthorized derivatives transactions or deliberate misclassification of securities among the available-for-sale, trading, or held-to-maturity categories (SAS No. 82, SFAS No. 115), and (3) model risk, or the risk of inaccurate estimation and/or reporting of fair value estimates for non-exchange traded derivatives, when highly stylized models are used to make such a determination.

Chapter 4 of the Practice Guide furnishes a detailed description of the risks surrounding derivatives. Accordingly, only a condensed portion of the recommendations below could be incorporated in the SAS itself, with a cross-reference made to the Practice Guide in a footnote.

Issue #1: Recommended changes to proposed SAS

The following general comments adapted from *Derivatives—Current Accounting and Auditing Literature* (AICPA, 1994, p.33) may be inserted under a separate caption:

Environmental Risk Considerations

The risks surrounding derivatives are many and need explicit consideration by the independent auditor, for instance, credit risk, market risk, legal risk, and control risk. Derivatives may be complex and volatile, and it is sometimes difficult to understand their features, risks, and intended uses. These factors increase the risk that derivatives in general, and embedded derivatives in particular, may fail to be recognized properly in accordance with generally accepted accounting principles. Further, accounting issues involving derivatives can be contentious especially because management's intentions may affect the applicable accounting. Instruments' reported financial statement amounts may involve accounting estimates that are based on subjective factors. Those matters may increase audit risk in audits of all financial statements that contain disclosures pertaining to derivatives.

In addition, the following considerations noted on p. 34 (ibid.) may also be included:

The auditor's assessment of factors such as the following may indicate higher than normal audit risk:

--Sudden or rapid growth in derivatives activities
--Significant use of derivatives without relevant expertise within the entity
--High volatility in interest rates, currencies, or other factors affecting the values of derivatives
--Inclusion of embedded options or other complex contractual terms
--Uncertainty regarding the financial stability of a counterparty
--Concentrations of credit risk with one counterparty
--Transactions involving derivatives having thin markets
--Large one-time transactions

--Little involvement by senior management or the board of directors in authorization of significant derivatives activities
--Absence of authorized limits for derivatives activities or noncompliance with such limits
--Failure to adequately segregate duties involving the execution of derivatives transactions from the accounting and internal audit functions
--Dependence on one individual for all organizational expertise on derivatives activities
--Inadequate information to effectively monitor derivatives transactions, including inadequate or untimely information about derivatives values.

These factors should be considered in the context of the complexity and extent of the entity's derivatives activities and the entity's financial statements taken as a whole.

Additional risks in the auditing of derivatives may arise from (1) inaccurate or incomplete confirmations; (2) the auditor's consideration of fraud risk in the context of unauthorized derivatives transactions or deliberate misclassification of securities among the available-for-sale, trading, or held-to-maturity categories, and (3) model risk, or the risk of inaccurate estimation and/or reporting of fair value estimates for non-exchange traded derivatives, when highly stylized models are used to make such a determination.

ISSUE #2: Management's Objectives (Paragraph 5, Bullet 1)

Under the section "management's objectives" a few key issues need comment. Each of these items is an element of inherent risk and thus warrants inclusion under this section.

The accounting treatment adopted for derivatives, including qualifying for hedge accounting under SFAS No. 133, could be subjective and dependent upon management intentions. However, management intentions are not directly "auditable." Absent compliance with SFAS 133 requirements for concurrent designation and documentation of a hedge transaction, management has significant latitude to manipulate earnings, whether by retroactively identifying a hedged item, a hedged transaction, or a method of achieving effectiveness. Fortunately, both to qualify for hedge accounting and to create an "audit trail," detailed documentation requirements including the written designation of a hedge are necessary. The implications of the entity's adhering to detailed documentation requirements imposed by SFAS No. 115 and SFAS No. 133 for "auditability" cannot be overemphasized. (See also discussion in paragraph 21of the proposed SAS No. 81).

Many large companies use an entity-wide approach in assessing the overall risk and the need to engage in derivatives transactions (i.e., the SFAS No. 80, or "macrohedging" approach). This entity-wide, macrohedging approach takes a portfolio view and is significantly different from the microhedging approach or transaction view taken in SFAS No. 133. Accordingly, there exists a "disconnect" between the operational/economic purposes (global treasury risk management; macrohedging) and the accounting purposes (qualifying for hedge accounting by determining hedge effectiveness; microhedging) of derivatives transactions. Auditors need to be aware of the fact that the operational/economic and accounting purposes of engaging in and reporting derivatives transactions may not necessarily be the same.

SFAS No. 133's orientation towards increased fair value reporting may motivate efforts to manage the resulting earnings volatility. Derivatives accounting-driven efforts at earnings management need to be carefully evaluated by the independent auditor to ascertain whether such management efforts are within the bounds of generally accepted accounting principles.

Issue #2: Recommended changes to proposed SAS

Add the following to paragraph 5 "Inherent Risk Considerations" prior to providing specific examples:

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. These considerations could be subjective and dependent upon management intentions that are not directly "auditable." However, the detailed and contemporaneous documentation requirements imposed by generally accepted accounting principles on entities desiring to qualify for hedge accounting, including the written designation of a hedge, would automatically serve as an "audit trail."

Many entities use an entity-wide approach in assessing the overall risk and the need to engage in derivatives transactions. This entity-wide approach is significantly different from the transaction view adopted by the accounting requirements related to derivatives and hedging activities. Accordingly, auditors need to be aware that under certain conditions the operational purposes (global treasury risk management) and the accounting purposes (qualifying for hedge accounting by determining hedge effectiveness) of derivatives transactions may not be the same, complicating documentation requirements. Management must attempt to reconcile the two approaches in the process of achieving its global risk management objectives.

The accounting for derivatives and hedging under generally accepted accounting principles is oriented towards increased fair value reporting that may motivate efforts to manage the resulting earnings volatility. Derivatives accounting-driven efforts at earnings management need to be carefully evaluated by the independent auditor to ascertain whether such management efforts are within the bounds of generally accepted accounting principles.

ISSUE #3: End-Users vs. Traders of Derivatives & Industry-Specific Factors (Paragraphs 2 & 5)

Footnote 1 of the proposed SAS No. 81 explains that the definition of *financial instrument* adopted is the one appearing in Appendix F of SFAS No. 133, which includes both sides in a derivatives contract, that is, the entity which has a contractual right and the entity which has a contractual obligation to perform. Nevertheless, the proposed SAS No. 81 deals primarily with the end users of derivatives (i.e., entities with contractual rights) rather than on the broader range of activities that includes the marketing of derivatives to others (i.e., entities with contractual obligations).

