

*Consultation Draft*

***Practice Note***

***23 (Revised)***

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***AUDITING COMPLEX FINANCIAL INSTRUMENTS***

**December 2008**

**The Auditing Practices  
Board**

## **THE AUDITING PRACTICES BOARD**

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and the Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' and reporting accountant's integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are not eligible for appointment as company auditors, as well as those who are so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

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The purpose of Practice Notes issued by the Auditing Practices Board is to assist auditors in applying Auditing Standards of general application to particular circumstances and industries.

Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for Auditing Standards.

This Practice Note replaces Practice Note 23, "Auditing Derivative Financial Instruments," which was issued in April 2002.

## INVITATION TO COMMENT

This consultation draft is issued by the Auditing Practices Board (APB) for public comment.

The current PN 23 was issued in April 2002 to provide guidance on auditing derivative financial instruments and is based on an International Auditing Practice Statement (IAPS) issued by the International Auditing and Assurance Standards Board (IAASB). The APB considers that it is helpful to widen the scope of PN 23 to cover other complex financial instruments, as well as derivatives, as many of the audit considerations are the same. Also, there have been a number of recent developments that make this an opportune time to update PN 23, in particular:

- The current difficult financial market conditions give rise to particular considerations in relation to valuations and to financial statement disclosures about risks and uncertainties pertaining to complex financial instruments. The consultation draft includes guidance that draws on the IAASB Staff Audit Practice Alert on “Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment” issued in October 2008. This guidance supplements that given in Bulletin 2008/1, “Audit Issues when Financial Market Conditions are Difficult and Credit Facilities may be Restricted.”
- There have been changes to the financial reporting frameworks used by entities in the UK and Ireland to account for complex financial instruments, including the recent amendments to accounting standards to permit the reclassification of certain financial assets.

The opportunity has also been taken to align the guidance in PN 23 with the APB’s International Standards on Auditing (ISAs) (UK and Ireland).

The APB develops guidance in Practice Notes to assist auditors apply ISAs (UK and Ireland) and to indicate best practice in other areas; Practice Notes reflect existing auditing standards and regulatory requirements. As they do not introduce new or additional standards the accordingly APB does not believe that the application of the guidance in this consultation draft will significantly increase audit costs but invites the views of commentators on this point. If commentators consider there is a cost impact from issuing this guidance the APB requests that the specific aspect of the guidance be identified and, as far as possible, the nature and quantum of the additional costs described. The APB will evaluate any comments on incremental costs before finalising the Practice Note.

Auditing transactions and balances relating to these instruments is likely to be challenging in the coming months. The APB would welcome comments on ways in which the draft guidance could usefully be expanded to address problem areas as well as receiving comments on any other aspects of the consultation draft. The APB would like to receive comments from those who agree with the consultation draft as well as from those who do not. Your comments will be most helpful if they refer to the relevant paragraphs and are supported by reasoning.

The APB would prefer to receive letters of comment in an electronic form that facilitates 'copy and paste': these may be sent by e-mail to [k.billing@frc-apb.org.uk](mailto:k.billing@frc-apb.org.uk). If this is not possible, please send letters of comment to:

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Letters of comment should be sent so as to be received no later than *27 March 2009*. All comments will be regarded as being on the public record, unless otherwise requested and will be posted to the APB's website soon after receipt.

**THE AUDITING PRACTICES BOARD**  
**AUDITING COMPLEX FINANCIAL INSTRUMENTS**

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## **INTRODUCTION**

1. The purpose of Practice Note 23 is to provide guidance to auditors in planning and performing auditing procedures for financial statement assertions related to complex financial instruments.
2. ISA (UK and Ireland) 545, “Auditing fair value measurements and disclosures,” includes requirements and guidance that are relevant to the audit of the fair valuation of complex financial instruments. This Practice Note does not obviate the need for the auditor to understand and apply ISA (UK and Ireland) 545.
3. The Practice Note focuses primarily on auditing complex financial instruments held by end users. An end user is an entity that enters into a financial transaction, through either an organised exchange or a broker, for the purpose of hedging, asset/liability management or investment. End users consist primarily of corporations, government entities, institutional investors and financial institutions. The accounting systems and internal control issues associated with writing or trading complex financial instruments may be different from those associated with using complex financial instruments.
4. For entities preparing their financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU, relevant accounting standards are International Accounting Standard (IAS) 32 “Financial Instruments: Presentation”, IAS 39 “Financial Instruments: Recognition and Measurement” and IFRS 7 “Financial Instruments: Disclosures”.
5. For entities preparing their financial statements in accordance with UK or Irish Generally Accepted Accounting Practice, relevant accounting standards are:
  - Financial Reporting Standard (FRS) 13 “Derivatives and other financial instruments: disclosures”; or
  - FRS 25 “(IAS 32) Financial Instruments: Presentation”, FRS 26 “(IAS 39) Financial Instruments: Recognition and Measurement” and FRS 29 “(IFRS 7) Financial Instruments: Disclosures”<sup>1</sup>.

