

# **AUDITING AND ASSURANCE STANDARDS COUNCIL**

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**January 31, 2011**

*Proposals Relating to Philippine Auditing Practice Statements (PAPSs)*

**WITHDRAWAL OF EXISTING PAPSs**

**CLARIFICATION OF THE STATUS AND AUTHORITY OF NEW PAPSs**

**PROPOSED AMENDMENTS TO THE PREFACE TO THE INTERNATIONAL  
QUALITY CONTROL, AUDITING, REVIEW, OTHER ASSURANCE, AND RELATED  
SERVICES PRONOUNCEMENTS**

**AND**

**PROPOSED AMENDMENTS TO THE PREFACE TO THE PHILIPPINE QUALITY  
CONTROL, AUDITING, REVIEW, OTHER ASSURANCE,**

**AND**

*Proposed Philippine Auditing Practice Statement 1000*  
**SPECIAL CONSIDERATIONS IN AUDITING COMPLEX FINANCIAL  
INSTRUMENTS**

**Issued for comment by the  
AUDITING AND ASSURANCE STANDARDS COUNCIL**

Comments should be submitted so as to be received by **February 10, 2011** and should be addressed to:

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Comments requested by February 10, 2011

Proposals Relating to Philippine International Auditing Practice Statements  
(IPAPSs)

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Withdrawal of Existing IPAPSs

Clarification of the Status and Authority of New IPAPSs

Proposed Amendments to the *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*

and

*Preface to the Philippine Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements*

Proposed Philippine International Auditing Practice Statement

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IPAPS 1000, *Special Considerations in Auditing Complex Financial Instruments*

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## **EXPLANATORY MEMORANDUM**

(Note: The attached Explanatory Memorandum is the exact version of what is included in the Exposure Draft prepared by the International Auditing and Assurance Board (IAASB) and has been retained in its entirety to provide readers with the necessary background in the issuance of these proposals.)

### **Introduction**

This memorandum provides background to, and an explanation of, the proposals relating to the withdrawal of existing International Auditing Practice Statements (IAPSs) and clarification of the status and authority of new IAPSs. The International Auditing and Assurance Standards Board (IAASB) approved these proposals in June 2010 for exposure.

### **Background**

The IAASB's *Strategy and Work Program, 2009–2011* includes a project to review:

- (a) The appropriateness of the content of the IAPSs and determine whether they should be withdrawn or revised; and
- (b) The authority of IAPSs and any other implementation guidance that the IAASB may develop.

### **The Existing IAPSs**

There are currently six IAPSs that are effective:<sup>1</sup>

IAPS 1000, *Inter-bank Confirmation Procedures*

IAPS 1004, *The Relationship Between Banking Supervisors and Banks' External Auditors*

IAPS 1006, *Audits of the Financial Statements of Banks*

IAPS 1010, *The Consideration of Environmental Matters in the Audit of Financial Statements*

IAPS 1012, *Auditing Derivative Financial Instruments*

IAPS 1013, *Electronic Commerce—Effect on the Audit of Financial Statements*

These IAPSs are largely now out-of-date and inconsistent with the text of the clarified International Standards on Auditing (ISAs). Of the above, interest in revising and updating has been expressed only in relation to IAPSs 1004,<sup>2</sup> 1006<sup>3</sup> and 1012 as they are currently being used in practice in some jurisdictions.

### **Rationale for the IAASB's Project to Review the IAPSs**

Over the last few years, several stakeholders have sought clarification about the level of authority, perceived and real, that attaches to IAPSs. Some have indicated that the current description of IAPSs

in the current *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (the Preface) is unsatisfactory in that it does not call for any sort of substantive obligation to use the material contained in an IAPS; it

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<sup>1</sup> These IAPSs are included in Part II of the 2010 IFAC *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*.

<sup>2</sup> IAPS 1004 is a joint document of the International Auditing Practices Committee (the predecessor of the IAASB) and the Basel Committee on Banking Supervision (the Basel Committee). Both have approved and published the document, which is based on ISAs extant at October 1, 2001.

<sup>3</sup> The IAPC bank audit sub-committee included observers from the Basel Committee; however, the IAPS has not been approved nor published by the Basel Committee. It is based on ISAs extant at October 1, 2001.

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can be ignored as long as the auditor can describe how the requirements of the ISAs have been met.

Others have indicated that they expect auditors to use certain IAPSs—for example, the IAPSs dealing with banks. On the other hand, some national standard setters (NSS) have decided to not adopt the IAPSs, choosing instead to issue other jurisdiction-specific guidance.

Existing IAPSs have been developed and approved following the same due process as that afforded ISAs, and this is expected to remain unchanged under the due process approved by the Public Interest Oversight Board (PIOB). In light of this, assigning IAPSs and ISAs different authorities is viewed by some as inconsistent and confusing. This issue is compounded by questions about the relationship between the IAPSs and the application and other explanatory material of the clarified ISAs.