Financial institutions that act as market makers or dealers in non-exchange traded derivatives earn income by exploiting the price-differential in the bid and offer prices. Interestingly, the risks attaching to many of the derivative financial instruments such as options and caps are asymmetrical. Thus, depending on the movement in the underlying stock price, reference rate, or index, only one party, the writer or seller of the instruments, loses. This poses a unique risk for commercial and investment banks that act as market makers or derivatives dealers (i.e., derivatives traders). Such activities may give rise to different risk configurations and thus, be subject to different accounting and auditing considerations. Auditors need to be sensitive to these issues and tailor their audit procedures to reflect each entity's goals from derivatives operations, whether as a derivatives end-user or as a derivatives trader.

Industry-specific issues also need to be considered, e.g., for commodity trading in corn, gold bullion, or oil, an additional risk is that quality of the commodity may not be as expected. Even though derivatives commonly used in commodity trading do fall within the scope of SFAS No. 133, the proposed SAS No. 81 does not take them into account. In other words, the scope of SAS No. 81 needs to be broadened.

Issue #3: Recommended changes to proposed SAS

The proposed SAS needs to clearly identify its scope of application. The present version seems to focus on end users of derivatives only and does not adequately address traders in financial instruments. We recommend that guidance as to application of SAS No. 81 to derivatives traders be expanded.

We understand the need for limiting the scope of application of the proposed SAS. Nevertheless, we recommend that the scope of the proposed SAS No. 81 be broadened beyond financial instruments (see para 2, bullet 1) to include all derivatives within the scope of SFAS No. 133, such as commodity derivatives. If this recommendation is accepted, conforming changes may be required in other paragraphs within the proposed SAS (e.g., paragraph 17 and related footnotes address only financial instruments and not other types of derivatives).

ISSUE #4: Assistance from Internal Audit Department (Paragraphs 6, 7, & 8)

Although the internal control environment is mentioned (esp. SAS No. 55 and SAS No. 78) in paragraphs 7-12 of the proposed SAS No. 81, there is no reference to SAS No. 65: *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, AU 322.* In our opinion, a discussion of SAS No. 65 is relevant when describing the independent auditor's evaluation of the control environment, especially in the context of internal audit's monitoring of treasury department activities.

In many companies, internal audit forms an integral part of the risk management function to enable senior management to review and evaluate the control processes over an entity's use of derivatives. If the independent auditor concludes that relevant activities are being performed by internal audit, and it appears that it would be efficient to consider those activities in assessing internal control risk, the independent auditor should assess the objectivity and competence of internal auditors (per SAS No. 65). Competent internal audit staff should also be able to provide assistance to the independent auditors.

Issue #4: Recommended changes to proposed SAS

Add the following, adapted from *Derivatives in a Corporate Environment: A Guide for Auditors* (Audit Faculty Technical Release, Audit 1/97, Institute of Chartered Accountants in England and Wales, 1997), as a separate paragraph after the existing paragraph 8 as follows:

As part of the assessment of the accounting system and control environment, independent auditors consider the role, if any, played by internal audit (See SAS No. 65: *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, AU 322).* As noted in paragraphs 2 and 3, the knowledge and skills required to understand and audit an entity's use of derivatives are specialized and quite different from those needed in auditing other areas. Independent auditors consider the extent to which the internal audit function has the skill and experience to cover, and has in fact covered, the entity's treasury and derivatives activities. Where sufficient audit coverage by internal audit exists, the work performed by internal audit may be used by the independent auditors in assessing the control environment and control risk of the entity's derivatives activities. Competent internal audit staff should also be able to provide assistance to the independent auditors.

<u>ISSUE #5: Tests of Controls and Substantive Tests (Paragraphs 13-16)</u>

The proposed SAS No. 81 describes a very limited number of "tests of controls" in the area of derivatives (see paragraphs 7-12). Even if internal control risk is assessed as low, given that derivatives transactions are often not homogenous, a primarily substantive approach may prove to be both more efficient and more effective. This would be particularly true where the volume of derivatives transactions is quite small. The aforementioned rationale for recommending a primarily substantive approach could be incorporated in the proposed standard.

For situations in which reliance on controls is part of the audit approach, as may be expected in the case of an entity with a sophisticated corporate treasury operation, the proposed SAS should be expanded in its description of applicable tests of controls. A cross-reference to the COSO (1996) publication "Internal Control Issues in Derivatives Usage" in a footnote may be useful. Presently, there is very little discussion and examples of tests of controls relating to an audit of an entity's derivatives activities.

Examples of substantive tests of details also should be expanded to include careful and detailed "reading of derivatives contracts." Similarly, examples of the use of analytical procedures as rough predictive tests to compute the income from a homogenous portfolio of derivatives could be useful.

There is presently no discussion in the proposed standard of the applicability of "audit sampling" methods to an audit of derivatives (e.g., test-counts of derivatives securities for establishing physical existence of contracts and completeness, SAS No. 39).

Adding a discussion of each of these items would make the proposed standard more complete.

Issue #5: Recommended changes to proposed SAS

(a) Insert a new paragraph prior to the current paragraph 13 titled "Performing Substantive Tests."

Derivative contracts are often not homogenous, and for several entities, the volume of derivative transactions may be quite small. Under such circumstances, regardless of the internal control risk assessment, a primarily substantive approach may prove to be both more efficient and effective.

(b) Include a discussion and expanded coverage of applicable tests of controls when reliance of controls is part of the audit approach

Whenever independent auditors expect to place reliance on the accounting and internal control systems for derivatives, they carry out tests to obtain evidence as to whether their assessment of control risk is supported. Tests of controls seek to confirm that the controls, as described in the policies, procedures and guidelines or as discussed with senior management, are operating satisfactorily.

Tests of controls may include confirming, for a suitably sized sample of transactions, that:

--derivatives have been used in line with the agreed policies, guidelines and within authority limits;
--the transactions undertaken were *bona fide* within the terms of treasury limits and the mandates for undertaking business with the chosen counterparties;
--properly authorized confirmations have been sent and incoming confirmations from counterparties have been properly matched and reconciled;
--early termination of derivatives is controlled;
--switches between the hedging and trading portfolios are properly authorized and documented;

--periodic reviews of reconciliations pertaining to the complete and accurate recording of derivatives transactions and related valuations are being regularly performed.

(c) Insert after "Completeness" (paragraph 18, bullet 3):

Test-counts of derivatives securities for establishing physical existence of contracts and completeness.

(d) Add the following to "Completeness" (paragraph 18, bullet 4):

Analytical procedures, **including their use as rough predictive tests to compute the income from a homogenous portfolio of derivatives.**

(e) Add the following to "Rights and Obligations" (paragraph 19, bullet 2):

Inspecting underlying agreements, **and on a sample basis, detailed reading of derivatives contracts** and other forms of supporting documentation, in paper or electronic form.