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<sup>1</sup> Entities whose financial statements are prepared in accordance with the fair value accounting rules set out in the Companies Act, fall within the scope of FRS 26 and accordingly are required to comply with it and FRSs 25 and 29 (reporting entities applying the FRSSE are exempt). Other entities are required to comply with FRS 13 if they are within its scope.

## **Complex financial instruments**

6. Originators of complex financial instruments are continuously developing new products and as a result it is not possible to provide an exhaustive list of all such instruments. Examples of complex financial instruments include derivatives (e.g. option contracts, futures and swaps) and notes or security instruments involving:

- contracts with one or more optional or conditional characteristics embedded within them; and / or
- underlying risk exposures which are not apparent from the form of the financial instrument (sometimes described as the 'host contract').

Typical notes or security instruments are Collateralised Debt Obligations (CDOs), Collateralised Default Swaps (CDSs) and Mortgage Backed Securities (MBSs).

7. Values of complex financial instruments may be volatile. Large and sudden decreases in their value may increase the risk that a loss may exceed the amount, if any, recorded on the balance sheet. Furthermore, because of the complexity of these activities, management may not fully understand the risks of using complex financial instruments. Because of this, the accounting requirements to provide fair value and other information about them in financial statement presentations and disclosures are extensive.

8. The use of complex financial instruments can reduce exposures to certain risks, for example changes in exchange rates, interest rates and commodity prices. On the other hand, the inherent characteristics of complex financial instruments also may result in increased business risk, in turn increasing audit risk and presenting new challenges to auditors. For, example, some complex financial instruments may possess particular features that leverage the risks, such as:

- little or no cash outflows/inflows are required until maturity of the transactions;
- no principal balance or other fixed amount is paid or received;
- potential risks and rewards can be substantially greater than the current outlays; and
- the value of an entity's asset or liability may exceed the amount, if any, of the instrument that is recognised in the financial statements, particularly where the

financial reporting framework does not require such instruments to be recorded at fair value in the financial statements.

## **RESPONSIBILITIES OF MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE**

9. Management and those charged with governance are responsible for the preparation and presentation of the financial statements. As part of the process of preparing those financial statements, where applicable, management and those charged with governance make specific assertions related to complex financial instruments. Those assertions include that all complex financial instruments recorded in the financial statements exist, that there are no unrecorded complex financial instruments at the balance sheet date, that the complex financial instruments recorded in the financial statements are properly valued and presented, and that all relevant disclosures are made in the financial statements.

10. Effective internal control assists management and those charged with governance to fulfil their responsibilities. Generally, for internal control to be effective, those charged with governance of an entity, through oversight of management, accept responsibility for:

- establishing an appropriate control environment, including clear rules on the extent to which those responsible for complex financial instrument activities are permitted to participate in the trading markets<sup>2</sup> (see paragraphs 32-37);
- establishing information systems that provide those charged with governance with an understanding of the nature of the complex financial instrument activities and the associated risks;
- the design and implementation of a system of internal control to:
  - monitor risk and financial control;
  - provide reasonable assurance that the entity's use of complex financial instruments is within its risk management policies; and

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<sup>2</sup> Such rules should have regard to any legal or regulatory restrictions on using financial instruments. For example, UK public sector bodies may not have the power to conduct business using derivative financial instruments.

- ensure that the entity is in compliance with applicable laws and regulations; and
  - the integrity of the entity’s accounting and financial reporting systems to ensure the reliability of management’s financial reporting of complex financial instrument activities.
11. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

### ***THE AUDITOR’S RESPONSIBILITY***

12. The auditor’s responsibility related to complex financial instruments, in the context of the audit of the financial statements taken as a whole, is to obtain sufficient appropriate audit evidence to conclude whether management’s assertions related to complex financial instruments result in financial statements that give a true and fair view and are prepared in all material respects in accordance with the applicable financial reporting framework. Materiality may be difficult to assess in relation to those complex financial instrument transactions that may have little impact on the balance sheet even though significant risks may arise from them (see paragraph 72).