More recently, the IAASB has heard calls for more practical auditing guidance, foremost on the topic of complex financial instruments. Consultation with stakeholders has indicated there is a need for educational and practical guidance material on this topic, at a level of detail beyond that which would ordinarily be appropriate for an international standard. Accordingly, in June 2009 the IAASB approved a project proposal, in accordance with due process,<sup>4</sup> to revise existing IAPS 1012 to highlight practical considerations on matters that are currently posing auditing challenges. The IAASB's proposals in this regard are presented in the accompanying exposure draft of proposed new IAPS 1000, *Special Considerations in Auditing Complex Financial Instruments*.

In seeking to address the above developments, and to establish an appropriate basis for the proposed new IAPS 1000 and any future IAPS, the IAASB has focused on the following four interrelated issues:

- (i) What, if anything, should be done with respect to the existing IAPSs?
- (ii) How should the authority and purpose of new IAPSs be described, to make clear that they contain important material to be considered by the auditor while at the same time keeping them distinguishable from the body of ISAs to which compliance is required?
- (iii) Following from (ii), how should such a statement be positioned?
- (iv) How could the IAASB best proceed to ensure that any new IAPS is carefully considered and unhelpful proliferation of IAPSs is avoided?

The IAASB's deliberations and proposals on these matters are discussed in more detail below.

## **Proposal to Withdraw Existing IAPSs**

The IAASB has agreed in principle to withdraw the six existing IAPSs, subject to the views on consultation. This is seen as necessary to create a clean slate approach to any new IAPS in relation to the issue of status and authority, and allows the IAASB to determine what new IAPSs should be developed for the future.

The proposed treatment of the existing IAPSs is as follows:

- IAPS 1000, 1010, and 1013—Withdrawal with no further action.

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<sup>4</sup> IFAC's Standards-Setting Public Interest Activity Committees' Due Process and Working Procedures can be accessed at [web.ifac.org/download/PIAC-Due\\_Process\\_and\\_Working\\_Procedures.pdf](http://web.ifac.org/download/PIAC-Due_Process_and_Working_Procedures.pdf).

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- IAPS 1004—Withdrawal and explore how the relevant material in the IAPS may be maintained in some form.
- IAPS 1006—Withdrawal with consideration of the need for a future project to address the topic.
- IAPS 1012—Withdrawal and replace with the proposed new IAPS 1000 in the accompanying exposure draft.

Should respondents believe that revision, rather than withdrawal, of any of the existing IAPSs would be necessary, it would be helpful for the IAASB to be aware of this view. In considering this matter, respondents are asked to take into account the IAASB's plans to evaluate the development of new IAPSs based on criteria, as discussed below.

## **Factors to Be Considered in the Development of New IAPSs**

IAASB discussions have indicated the need for a vehicle to provide practical assistance to auditors. However, the IAASB's discussions have also highlighted concerns about:

- Possible proliferation of IAPSs.
- Development of IAPSs that contain industry-specific guidance that may be substantially affected by regulations in particular jurisdictions, thereby causing the IAPSs to be of limited value to those particular jurisdictions.
- Development of IAPSs when non-authoritative IAASB Staff publications would suffice.

Taking these concerns into account, the IAASB proposes that new IAPSs should only be developed if there is not likely to be a need for new or modified requirements or application material in the ISAs; in such circumstance it may be more appropriate to develop or revise an ISA. If the IAASB determines that such a need is not likely to arise, it may then consider whether:

- Research and discussions with stakeholders who may have recommended the project for the IAASB's consideration have indicated that:
  - There is divergent practice in the application of the ISAs internationally, or a need to raise

- awareness of issues being encountered in practice in particular areas, and therefore promulgating an IAPS would promote high-quality auditing practice, contributing to improved financial reporting;
  - Background and informational material is needed or the issue extends across a number of ISAs but does not necessitate the development of new requirements, and therefore promulgating an IAPS will be effective in promoting good practice; and
  - Such guidance would provide practical assistance to auditors in particular circumstances or industries, and would be expected to be applicable internationally; and
- The need for guidance is widely acknowledged by stakeholders and the guidance would be expected to remain useful for the foreseeable future.

It is envisioned that the above considerations would be taken into account in the IAASB's evaluation of any future proposals to start a project to develop a new IAPS. Further, the explanatory

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memorandum of a proposed new IAPS would explain how the IAASB determined an IAPS was necessary in the circumstances.

### **Proposal to Clarify the Status and Authority of New IAPSs**

The current Preface states:

International Auditing Practice Statements (IAPSs) are issued to provide interpretive guidance and practical assistance to professional accountants in implementing ISAs and to promote good practice ... Professional accountants should be aware of and consider Practice Statements applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Practice Statement should be prepared to explain how: (a) the requirements in the ISAs; or (b) the basic principles and essential procedures in the IAASB's other Engagement Standard(s), addressed by the Practice Statement, have been complied with.

The IAASB has expressed divergent views on the intent of the current Preface and agrees that clarification is needed. Some interpret the Preface to impose a strong obligation for the auditor to read, understand and apply the guidance in IAPSs. Others view it as a —comply or explain|| model that promotes awareness of IAPSs but does not directly impose an obligation on the auditor, because the compliance is in relation to the requirements of the ISAs rather than the IAPSs.