ISSUE #6: Confirmations as Substantive Tests (Paragraph 17)

Confirmations are typically requested by the independent auditor directly from the counterparty to or the holder of the financial instrument (e.g., a safekeeping agent), and for unsettled transactions, from the broker-dealer, in writing. Confirmations received from third parties, in addition to results from other procedures enumerated in paragraph 17 of the proposed SAS, indicate only that the third parties take responsibility for an asset, not that the asset exists or that the safekeeping agent can produce the asset upon demand. Because the evidentiary objective is to confirm the existence of the securities that are shown on the balance sheet and not the "receivable" when the safekeeping agent is unable to produce the securities (i.e., a default position), confirming the existence of securities is fundamentally different from confirming receivables.

Accordingly, whenever the derivative securities portfolio represents a significant proportion of current or total assets, to obtain sufficient evidence regarding the existence/occurrence assertion about financial instruments and other derivatives, counterparty or third party confirmations should be combined with one or more of the following: (i) evaluation of controls over physical custody by reference to the related SAS No. 70 reports to gain reasonable assurance that information received from the safekeeping agent and the broker-dealer is reliable (doing this in conjunction with confirmations makes it effectively a dual-test procedure), (ii) observation of physical counts of the securities, whenever practicable and reasonable, and (iii) evaluation of the business reputation and financial standing of the counterparty, the safekeeping agent, and the broker-dealer.

It is unclear how analytical procedures could be used as substantive tests to provide evidence pertaining to the existence and occurrence assertions about financial instruments or other derivatives. Perhaps an illustration of such a procedure could be provided in para 17, bullet point 4.

ARTHUR ANDERSEN

Issue #6: Recommended changes to proposed SAS

(a) para 17, change lead-in sentence

"Substantive tests for existence or occurrence assertions about financial instruments **or other derivatives** ~~may~~ **should** include **one or more of the following**—"

(b) The following wording in para 17, bullet 1, is suggested:

Confirmations with the counterparty to or the holder of the financial instrument (e.g., a safekeeping agent), and for unsettled transactions, with the broker-dealer, in writing.

After bullet point 5, but before para 18, insert the following:

Safekeeping confirmations received from third parties, in addition to results from other substantive procedures enumerated above, indicate only that the third parties take responsibility for an asset, not that the asset exists or that the safekeeping agent can produce the asset upon demand. Therefore, whenever the financial assets and/or derivatives portfolio represents a significant proportion of current or total assets, to obtain sufficient evidence regarding the existence/occurrence assertion about financial instruments and other derivatives, counterparty or third party confirmations should be combined with one or more of the following: (i) evaluation of controls over physical custody by reference to the related SAS No. 70 reports to gain reasonable assurance that information received from the safekeeping agent and the broker-dealer is reliable, (ii) observation of physical counts of the securities, whenever practicable and reasonable, and (iii) evaluation of the business reputation and financial standing of the counterparty, the safekeeping agent, and the broker-dealer.

(c) para 17, bullet point 4 should include a clear illustration of how analytical procedures could be used as substantive tests to obtain evidence regarding the existence and occurrence assertions about financial instruments or other derivatives.

ISSUE #7: Non-Temporary Impairment (Paragraph 37)

The first bullet point of paragraph 37 of the proposed SAS No. 81 reads:

"Fair value is significantly below cost and—

-- The decline is attributable to a condition specifically related to the financial instrument or to conditions in an industry or in a geographic area.
-- The decline has existed for an extended period of time.
-- Management does not possess both the intent and the ability to hold the instrument for a period of time sufficient to allow for any anticipated recovery in fair value."

As written, the last condition allows an unlimited future period to be available for an existing decline to reverse. If the issue was whether the decline is permanent, this might be an appropriate consideration. However, the issue is whether the decline is other than temporary and we believe that "temporary" does not extend for more than a few months (see paragraph 28 of the proposed Standard). Accordingly, the Auditing Standards Board should consider revising the third condition to indicate specifically a period of time not to exceed one year to signify an "other than temporary" decline in value.

As a general principle, the Auditing Standards Board should refrain from providing accounting advice and any attempts to do so should be discouraged. Nevertheless, the conditions listed in paragraph 37 appear to be so vague and unspecific that the language used needs to be clarified.

As for each of the conditions noted above, it is not clear whether their effect is meant to be cumulative or alternative. Inclusion of an appropriate disjunction ("or") after each of the first two conditions would remedy this ambiguity (see comments in D-44 of EITF abstracts, *Recognition of Other-Than-Temporary Impairment Upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* discussed March 23 & May 18-19, 1995).

Issue #7: Recommended changes to proposed SAS

The first bullet point of paragraph 37 should be changed as follows:

"Fair value is significantly below cost and **one or more of the following conditions exists:**

> -- The decline is attributable to a condition specifically related to the financial instrument or to conditions in an industry or in a geographic area, **or**
> -- The decline has existed for an extended period of time, **for example, 6 months, or**
> -- Management does not possess both the intent and the ability to hold the instrument for a period of time sufficient to allow for any anticipated recovery in fair value. **However, anticipated recovery beyond 12 months from the initial date of significant decline below cost would indicate non-temporary impairment.**"

<u>ISSUE #8: Auditor Independence and FAS 133 Assistance</u>

Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)* issued by the Independence Standards Board anticipates several ways in which providing SFAS 133 assistance would pose a threat to auditor independence. In particular, it describes circumstances under which an auditor could end up "auditing his or her own work" or act in the capacity of management. ISB Interpretation 99-1 lays out examples of "permitted" FAS 133 assistance as well as "prohibited" FAS 133 assistance.

SAS No. 81 should include general consideration of issues relating to auditor independence whenever FAS 133 assistance is provided to an audit client, such as the performance of appraisals and valuation services.

We would be pleased to discuss this letter with you or another member of the AICPA technical staff. If you have any questions, please call Dorsey Baskin at (312) 931-2238.

Very truly yours,

Arthur Andersen LLP

Arthur Andersen LLP

Attachments

ARTHUR ANDERSEN

APPENDIX

Editorial Comments

#1) para 2 insert "relevant," as well as "and commodity trading"

"...may require that the auditor have an understanding of the **relevant** operating characteristics of entities in a certain industry, for example, financial institutions **and commodity trading.**"

#2) para 2 "may require that the auditor have special skill or knowledge"

It would help if the nature of the special skill and knowledge to be possessed by the auditor is described in greater detail.

#3) para 2, bullet point 3, insert the word "recognition'

"...In addition, a financial instrument may have complex features that require the auditor to have special knowledge to evaluate their **recognition**, measurement and disclosure in conformity with generally accepted accounting principles."