13. The auditor establishes an understanding with those charged with governance that the purpose of the audit work is to be able to express an opinion on the financial statements as a whole. It is not to provide assurance on the adequacy of the entity’s risk management related to complex financial instruments, or the controls over related activities. To avoid any misunderstanding the auditor may discuss with management and those charged with governance the nature and extent of the audit work related to complex financial instruments. ISA (UK and Ireland) 210 “Terms of Audit Engagements” establishes requirements and guidance on agreeing upon the terms of the engagement.

### **Quality control**

#### ***Special skill and knowledge***

14. ISQC (UK and Ireland) 1 “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements” requires that firms should assign appropriate staff with the

necessary capabilities and competence to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances<sup>3</sup>. ISA (UK and Ireland) 220 “Quality Control for Audits of Historical Financial Information” requires engagement partners to be satisfied that the engagement team collectively has the appropriate capabilities and competence<sup>4</sup>.

15. Complex financial instruments may have features that require the auditor to have special knowledge to evaluate their measurement, recognition and disclosure. To comply with the requirements of ISQC (UK and Ireland) 1 and ISA (UK and Ireland) 220, the auditor may need special skills or knowledge to plan and perform auditing procedures for certain assertions about complex financial instruments. Special skills and knowledge may be needed to obtain an understanding of:

- the operating characteristics and risk profile of the industry in which the entity operates;
- the complex financial instruments used by the entity, and their characteristics;
- the entity’s information system for complex financial instruments, including any relevant services provided by a service organisation (see paragraphs 25 - 29). This may require the auditor to have special skills or knowledge about computer applications when significant information about those complex financial instruments is transmitted, processed, maintained or accessed electronically;
- the methods of valuation of the complex financial instrument, for example, whether fair value is determined by quoted market price (“marked to market”), or a pricing model (“marked to model”); and
- the requirements of relevant legislation, regulations and applicable accounting standards for financial statement assertions related to complex financial instruments.

16. Where necessary the audit engagement team make use of the assistance of an expert, from within or external to the firm, with the necessary skills or knowledge to help plan and perform the auditing procedures, especially when:

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<sup>3</sup> ISQC 1.36

- the financial instruments are very complex;
- relatively simple financial instruments are used in complex situations;
- the entity is engaged in active trading of complex financial instruments; or
- the valuations of the instruments are based on complex pricing models.

ISA (UK and Ireland) 620 “Using the Work of an Expert” establishes requirements and guidance on the use of an expert’s work to obtain audit evidence.

17. Market conditions may lead to the need for the auditor to make use of the work of an expert where previously it was not considered necessary, or to use an expert with different expertise to one who was used previously (e.g. when valuation methods are changed).

### ***Consultation***

18. ISA (UK and Ireland) 220 requires that the engagement partner takes responsibility for the audit engagement team undertaking appropriate consultation on difficult or contentious matters<sup>5</sup>. The nature and use of particular types of complex financial instruments, the complexities associated with their valuation and disclosure, and market conditions may lead to a need for the audit team to consult with other professionals with relevant technical expertise and experience.

### ***Engagement quality control review***

19. ISQC (UK and Ireland) 1 and ISA (UK and Ireland) 220 require that there is an engagement quality control reviewer for all audits of financial statements of listed entities and those other audits, if any, that meet criteria set by the audit firm for such a review<sup>6</sup>. Criteria that a firm considers when determining which audits other than those of listed entities are to be subject to an engagement quality control review include “the identification of unusual circumstances or risks in the engagement”. In this context, the auditor considers whether the attributes of the complex financial instruments used by the entity or market conditions make the appointment of an engagement quality control reviewer appropriate.

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<sup>4</sup> ISA (UK and Ireland) 220.19

<sup>5</sup> ISA (UK and Ireland) 220.30

<sup>6</sup> ISQC (UK and Ireland) 1.60 and ISA (UK and Ireland) 220.36

20. ISA (UK and Ireland) 220 establishes requirements and provides guidance on what considerations should be included in the performance of an engagement quality control review<sup>7</sup>.

### ***UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT***

21. ISA (UK and Ireland) 315 “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement” requires the auditor to obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures<sup>8</sup>.

22. The auditor obtains an understanding of the entity’s objectives and strategies for using complex financial instruments, as well as understanding the entity’s process for identifying business risks relevant to financial reporting objectives and deciding how to address those risks. For example, complex financial instrument activities may range from those whose primary objective is to reduce or eliminate risk (hedging or asset/liability management) to those whose primary objective is to maximise income (investment). All other things being equal, risk increases as maximising income in the short term becomes the focus.