In considering how to clarify the status and authority, some IAASB members feel strongly that, if the IAASB determines it is necessary to develop an IAPS and the expectation is that the IAPSs would be read, an obligation should attach. In contrast, adopting a —comply or explain|| model would introduce a level of discretion that is less than helpful.

Others consider that if the material in an IAPS is of importance, it should be incorporated into the body of the ISAs. However, it was acknowledged that doing so may affect a number of ISAs and

result in the inclusion of educational-type material that would not be appropriate for the ISAs. Similarly, the IAASB considered, and rejected, a proposal to give IAPSs the same status as application and other explanatory material in the ISAs as this would be seen to extend the ISAs. The majority of the IAASB believes that there is a distinction between application and other explanatory material (which is guidance that is necessary to understand how a particular requirement should be applied) and an IAPS (which is guidance to provide practical assistance but is not essential to the proper application of the requirements in the ISAs).

The IAASB has concluded that any change to the status and authority for purposes of new IAPSs should serve to:

- Clarify the purpose of IAPSs and the nature of the material contained therein;
- Explain that IAPSs do not impose additional requirements on auditors beyond the ISAs; and
- Ensure that auditors are aware of the existence of the IAPSs and have an understanding of any IAPS(s) that may be relevant to the circumstances of the audit.

The IAASB's proposals to describe the status and authority of the IAPSs are presented in paragraph 23 of the proposed amended Preface.

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In clarifying the auditor's obligation with respect to the IAPSs, it is not the IAASB's intent to establish a specific documentation requirement (or suggest that documentation may be appropriate) addressing the auditor's determination as to whether any IAPS was relevant to the audit and, if so, the required understanding of its content. The IAASB believes that documenting this determination and the required understanding of the IAPS is not meaningful and might imply the existence of requirements in the IAPS when none exists.

#### **Placement of the Wording to Describe the Auditor's Obligation**

The IAASB also considered the question of where the wording of the auditor's obligation with respect to the IAPSs should be placed. It noted that the solution will be important in regard to promoting the expected use of IAPSs, while also recognizing there are practical implications to be considered.

The IAASB discussed a range of options that could be considered, individually or in combination. These included:

- Continuing to use (only) the Preface to describe the authority of IAPSs.
- Relying on the IFAC Statement of Membership Obligation (SMO) 3<sup>5</sup> and the IAASB Policy Position (June 2006), *Modifications to International Standards of the IAASBA Guide for National Standard Setters that Adopt IAASB's International Standards but Find It Necessary to Make Limited Modifications*<sup>6</sup> to highlight IAPSs and how they should be considered by IFAC member bodies and used by NSS.
- Describing the IAASB's views on the hierarchy of its standards and guidance in another manner, such as an IAASB Policy Position.
- Incorporating the auditor's obligation into ISA 200.<sup>7</sup>

In deliberating these options, the IAASB acknowledged the merits of including the auditor's obligation within ISA 200 as an effective approach to ensuring that auditors are aware of the fact that there may be material in addition to the ISAs that is relevant to the conduct of an audit in particular circumstances. The IAASB concluded, however, that it would not be appropriate to adopt this approach at this time given the implications to jurisdictions that are currently adopting, or planning to adopt, the clarified ISAs into law or regulation and the possible confusion that might arise between the guidance in an IAPS and the application material within the ISAs.

While the IAASB was not unanimous in its view, it concluded that the most appropriate approach would be to continue to describe the auditor's obligations relating to IAPSs in the

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<sup>5</sup> IFAC SMO 3 (Amended November 2006), *International Standards, Related Practice Statements and Other Papers Issued by the IAASB*. SMO 3 states that —Member bodies should use their best endeavors ...to assist with the implementation of International Standards [ISs] or national standards [NSs] and related other pronouncements that incorporate International Standards. This includes promoting the use of related Practice Statements, or the development of national pronouncements that incorporate related Practice Statements or that provide similar implementation guidance.||

<sup>6</sup> The Modifications Policy can be accessed at: [web.ifac.org/publications/international-auditing-and-assurance-standards-board/policy-positions-and-papers](http://web.ifac.org/publications/international-auditing-and-assurance-standards-board/policy-positions-and-papers).

<sup>7</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

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Preface and to also develop a hierarchy explaining the relationship of the ISAs, IAPSs and non-authoritative Staff publications. The IAASB's proposals to describe the status and authority of the IAPSs are presented in paragraph 23 of the amendments to the Preface. The IAASB's proposals to describe the distinction between the IAASB's authoritative pronouncements and non-authoritative material are presented in paragraphs 3–7 of the proposed amended Preface. Views on both these proposals are encouraged.

## **Effective Date**

Subject to views on consultation, the IAASB intends to consider the withdrawal of the existing IAPSs at its June 2011 meeting. The proposed changes to the Preface would become effective when approved by the IAASB.

## **Guide for Respondents**

The IAASB invites comments on any aspects of the proposals to withdraw the existing IAPSs and clarify the status and authority of new IAPSs discussed in this memorandum.

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