#4) para 5, bullet point 1, *Management's objectives*

insert "instrument transactions or contracts"

"...the entity may enter into derivative financial ~~instruments~~ **instrument transactions or contracts** as hedges."

#5) para 5, insert "possibility"

"That **possibility** increases the inherent risk for certain assertions about those instruments."

#6) paras 9, 10 & 11: Overemphasis on Service Organizations

The proposed SAS No. 81 appears to place too much emphasis on service organizations (see paragraphs 9, 10, & 11). We believe that the lengthy passages relating to service organizations needs to be condensed and appropriate cross-referencing and reconciliation with SAS No. 70 and the "Omnibus SAS—1999" is called for.

#7) para 15, replace "support" with "evaluate the propriety and continued applicability of"; delete latter part of sentence

The independent auditor is not responsible for "supporting" the initial designation of a derivative instrument as a hedge, although s/he is responsible for evaluating the propriety and continued applicability of such designation.

Hence, the following wording in para 15 is suggested:

"The auditor should gather evidential matter to ~~support~~ **evaluate the propriety and continued applicability** of the initial designation of the instrument as a hedge. ~~and the continued application of hedge accounting~~."

Editorial Comments (continued)

#8) para 16, bullet points 2 and second item under bullet point 3

Both of these bullet points pertain to tests of controls, not substantive tests of details, and properly belong prior to the discussion in para 12.

#9) para 20, add the following as bullet point 3

"The accounting treatment allowing debt and equity securities to be reported at their fair value with unrealized holding gains and losses included in earnings may depend on whether management bought and holds them principally for purpose of selling them in the near term."

#10) para 24, *Valuation Based on an Investee's Financial Results*.

Where equity method accounting is being followed, the auditor should be instructed to look for guarantees of debt of the investee or commitments to make additional capital contributions. These commitments impact how one does equity method accounting (see APB 18: *The Equity Method of Accounting for Investments in Common Stock* and FASB Interpretation 35: *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*).

The following wording is recommended:

"Whenever equity method accounting is adopted, the auditor should confirm that guarantees of debt of the investee or commitments to make additional capital contributions exist."

#11) para 26, "...whether the entity's management has properly considered the lack of comparability."

If the effect of the time lag between the date of the entity's financial statements and those of the investee is material, it is incumbent upon management to make appropriate adjustments that may be called for, not just "consider the problem."

The following wording is recommended:

"...whether the entity's management has properly considered the lack of comparability **and made appropriate adjustments, where necessary.**"

#12) para 27, insert "and the auditor should"

"...should be obtained ~~to~~ **and the auditor should** evaluate the propriety of the elimination of unrealized interentity profits and losses..."

#13) para 29, add ", including the need to recognize an impairment loss."

"The auditor should evaluate management's judgments about the asserted values of those instruments**, including the need to recognize an impairment loss**."

#14) para 30, *Valuation Based on Fair Value* replace "Such differences" with "Differences in method..."

"~~Such differences~~ **Differences in method** may relate to the consideration of price quotations from inactive markets..."

ARTHUR ANDERSEN

Editorial Comments (continued)

#15) para 30, *Valuation Based on Fair Value*

The discussion in this paragraph is quite vague. It would be useful to make clear as to how values can depend on the industry and nature of the entity by providing an example.

#16) para 31, add a final sentence at the end

"The auditor should learn whether the basis of the quote is the bid or ask price or some price in between and why the entity uses a particular basis for a particular investment."

#17) para 32, obtaining estimates from more than one pricing source

The feasibility/practicality of the suggestion that "the auditor may also determine that it is necessary to obtain estimates from more than one pricing source" is doubtful.

#18) para 33, the title and AU reference for SAS No. 73 needs to be included in parentheses or footnoted.

Reference needed: *SAS No. 73: Using the Work of a Specialist*, AU 336

#19) para 34, bullet point 1, insert "the particular model in question,"

"The evaluation of the appropriateness of valuation models and each of the variables and assumptions used in the models may require considerable judgment and knowledge of valuation techniques, **the particular model in question,** market factors that affect value..."

#20) para 34, add another bullet point at end

- **"Backtesting model"**

#21) para 35, more elaboration required

Additional guidance regarding "transferability" would be helpful. For instance, evaluating the availability of an entity's rights to collateral may require a legal opinion or other document evidencing transferability. Adding a footnote to elaborate on "rights to collateral" may also be warranted.

#22) para 38, change last sentence

"~~That evaluation requires the~~ **The auditor** ~~to~~ **should** obtain evidence about factors that tend to corroborate or conflict with management's conclusions."

COMMENT LETTER #20

November 10, 1999

Mrs. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, N.Y. 10036-8775

Re: Proposed Statement on Auditing Standards, *Auditing Financial Instruments*

Dear Mrs. Sherinsky:

One of the objectives that the Council of the American Institute of CPAs established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee ("TIC"). This communication is in accordance with that objective.

TIC has reviewed the above referenced exposure draft and is pleased to provide the following comments.

General

The members of TIC appreciate having had the opportunity to review and comment on a preliminary version of the exposure draft. TIC members agree with the proposed Statement as currently written.

Implementation Guidance

TIC believes that practical implementation guidance enhances the auditor's ability to effectively, consistently and efficiently apply the authoritative literature. Consequently, TIC members urge the ASB to issue the non-authoritative implementation guidance currently being developed as soon as practicable. TIC members would like to offer their assistance in reviewing such guidance and to enhance its utility, TIC recommends that it include practical examples of:

- Gathering evidential matter about the operating effectiveness of a service organization's controls through tests performed by an auditor engaged by either the auditor or the service organization as part of an agreed-upon procedures engagement. This provision is discussed in paragraph 12.

- Any situations where control risk may possibly be assessed at the maximum even though, as described in paragraph 16, one service organization initiates trades as an investment advisor and also holds and services the securities. These examples could be contrasted with similar scenarios where control risk may not be assessed at the maximum.

Continuing Professional Education Courses

In addition to the timely development of the implementation guidance referred to above, TIC members also urge the ASB to encourage the AICPA staff to develop appropriate continuing professional education courses to help practitioners apply the proposed Statement.

We appreciate the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

James A. Koepke, Chair
PCPS Technical Issues Committee

JAK:lec

cc: PCPS Executive and Technical Issues Committees

Letter #21

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
500 Campus Drive
P.O. Box 805
Florham Park NJ 07932
Telephone (973) 236 7000
Facsimile (973) 236 7200

November 15, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards, File 2405
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Comments on proposed SAS, *Auditing Financial Instruments*

Dear Ms. Sherinsky:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the proposed Statement on Auditing Standards ("the SAS"), *Auditing Financial Instruments.*

We support the final issuance of the SAS as well as the accompanying Practice Aid as guidance for the planning and performing auditing procedures for a complex area such as financial instruments.