23. Due to the complex nature of certain financial instruments it is vital that both the entity and auditor understand the instruments in which the entity has invested or to which it is exposed. In relation to this, the auditor considers the knowledge and experience of management and those charged with governance. The use of complex financial instruments without relevant expertise within the entity may result in the entity’s risk being significantly in excess of its risk appetite.

24. The auditor also determines whether the entity, or a group component in the case of a group audit, operates in a regulated industry sector and, if so, obtains an understanding any relevant requirements established by the regulator. Other Practice Notes issued by the APB provide guidance on auditing entities that operate in particular regulated industry sectors.

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<sup>7</sup> ISA (UK and Ireland) 220.38

<sup>8</sup> ISA (UK and Ireland) 315.2

## **Service organisations**

25. Entities may use service organisations (for example asset managers) to initiate the purchase or sale of complex financial instruments or maintain records of transactions for the entity. Some entities may be dependent on these service organisations to provide valuations of the complex financial instruments held.

26. The use of service organisations may strengthen controls over complex financial instruments. For example, a service organisation's personnel may have more experience with complex financial instruments than the entity's management. The use of the service organisation also may allow for greater segregation of duties. On the other hand, the use of a service organisation may increase risk because it may have a different control culture or process transactions at some distance from the entity.

27. ISA (UK and Ireland) 402 "Audit Considerations Relating to Entities Using Service Organisations" establishes requirements and provides guidance to the auditor when the entity being audited uses a service organisation. ISA (UK and Ireland) 402 requires the auditor to consider how an entity's use of a service organisation affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures<sup>9</sup>.

28. Because service organisations often act as investment advisors, the auditor considers the risks associated with service organisations when acting as investment advisors, including:

- how their services are monitored;
- the procedures in place to protect the integrity and confidentiality of the information;
- contingency arrangements; and
- any related party issues that may arise because the service organisation can enter into its own complex financial instrument transactions with the entity while, at the same time, being a related party.

29. If the auditor considers that sufficient audit evidence about transactions and balances affected by the services provided by the service organisation may not be available at the entity the auditor considers other possible sources of audit evidence,

including whether a report on the service organisations internal controls by their auditors is available covering control objectives relevant to the audit.

### **Accounting considerations**

30. The accounting requirements for complex financial instruments (see paragraphs 4 and 5) generally require management to designate the instruments as:

- loans and receivables;
- held to maturity;
- available for sale which requires fair value movements to be taken to equity unless there is an other than temporary impairment for which the charge is taken to the income statement; or
- fair value through profit or loss or trading, both of which require fair value movements to be taken to the income statement.

In addition, management may adopt hedge accounting for certain complex financial instruments if the relationship between the instrument and the hedged item meet certain criteria. Management's designation of a complex financial instrument may be, or in the case of hedge accounting may need to be, changed in certain circumstances.

### **Internal control**

31. ISA (UK and Ireland) 315 requires that the auditor obtain an understanding of internal control relevant to the audit<sup>10</sup>. Internal control, as discussed in ISA (UK and Ireland) 315, consists of:

- (a) the control environment.
- (b) the entity's risk assessment process.
- (c) the information system, including the related business processes, relevant to financial reporting, and communication.
- (d) control activities.
- (e) monitoring of controls.

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<sup>9</sup> ISA (UK and Ireland) 402.2

<sup>10</sup> ISA (UK and Ireland) 315.41

The extent of an entity's use of complex financial instruments and the degree of complexity of the instruments are important determinants of the necessary level of sophistication of both the entity's information systems (including the accounting system) and control activities.

### ***Control environment***

32. The control environment is influenced by the attitude towards corporate governance in an entity and affects the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The control environment has a pervasive influence on the way business activities are structured, objectives established and risks assessed.

33. The auditor considers the overall attitude toward, and awareness of, complex financial instrument activities on the part of both management and those charged with governance. It is the role of those charged with governance to determine an appropriate attitude towards the risks. It is management's role to monitor and manage the entity's exposures to those risks. The auditor considers whether the structure implemented to monitor and manage effectively exposure to risks:

- is appropriate and consistent with the entity's attitude toward risk as determined by those charged with governance;
- specifies the approval levels for the authorisation of different types of complex financial instruments and transactions that may be entered into and for what purposes. The permitted instruments and approval levels should reflect the expertise of those involved in complex financial instrument activities;
- sets appropriate limits for the maximum allowable exposure to each type of risk (including approved counterparties). Levels of allowable exposure may vary depending on the type of risk, or counterparty;
- provides for the independent and timely monitoring of the financial risks and control activities; and
- provides for the independent and timely reporting of exposures, risks and the results of complex financial instrument activities in managing risk.

34. Complex financial instrument activities may be run on either a centralised or a decentralised basis. Such activities and related decision making depend heavily on the flow of accurate, reliable, and timely management information. The difficulty of collecting and aggregating such information increases with the number of locations and businesses in which an entity is involved. The risks of material misstatement associated with complex financial instrument activities may increase with greater decentralisation of control activities. This especially may be true where an entity is based in different locations, some perhaps in other countries.

35. Four elements of the control environment deserve special mention for their potential effect on controls over complex financial instrument activities:

- *The level of knowledge and experience of management and those charged with governance.* The degree of complexity of some complex financial instrument activities may mean that only a few individuals within the entity fully understand those activities. Furthermore, the complexity of various contracts or agreements may make it possible for an entity to enter inadvertently into a transaction for which the level of risk is higher than expected. Significant use of complex financial instruments, without relevant expertise within the entity, therefore increases the risk of material misstatement. This may prompt the auditor to question whether there is adequate management control, and may affect the auditor's risk assessment and the nature, extent and timing of audit testing considered necessary.
- *Direction from management and those charged with governance.* Management is responsible for providing direction, through clearly stated policies approved by those charged with governance, for the purchase, sale and holding of complex financial instruments. The auditor considers whether the policies state clearly the entity's objectives with regard to its risk management activities and the investment and hedging alternatives available to meet these objectives. The auditor considers whether the policies and procedures reflect the:
  - level of the entity's management expertise;
  - sophistication of the entity's internal control and monitoring systems;
  - entity's asset/liability structure;

- entity's capacity to maintain liquidity and absorb losses of capital;
- types of complex financial instruments that management believes will meet its objectives;
- uses of complex financial instruments that management believes will meet its objectives, for example, whether derivatives may be used for speculative purposes or only for hedging purposes.

An entity's policies for the purchase, sale and holding of complex financial instruments should be appropriate and consistent with its attitude toward risk and the expertise of those involved in complex financial instrument activities.

- *Segregation of duties and the assignment of personnel.* Complex financial instrument activities may be categorised into three functions:
  - committing the entity to the transaction (dealing);
  - initiating cash payments and accepting cash receipts (settlements); and
  - recording of all transactions correctly in the accounting records, including the valuation of complex financial instruments.

As part of the auditor's risk assessment, the auditor considers the segregation of duties among these three functions. Where an entity is too small to achieve proper segregation of duties, the auditor considers the role of management in monitoring complex financial instrument activities.

Some entities have established a fourth function, *Risk Control*, which is responsible for reporting on and monitoring complex financial instrument activities. Examples of key responsibilities in this area may include:

- setting and monitoring risk management policy (including analyses of the risks to which an entity may be exposed);
- designing risk limit structures;
- developing disaster scenarios and subjecting open position portfolios to sensitivity analysis, including reviews of unusual movements in positions;
- reviewing and analysing new complex financial instrument products; and
- independent price verification.

In entities that have not established a separate risk control function, reporting on and monitoring complex financial instrument activities may be a component of the accounting function's responsibility or management's overall responsibility.

- *Whether or not the general control environment has been extended to those responsible for complex financial instrument activities.* An entity may have a control culture that is generally focused on maintaining a high level of internal control. Because of the complexity of some treasury activities, this culture may not pervade the group responsible for complex financial instrument activities. Alternatively, because of the risks associated with complex financial instrument activities, management may enforce a more strict control environment than it does elsewhere within the entity. In groups without a treasury function, dealing in complex financial instruments may be rare and management's knowledge and experience limited. Accordingly, the auditor may need to consider in its risk assessment the control environment applicable to those responsible for functions dealing with complex financial instruments.

36. Some entities may operate an incentive compensation system for those involved in complex financial instrument transactions. In such situations, the auditor considers the extent to which proper guidelines, limits and controls have been established to ascertain if the operation of that system could result in transactions that are inconsistent with the overall objectives of the entity's risk management strategy.

37. When an entity uses electronic commerce for complex financial instrument transactions, it should address the security and control considerations relevant to the use of an electronic network.