Our specific comments relating to the proposed SAS are attached.

If you have any questions regarding our comments, please feel free to contact James Gerson at (973) 236 7247, Deidre Schiela at (973) 236 7222, or Teresa Liang at (973) 236 7345.

Sincerely,

PricewaterhouseCoopers LLP

PRICEWATERHOUSECOOPERS

Paragraph 1:

The proposed SAS makes reference to the five assertions discussed in SAS No. 31, *Evidential Matter*. The document proceeds to provide guidance on developing appropriate auditing procedures for only four assertions. However, the assertion of presentation and disclosure has not been directly addressed in the proposed SAS. We believe that a discussion of presentation and disclosure is essential to developing a complete audit plan for financial instruments. This assertion is particularly important due to the stringent documentation and effectiveness measurement requirements set out in Statement of Financial Accounting Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), as these requirements determine the eligibility for hedge accounting and the amount of hedge ineffectiveness that is ultimately disclosed in the financial statements.

The stated scope of the proposed SAS is to address auditing procedures for assertions about financial instruments. Footnote 1 to this paragraph indicates that, for the purposes of the SAS, the definition of financial instrument used is extracted from the definition given in Appendix F of SFAS 133. We suggest that the scope and applicability of this Standard be expanded to include non-financial instruments that nevertheless fall within the scope of SFAS 133. SFAS 133 provides guidance in relation to the accounting for derivative instruments. In order to better harmonize the guidance provided in this proposed SAS with that provided in SFAS 133, we believe that this Standard should be extended to encompass all instruments, including contracts other than financial instruments, that meet the definition of a derivative as set out in paragraphs 6-9 of SFAS 133.

Paragraph 5:

The assessment of inherent risk is an integral part of the overall risk assessment process. For a complex area such as assertions about financial instruments, this assessment is further complicated by the multitude of considerations that could affect inherent risk. In paragraph 5, some of these considerations are outlined with examples. We believe that the considerations detailed in this section would be better understood if the example given were preceded with an explanation of the consideration.

In addition, we believe that there are a number of considerations that have not been included in this list which may significantly affect the inherent risk assessment. These include assessments of:

- Materiality
- Organizational structure and responsibilities
- Historical results

- Market and credit risk management functions and their effectiveness
- Operations/settlements functions and their effectiveness
- Management reporting
- Regulatory environment

The first bullet point in paragraph 5 includes the following sentence:

> The use of hedges is subject to the risk that market conditions will change so that the hedge is no longer effective and continued hedge accounting will improperly exclude unrealized gains and losses from net income.

We believe that this sentence is misleading and may not be entirely consistent with the provisions of SFAS 133 as improper exclusion of unrealized gains and losses from net income is not the *only* possible outcome from the continued application of hedge. We believe that the intent of the sentence is to highlight the fact that inherent risk is increased by the possibility that inappropriate accounting may be applied under certain circumstances. In order to ensure that the intent of this sentence is not obscured, we suggest that the sentence above be amended as follows:

> The use of hedges is subject to the risk that market conditions will change so that the hedge is no longer effective and continued hedge accounting will *result in the application of improper accounting.*

In addition, the last bullet point in paragraph 5 points out that external considerations such as credit risk and interest rate are considerations that should be considered in assessing the inherent risk for valuation assertions of related financial instruments. In order to provide more complete guidance on the factors that affect the volatility of the fair value of financial instruments, we believe that the SAS should also include a discussion of other external factors such as foreign exchange and commodity or equity prices.

Paragraph 8:

The proposed SAS states that when a service organization affects how an entity's financial instrument transactions are initiated, this service forms a part of the entity's information systems for financial instruments. However, it is unclear from this statement how a service organization would affect how an entity's financial instrument transactions are initiated. We believe that it would be beneficial to include an explanation of the type of services offered by a service organization that are relevant to the discussion. In particular, such services typically would include record keeping and information tracking.

Paragraph 12:

The second to last sentence in paragraph 12 states "Evidential matter about the operating effectiveness of a service organization's controls may be gathered ... (a) as part of an *examination engagement* under SAS No. 70..." SAS No. 70 does not refer to "an examination engagement". This reference would be more accurately stated as "...(a) as part of a service auditor's report on the controls placed in operations by the service organization and the operating effectiveness of those controls, pursuant to SAS No. 70". The footnote (number 4) would then be unnecessary.

Paragraph 14:

The statement "considerable judgment may also be required in evaluating evidential matter for assertions based on features of the financial instrument and applicable accounting principles, including underlying criteria, that are both extremely complex" appears in paragraph 14. We do not understand the intent of this sentence and we believe that an example, similar to the example set out in the third sentence of paragraph 14, would be beneficial in illustrating the Board's intent for incorporating this sentence into the Standard.

Paragraph 15:

Generally accepted accounting principles ("GAAP") separately require the following:

1) At inception of the hedge, there is formal documentation of the hedge relationship and the entity's risk management objective and strategy for undertaking the hedge... (¶20(a) and 28(a) of SFAS 133)
2) Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective. A periodic assessment of effectiveness is required at least every three months. (¶20(b) and 28(b) of SFAS 133)

Because these are two distinct GAAP requirements which deal with dissimilar risks, we believe that paragraph 15 should separately address the auditor's obligation to gather evidential matter to support each requirement.

In addition, the assessment of hedge effectiveness is particularly complex and has been the subject of much discussion by the DIG/FASB; however, the guidance in this area to date has generally been ambiguous. As the DIG/FASB continues to develop additional guidance on this topic, we encourage the Board to contemporaneously provide additional guidance on the auditing aspects of these new developments through its intended updates of the accompanying Practice Aid.

Paragraph 17 & 18:

Suggested substantive tests for both the existence or occurrence and the completeness assertions include "inquiry and observation" as examples. It is not clear what these tests may entail. Furthermore, by itself, inquiry and observation may not be a persuasive substantive test. We suggest that these tests be deleted from the list provided.

Paragraph 36:

This paragraph recognizes that although GAAP may specify how to account for unrealized changes in fair value of financial instruments, the amount of gains or losses recognized in net income may vary for various reasons including declines in fair value that are other than temporary. Another factor that may affect the amount of gains or losses recognized in net income from financial instruments is hedge ineffectiveness. The assessment of hedge ineffectiveness relies on the assessment of the method used to measure hedge effectiveness and the valuation of both the hedged item and the hedging instrument. Both of these areas are highly complex and require a significant amount of judgment. Consequently, we believe that the SAS should address auditing procedures directed at evaluating the amount of hedge ineffectiveness that is recognized in net income.