### ***Entity's risk assessment process***

38. ISA (UK and Ireland) 315 requires that the auditor obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof<sup>11</sup>. In evaluating the design and implementation of the entity's risk assessment process, the auditor determines how management identifies business risks relevant to financial reporting that derive from its use of complex financial instruments, including how

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<sup>11</sup> ISA (UK and Ireland) 315.76

management estimates the significance of the risks, assesses the likelihood of their occurrence and decides upon actions to manage them.

39. The auditor inquires about business risks related to complex financial instruments that management has identified and considers whether they may result in material misstatement. During the audit, the auditor may identify risks of material misstatement that management failed to identify. In such cases, the auditor considers whether there was an underlying risk of a kind that should have been identified by the entity's risk assessment process, and if so, why that process failed to do so and whether the process is appropriate to its circumstances. If, as a result, the auditor judges that there is a material weakness in the entity's risk assessment process, the auditor communicates it to those charged with governance.

40. The auditor obtains an understanding of the principal types of risk, related to complex financial instrument activities, to which entities may be exposed. These include:

- (a) *Operational risk*, which relates to the specific processing required for complex financial instruments and which captures:
- the risk that transactions from a trade entry, operational processing, financial accounting or risk management perspective are split into individual transaction legs or cash flows, which do not obviously represent the economics of the overall trade, and which are therefore potentially incorrectly recorded, processed or risk managed;
  - the risk that undue reliance is placed by staff on the accuracy of model valuations or processing, without adequate review, and transactions are therefore incorrectly valued or risk managed;
  - the risk that undue reliance is placed by staff on information derived from value at risk or stand alone models, in managing complex financial instrument positions, with the result that they overlook the fundamentals of risk management and control of market, counterparty and operational risk for these types of transactions; and
- (b) *Valuation risk*, which is the risk that the value of the derivative and the related sensitivities are determined incorrectly. A component of valuation risk is *model*

*risk*, which is the risk associated with the imperfections and subjectivity of valuation models used to determine the value of a complex financial instrument. This includes the risk that models operate on a "black box" basis, in respect of transparency of inputs used (interest rates, dividend assumptions, etc), of processing of transactions and/or of reporting outputs, and so management do not have the understanding to challenge the output of the valuation models.

(c) *Market risk*, which relates broadly to economic losses due to adverse changes in the value of the complex financial instrument. Related risks include:

- Price risk, which relates to changes in the level of prices due to changes in interest rates, foreign exchange rates, or other factors related to market volatilities of the underlying rate, index, or price. Price risk includes interest rate risk and foreign exchange risk;
- Liquidity risk, which relates to changes in the ability to sell or dispose of the complex financial instrument. Complex financial instrument activities bear the additional risk that a lack of available contracts or counterparties may make it difficult to close out a transaction or enter into an offsetting contract.

Economic losses also may occur if the entity makes inappropriate trades based on information obtained using poor valuation models.

Complex financial instruments used in hedging transactions bear additional risk, known as *basis risk*. Basis is the difference between the price of the hedged item and the price of the related hedging instrument. Basis risk is the risk that the basis will change while the hedging contract is open, and thus, the price correlation between the hedged item and the hedging instrument will not be perfect. For example, basis risk may be affected by a lack of liquidity in either the hedged item, or the hedging instrument;

(d) *Credit risk*, which relates to the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. For certain complex financial instruments, market values are volatile, so the credit risk exposure also is volatile. Generally, a complex financial instrument has credit exposure only when the complex financial instrument has positive market

value. That value represents an obligation of the counterparty and, therefore, an economic benefit that can be lost if the counterparty fails to fulfil its obligation. Furthermore, the market value of a complex financial instrument may fluctuate quickly, alternating between positive and negative values. The potential for rapid changes in prices, coupled with the structure of certain complex financial instruments, also can affect credit risk exposure. For example, highly leveraged complex financial instruments or complex financial instruments with extended time periods can result in credit risk exposure increasing quickly after a transaction has been undertaken.

Many complex financial instruments are traded under uniform rules through an organised exchange (exchange-traded instruments). Exchange traded instruments generally remove individual counterparty risk and substitute the clearing organisation as the settling counterparty. Typically, the participants in an exchange-traded instrument settle changes in the value of their positions daily, which further mitigates credit risk. Other methods for minimising credit risk include requiring the counterparty to offer collateral, or assigning a credit limit to each counterparty based on its credit rating.

*Settlement risk* is the related risk that one side of a transaction will be settled without value being received from the customer or counterparty. One method for minimising settlement risk is to enter into a master netting agreement, which allows the parties to set off all their related payable and receivable positions at settlement;

- (e) *Solvency risk*, which relates to the risk that the entity would not have the funds available to honour cash outflow commitments as they fall due. For example, an adverse price movement on a futures contract may result in a margin call that the entity may not have the liquidity to meet;
- (f) *Legal risk*, which relates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in

tax laws, or statutes that prohibit entities from investing in certain types of complex financial instrument.

- (g) *Customer relationship risk, which relates to the risk that the entity will take over-ride the contractual terms to protect an ongoing customer relationship.*

### **Information systems**

41. Certain complex financial instruments may require a large number of accounting entries. Although the information system used to process complex financial instrument transactions likely will need some manual intervention, ideally, the information system is able to process such entries accurately with minimal manual intervention. As the sophistication of the complex financial instrument activities increases, so should the sophistication of the information system. Because this is not always the case, the auditor remains alert to the possible need to modify the audit approach if the quality of the information system, or aspects of it, appears weak. The specific issues which can arise in respect of complex financial instruments include:

- the potential diversity of systems required to process more complex trades, and the need for regular reconciliations between them;
- the potential that more complex transactions, if they are only traded by a small number of individuals, may be valued or risk managed on spreadsheets rather than on main processing systems, and for the physical and logical password security around those spreadsheets to be more easily compromised;
- the potential issues around segregation of duties and lack of clarity in the delineation between development and operational roles for bespoke or more complex transaction systems, where a limited number of trades are being processed;
- the reliance on recruiting and retaining expert individuals to initially represent the accounting, processing, and risk management of transactions correctly on systems and to validate periodically that they continue to be correctly recorded;
- the need to review exception logs from systems, external confirmations and broker quotes, where available, to sense check the entries generated by the complex financial instruments systems;

- the difficulties in controlling and checking the key inputs to systems for valuation of complex financial instruments, particularly where those systems are maintained by the front office and/or the transactions in question are bespoke, thinly traded or illiquid;
- the need for a specialist team of quantitative staff to check the design and calibration of complex models used to process these transactions initially and on a periodic basis;
- the need to set up a model library, with access and change controls around it, in order to maintain an strong audit trail of the accredited versions of models and in order to prevent unauthorised access or amendments to those models;
- the disproportionate investment which may be required in risk management and control systems, where firms only undertake a limited number of complex financial instrument transactions, and the potential for misunderstanding of the output by management if they are not used to these types of transactions; and
- the potential requirement for third party systems provision to record, process, account for or risk manage appropriately complex financial instrument transactions, and the need for staff members to reconcile appropriately and challenge the output from those providers.

### ***Control activities***

42. Control activities over complex financial instrument transactions should prevent or detect problems that hinder an entity from achieving its objectives. These objectives may be either operational, financial reporting, or compliance in nature.

43. ISA (UK and Ireland) 315 requires the auditor to obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks<sup>12</sup>. For significant risks, to the extent the auditor has not already done so, the auditor evaluates the design of the entity's related controls, including relevant control activities, and determines whether they have been implemented. On a recurring engagement, having evaluated the design of the entity's internal control in a previous audit does not obviate the need to consider it in the current period. Matters to consider

on recurring engagements include whether the design of the entity's related controls remains capable of effectively preventing, or detecting and correcting, material misstatements. For example, changes in the entity's activities and the way it uses complex financial instruments, or changes in the environment or market conditions in which the entity operates, may have introduced new or increased risks to be addressed.

44. The auditor, in planning the audit, considers the effectiveness of control activities over complex financial instruments. These will generally include adequate segregation of duties, risk management monitoring, management oversight, and other policies and procedures designed to ensure that the entity's control objectives are met. Those control objectives include:

- *Authorised execution.* Complex financial instrument transactions are executed in accordance with the entity's approved policies.
- *Complete and accurate information.* Information relating to complex financial instruments, including valuation information, is recorded on a timely basis, is complete and accurate when entered into the accounting system, and has been properly classified, described and disclosed.
- *Prevention or detection of errors.* Misstatements in the processing of accounting information for complex financial instruments are prevented or detected in a timely manner.
- *On-going monitoring.* Activities involving complex financial instruments are monitored on an on-going basis to recognise and measure events affecting related financial statement assertions.
- *Valuation.* Changes in the value of complex financial instruments are appropriately accounted for and disclosed to the right people from both an operational and a control viewpoint. Valuation, including independent price verification, may be a part of on-going monitoring activities.

In addition, control activities should assure that those complex financial instruments accounted for using hedge accounting meet criteria to justify hedge accounting, both at the inception of the hedge, and on an ongoing basis.