Paragraph 37:

The issue of impairment is a difficult one to assess due to its highly subjective nature. In paragraph 37, the Board has recognized that while impairment of a financial instrument is typically related to the creditworthiness of the issuer, it may also be due to other than temporary market factors. However, the examples of factors that may contribute to impairment provided in the proposed SAS are largely focused on those that affect the creditworthiness of the issuer.

We believe that the Board should consider including a list of other factors, which may lead to impairment in the value of financial instruments. SEC Staff Accounting Bulletins Topic 5M may assist the Board in expanding the examples provided in this paragraph.

Paragraph 39:

The proposed SAS sets the effective date for application of the provisions of the Standard for audits of financial statements for periods beginning on or after December 15, 1999. We believe that the effective date of this Standard should be deferred to be applied to audits of financial statements for periods beginning on or after December 15, 2000. The reasons for the deferral are as follows:

1) To coincide more closely with the effective date for application of SFAS 133;
2) The Board has indicated that it intends to issue the SAS and the accompanying Practice Aid at approximately the same time. The Practice Aid is intended to show how to use the framework provided by the proposed SAS to address a variety of practice issues. In order to ensure the guidance provided in the SAS is relevant and correctly applied, we believe that the effective date of the SAS, or its applicability to transactions, should not precede the issuance of the Practice Aid.

#22

Deloitte & Touche

Deloitte & Touche LLP
Ten Westport Road
P.O. Box 820
Wilton, Connecticut 06897-0820

Telephone: (203) 761-3000

November 9, 1999

Ms. Judith M. Sherinsky
Technical Manager
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: **File 2405**

Dear Ms. Sherinsky:

We are pleased to comment on the Proposed Statement on Auditing Standards, *Auditing Financial Instruments*.

We fully support the issuance of the proposed standard, as we believe that the proposal provides a clearer framework for auditing a complex financial statement area. However, we do have some recommendations for clarifying the application of the proposed standard to services provided by service organizations, as described in the attachment to this letter. Our recommended revisions to the proposed standard are shown in bold text and strike-through text.

The attachment also contains several editorial comments for your consideration.

Please contact Robert C. Steiner at (203) 761-3438 if you wish to discuss our comments.

Sincerely,

Deloitte & Touche LLP

Attachment

Deloitte Touche Tohmatsu

OTHER COMMENTS

Control Risk Considerations—Paragraphs 6-9

We are concerned about the clarity of the guidance provided in paragraphs 6-9 with respect to the auditor's consideration of control risk when trust companies, investment advisors or other service organizations initiate financial instrument transactions under discretionary investment arrangements or other arrangements and under which the entity may not have complete knowledge or records of transaction executed on its behalf by the service organization.

Many entities enter into discretionary investment arrangements with service organizations, such as trust companies or broker dealers, whereby the service organization is granted authority to initiate specific transactions to purchase or sell securities within investment guidelines established in a contract with the service organization. In those situations, the entity generally will not have a complete record of all securities transactions executed by the service organization. Consequently, the auditor is unable to obtain from the entity brokers' advices, cash records or other supporting documentation needed to test securities transactions.

We offer the following recommendations to clarify the guidance in paragraphs 6-9:

- Paragraph 6: Insert a reference to "an entity's information system" and a footnote to recite the reference to AU 319.34 presently included in paragraph 8
- Paragraph 7: Clarify the guidance regarding the "assertion" and reorder the examples of the considerations in a more logical order; place paragraph 7 after paragraph 8.
- Paragraph 8: Clarify the guidance concerning the auditor's consideration of control risk when a service organization performs activities that may affect an entity's financial instrument transactions
- Paragraph 9: Modify the first bullet of paragraph 9 to sharpen the distinction between that example and the example in the second bullet of paragraph 10.

Paragraphs 6-9 are shown below with our recommendations illustrated:

6. **Consistent with** SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319), ~~requires~~ the auditor **should** ~~to~~ obtain an understanding of **an entity's information system**[3]

[3] SAS No. 55 as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.34) defines the information system as the methods and records established by an entity to record, process, summarize, and report entity transactions **(as well as events and conditions)** and to maintain accountability for the related assets, liabilities, and equity.

and internal control over **financial statement-related** assertions about financial instruments that will enable the auditor to do *all* of the following:

a. Identify the types of potential misstatements of the **financial statements related to financial instrument** assertions

b. Consider factors that affect the risk ~~that the~~ **of material** misstatemen~~ts would be material to the financial statements~~

c. Design substantive tests

~~8~~7. The extent of the understanding of **the entity's information system and** internal control ~~over financial instruments~~ obtained by the auditor depends on how much information the auditor needs to identify the types of potential misstatements, consider factors that affect the risk of material misstatement, and design **substantive** tests. The understanding obtained may include controls over financial instrument transactions from their initiation to their inclusion in the financial statements. It may encompass controls placed in operation by the entity and ~~by~~ **controls in operation at** service organizations ~~whose services are part of~~ **engaged by** the entity~~'s information system~~. **The auditor's consideration of internal control may need to encompass controls in effect at the service organization when the service organization performs any of the following activities with respect to an entity's financial instrument transactions:**

a. has discretionary authority to initiate financial instrument transactions;

b. originates or maintains documentation supporting the entity's financial instrument transactions;

c. processes or summarizes financial instrument transactions for recording in the entity's accounting records, including the use of electronic means (such as computers and electronic data interchange) to transmit, process, maintain and access information;

d. processes or summarizes information about an entity's financial instrument transactions for reporting in its financial statements, including significant accounting estimates and disclosures.

~~SAS No. 55 as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.23) defines the information system as the methods and records established by an entity to record, process, summarize, and report entity transactions and to maintain accountability for the related assets, liabilities, and equity. A service organization's services are part of the entity's information system for financial instruments if they affect any of the following:~~

~~*a.* How the entity's financial instrument transactions are initiated~~

~~*b.* The accounting records, documentation supporting the entity's financial instrument transactions, and specific accounts in the financial statements involved in the processing and reporting of those transactions~~

~~c. The accounting processing involved from the initiation of financial instrument transactions to their inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information~~

~~d. The process the entity uses to report information about financial instrument transactions in its financial statements, including significant accounting estimates and disclosures~~

~~7~~8. After obtaining this understanding, the auditor should assess control risk for ~~the~~ **financial instrument–related** assertions. The auditor may assess control risk at the maximum level because the auditor believes controls are unlikely to pertain to ~~the~~ **a particular financial instrument–related** assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the operating effectiveness of controls to support a lower assessed level of control risk for ~~the~~ **a particular financial instrument–related** assertion. Examples of considerations that might affect the auditor's assessment of control risk for assertions about financial instruments include—

- **The systems that management uses to capture information about financial instruments.**
- Whether controls reflect management's objectives.
- The process that management uses to inform its personnel of controls.
- ~~The system that management uses to capture information about financial instruments.~~
- How management assures itself that controls over financial instruments are operating as designed.

9. Examples of a service organization's services that would be part of the entity's information system are—

- The ~~initiation of the~~ purchase or sale of ~~equity~~ securities by a service organization, ~~acting~~ **such** as **an** investment advisor, **having discretionary authority to initiate specific securities transactions.**

- Services that are ancillary to holding[34] an entity's investment in debt and equity securities such as—

  — Collecting dividend and interest income and distributing that income to the entity.

  — Receiving notification of corporate actions.

  — Receiving notification of security purchase and sale transactions.

[34] In this SAS, maintaining custody of financial instruments, either in physical or electronic form, is referred to as *holding*, and performing ancillary services is referred to as *servicing*.

- Receiving payments from purchasers and disbursing proceeds to sellers for security purchase and sale transactions.
- Maintaining records of financial instrument transactions for the entity.

- Servicing mortgage loans through the initiation and accounting processing of activities related to collections, foreclosures, and property taxes and insurance.
- The provision of market quotes on debt and equity securities by a pricing service through paper documents or electronic downloads the entity uses to value its securities for financial statement reporting.

Paragraph 12 (footnote 5)

Footnote 5 to paragraph 12 refers only to SSAE No. 4 for guidance on applying agreed-upon procedures to controls. We believe that SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, is also applicable, as stated in AU sec. 622.20. Accordingly, we recommend that footnote 5 be amended to include a reference to SAS 75 (AU sec. 622.20).

EDITORIAL COMMENTS

Paragraph 1 (footnote 2)

It is unclear what is meant in footnote 2 by "references in this SAS to generally accepted accounting principles are intended to *include them where relevant to the basis of accounting used*" [emphasis added]. We recommend that the meaning of the sentence be clarified or alternatively, that the sentence end after the reference to AU 623.04.

In addition, we believe references to "this SAS" in footnote 2 and in paragraphs 22, 25, 30, and 39 should be replaced with "this Standard."

Paragraph 11

As making inquiries of or observing personnel at the entity or at a service organization would typically be performed after reading relevant information, we recommend that the second bullet of paragraph 11 be placed as the last bullet of such paragraph.

Paragraph 12

We believe that the auditor never "*plans to assess* control risk below maximum [emphasis added]," but rather develops an expectation of the assessed level of control risk (as discussed in AU sec. 319.58) or "considers control risk to be less than the maximum" (as discussed in AU sec. 312.31). Accordingly, we recommend that the first sentence of paragraph 12 be revised to be consistent with terminology used in either AU secs. 312.31 or 319.58.

Paragraphs 13-14

We recommend that the following revisions be made to paragraphs 13 and 14 to focus the auditor's attention on the financial statement-related aspect to the assertions about financial instruments:

> 13. The auditor should use the assessed levels of inherent and control risk to determine the acceptable level of detection risk for **financial statement-related** assertions about financial instruments and to determine the nature, timing, and extent of the substantive tests to be performed to detect material misstatements of the assertions. . . .
>
> 14. Evaluating evidential matter for **financial statement-related** assertions about financial instruments may require the auditor to use considerable judgment. . . . In those situations, the auditor should consider the guidance in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates **in relation to the financial statements taken as a whole**, and SAS No. 73 on the use of the work of a specialist in performing substantive tests.

Paragraph 15

We propose the following changes to distinguish between management's and the auditor's responsibility:

> 15. Generally accepted accounting principles require management to periodically assess the effectiveness of a hedging relationship in order for designated hedging instruments and hedged items or transactions to continue to qualify for hedge accounting. The auditor should gather **sufficient competent** evidential matter to support the **auditor's conclusion about management's** initial designation of the instrument as a hedge and the continued application of hedge accounting.

Paragraph 21 (footnote 10) and 31

We propose the following revisions to paragraphs 21 (footnote 10) and 31:

> [10] Paragraphs 20 and 28 of FASB Statement No. 133 require formal documentation of prescribed aspects of hedging relationships at the inception of the hedge. In addition, paragraph 83 of FASB Statement ~~of Financial Accounting Standards~~ No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, requires an investor to document the classification of debt and equity securities into one of three categories—held-to-maturity, available-for-sale, or trading—at their acquisition.
>
> 31. Quoted market prices for securities listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, the National Association of Securities Dealers Automated Quotations System (NASDAQ), or pricing services based **thereon** ~~sources such as those~~. For certain other financial instruments, . . .

Paragraph 27

Paragraph 27 introduces the concept of "unrealized interentity profits and losses." The term "interentity" is undefined in the authoritative accounting literature. We recommend that the proposed standard use terminology that is defined in the accounting literature.

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November 18, 1999

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Proposed Statement on Auditing Standards (SAS)—Comment Letter
Auditing Financial Instruments (To Supersede Statement on Auditing Standards No. 81, *Auditing Investments*)

Dear Ms. Sherinsky:

We are pleased to submit this comment letter to the Auditing Standards Board with regard to the Proposed SAS *Auditing Financial Instruments*, and we support the issuance of this SAS. The area of financial instruments frequently presents risks to auditors and, therefore, providing guidance to auditors in planning and performing auditing procedures for financial assertions about financial instruments is both timely and appropriate.

We based our comments in this letter not only on the proposed SAS, but also on our review of the draft Practice Aid (including examples as of November 10, 1999) that will accompany the issuance of the SAS. We understand that as the Practice Aid continues to develop, the Auditing Standards Board intends to challenge whether any additional content needs to be added to the proposed SAS, to reflect significant issues addressed in the Practice Aid. Because the Practice Aid is a nonauthoritative supplement to the SAS, we believe that the process of comparing the final Practice Aid with the proposed SAS is a critical step in ensuring the completeness of the SAS. We urge the Board to complete this analysis, and expect that we may have additional comments on the SAS when we perform a similar analysis.

The appendix to this letter includes certain additional comments for improving the exposure draft.

We would be pleased to discuss our comments with members of the Auditing Standards Board or its staff.

Sincerely,

Ernst + Young LLP

Attachment (see below)

APPENDIX

Reference on Exposure Draft	Comment
Page 11, paragraph 1, footnote 1	We believe the definition cited here needs to be modified, in order to be consistent with the intended scope of the proposed SAS. For example, we believe the proposed SAS intended to include all derivatives within its scope; however, not all derivatives are financial instruments. We suggest adding the following sentence to footnote 1: "Additionally, this SAS also applies to contracts that are not financial instruments but are derivative instruments as defined by paragraphs 6-9 of Statement No. 133." Similarly, in the remainder of the proposed SAS, "derivative financial instruments" should refer simply to "derivative instruments" (e.g., paragraph 2, second bullet point).
Page 12, paragraph 2	The examples listed of special skills or knowledge that may be required should include valuation expertise as well as knowledge of risk management concepts. We suggest adding the following bullet points: • Understanding the valuation of certain financial instruments, including the appropriateness of various types of valuation models and the reasonableness of key factors and assumptions, may require knowledge of valuation concepts. • Assessing inherent and control risk may require an understanding of general risk management concepts and typical asset/liability management strategies.
Page 13, paragraph 5	We believe another example should be included in the last bullet point, *Whether external factors affect the assertion*, to clarify that other factors must be assessed in addition to the risks mentioned. We

Reference on Exposure Draft	Comment
	suggest inserting, as the last sentence of the bullet point: "In the example of valuing retained interests in a securitization, assumptions regarding default rates and prepayments represent increased risk because they are important components of the valuation result."
	We also believe that it is significant that the FASB staff, with the assistance of the Derivatives Implementation Group, has been developing Interpretive Guidance (in question-and-answer format) to answer constituent questions related to Statement No. 133. Similarly, the FASB staff has issued several question-and-answer documents on Statement No. 125 to address numerous implementation issues related to that Statement. We expect this process to continue, and accordingly suggest the following additional examples to the paragraph:
	The rapidly evolving nature of GAAP for financial instruments. The accounting principles for financial instruments are complex and require frequent interpretation by various standard setting bodies as new instruments are developed and used in the marketplace. Accordingly, management and auditors need to be aware of evolving interpretative guidance and its applicability.
	Significant reliance on outside parties. For example, an entity may need to rely on external valuation expertise when the required expertise is not available internally. The entity may not have the expertise required to appropriately challenge the valuation expert's methodology or assumptions, particularly if the valuation expert is also a counterparty to the transaction. In another example, transfers of financial assets, the entity will frequently be required to obtain a legal opinion to support whether the transfer qualifies as a sale.

Reference on Exposure Draft	Comment
	Accounting for financial instruments is often highly complex and may involve judgment. Transactions involving financial instruments often involve the use of assumptions about future conditions. For example, the valuation of financial instruments may require assumption about future events and conditions. Auditors should determine that the assumptions used in making such estimates are reasonable (see AU 342, *Auditing Accounting Estimates*).
Page 15, paragraph 9	In the last bullet point, the words "market quotes" should be replaced with "fair value," "derivatives" should be inserted before "debt," and the words "or in models and fair value appraisals" added to the end of the sentence. The sentence should read: "The provision of fair values ~~market quotes~~ on derivatives, debt and equity securities…to value its securities for financial statement reporting or in models and fair value appraisals."
Page 17, paragraph 14	We suggest that the following be added to the end of this paragraph: "However, the auditor should not let the complexity of a valuation model obscure whether the fundamental GAAP hierarchy for determining fair value has been properly applied (i.e., quoted market prices, if available, always take precedence over the results of valuation models or other techniques)."
Page 17, paragraph 15	The second sentence should be modified to indicate that evidential matter supporting the initial designation of the hedge is required to be in writing. We suggest the sentence be modified to read as follows: "The auditor should ~~gather evidential matter to support~~ examine the formal documentation supporting the initial and contemporaneous designation of the instrument as a hedge and the continued application of hedge accounting."

Reference on Exposure Draft	Comment
Page 17	We suggest the following paragraph be inserted in between current paragraphs 15 and 16: "The appropriate classification and accounting for debt and equity securities depends on management's intent in purchasing and holding those instruments, and for certain debt securities, on the entity's ability to hold the investment to maturity. In determining the nature, timing and extent of the auditor's substantive procedures, the auditor should obtain an understanding of the process used by management to classify these types of instruments. Unlike the formal hedge designation documentation referred to in the previous paragraph, evidential matter supporting the classification of debt and equity securities may be more informal." Further, we noted that this proposed SAS has attempted to incorporate the guidance on auditing management's intent and ability to hold an investment that is currently contained in SAS No. 81. In order to clarify for auditors that the guidance included in SAS No. 81 has in fact been included in this SAS, we suggest the Board consider developing a transition aid, which could take the form of an appendix to the SAS, indicating the new paragraphs in which the previous paragraphs AU 332.07-11 were incorporated.
Page 18, paragraph 17	We suggest adding the following wording to the second bullet point: "...in paper or electronic form, for amounts reported, <u>or for evidence that would preclude the sales treatment of a transfer, or for unrecorded repurchase agreements."</u> We also suggest adding the following substantive test: "Obtaining a legal letter corroborating management's assertion that the legal isolation criterion for transfers of financial instruments that

Reference on Exposure Draft	Comment
	have been accounted for as sales has been satisfied."
Page 18, paragraph 18	We suggest adding the following substantive test: "Comparing previous and current account detail to identify assets that have been removed from the balance sheet. Testing those items further to determine that the criteria for sales treatment have been met."
Page 22, paragraph 32	We suggest adding the following wording to the last sentence of the paragraph: "For example, this may be appropriate if the pricing source has a relationship with an entity that might impair its objectivity (i.e. an affiliate or a counterparty involved in selling or structuring the product) or the value of the item is not otherwise apparent. However, if a bona fide market price is available, then the GAAP hierarchy for determining fair value requires that this quote be used for fair value purposes (regardless of the results of any valuation models). Additionally, if the pricing source has a relationship with the entity that might impair its objectivity or if a valuation model is used to value an instrument that would be expected to have a quoted market price, the auditor should be aware of whether prices are available from other sources."
Page 23, paragraph 34, first bullet point	We suggest that this bullet point eliminate the words "market variables" and "variables" from the second and fourth sentences due the vagueness of the reference. We also suggest that a reference be made to the guidance in SAS No. 57, *Auditing Accounting Estimates,* that addresses evaluating the reasonableness of an estimate. Finally, to add clarification to the fourth sentence, we suggest inserting the words "actual and expected" before the words "market conditions." Accordingly, the bullet point would read as follows: "Assessing the reasonableness and appropriateness of the model. The auditor should determine whether the ~~market~~

Reference on Exposure Draft	Comment
	~~variables and~~ assumptions used are reasonable and appropriately supported. <u>In doing this, the auditor should consider guidance in AU 342.09-.11.</u> . . . The evaluation of the appropriateness of valuation models and each of the ~~variables and~~ assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect value, and <u>actual and expected</u> market conditions, particularly. . ."