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<sup>12</sup> ISA (UK and Ireland) 315.90

45. As it relates to the purchase, sale and holding of complex financial instruments the auditor obtains an understanding of the level of sophistication of an entity's control activities, which will vary according to:

- the degree of complexity of the complex financial instrument and the related risk – more complexity will require more sophisticated systems;
- the risk exposure of complex financial instrument transactions in relation to the capital employed by the entity; and
- the volume of transactions – entities that do not have a significant volume of complex financial instrument transactions will require less sophisticated accounting systems and internal control.

46. In larger entities, sophisticated computer information systems generally keep track of complex financial instrument activities, and to ensure that settlements occur when due. More complex computer systems may generate automatic postings to clearing accounts to monitor cash movements. The auditor considers controls over processing to ensure that complex financial instrument activities are correctly reflected in the entity's records. Computer systems may be designed to produce exception reports to alert management to situations where complex financial instruments have not been used within authorised limits or where transactions undertaken were not within the limits established for the chosen counterparties. However, even a sophisticated computer system may not ensure the completeness of complex financial instrument transactions. Accordingly, the auditor obtains an understanding as to how management ensures completeness of all transactions.

47. Some complex financial instruments, by their very nature, can involve the transfer of sizable amounts of money both to and from the entity. Often, these transfers take place at maturity. In many instances, a bank is only provided with appropriate payment instructions or receipt notifications. Some entities may use electronic fund transfer systems. Such systems may involve complex password and verification controls, standard payment templates and cash pooling/sweeping facilities. The auditor gains an understanding of the methods used to transfer funds, along with their strengths and weaknesses, as this will affect the risks the business is faced with and accordingly, the audit risk assessment.

48. Regular reconciliations are an important aspect of controlling complex financial instrument activities. The auditor considers whether:

- formal reconciliations are performed on a regular, timely, basis to ensure that the financial records are properly controlled, all entries are promptly made and the dealers have adequate and accurate position information before formally committing the entity to a legally binding transaction; and
- reconciliations are properly documented and independently reviewed.

49. The following are some of the more significant types of reconciliation procedures associated with complex financial instrument activities:

- reconciliation of dealers' records to records used for the ongoing monitoring process and the position or profit and loss shown in the general ledger;
- reconciliation of subsidiary ledgers, including those maintained on computerised data bases, to the general ledger;
- reconciliation of all clearing and bank accounts and broker statements to ensure all outstanding items are promptly identified and cleared; and
- reconciliation of the entity's accounting records to records maintained by service organisations, where applicable.

50. The auditor assesses whether an entity's deal initiation records identify clearly the nature and purpose of individual transactions, and the rights and obligations arising under each complex financial instrument contract. In addition to the basic financial information, such as a notional amount, the auditor considers whether these records include:

- the identity of the dealer;
- the identity of the person recording the transaction, if that person is not the dealer;
- the date and time of the transaction;
- the nature and purpose of the transaction, including whether or not it is intended to hedge an underlying commercial exposure; and

- information on compliance with accounting requirements related to hedging, such as:
  - designation as a hedge; and
  - identification of the hedged item in a hedging relationship.

51. Transaction records for complex financial instruments may be maintained in a database, register or subsidiary ledger, which are then checked for accuracy with independent confirmations received from the counterparties to the transactions. Often, the transaction records will be used to provide accounting information, including information for disclosures in the financial statements, together with other information to manage risk, such as exposure reports against policy limits. The auditor considers whether there are appropriate controls over input, processing and maintenance of the transaction records, whether they are in a database, a register or a subsidiary ledger.

52. The main control activity over the completeness of the complex financial instrument transaction records is the independent matching of counterparty confirmations against the entity's own records. In planning the audit the auditor considers whether:

- counterparties are asked to send confirmations back directly to management of the entity that are independent from the dealers, to guard against dealers suppressing confirmations and "hiding" transactions, and all details should be checked off against the entity's records;
- management independent of the dealers resolve any exceptions contained in the confirmations, and fully investigate any confirmation that is not received;
- dealers are only allowed to deal with approved counterparties.

### ***Monitoring of controls***

53. Entities' ongoing monitoring activities should detect and correct any weaknesses in the effectiveness of internal controls over transactions for complex financial instruments and their valuation. ISA (UK and Ireland) 315 requires the

auditor to obtain an understanding of the major types of monitoring activity, including those related to those control activities relevant to the audit<sup>13</sup>.

54. Such monitoring activities may include a number of oversight/supervisory controls built into the entity's recurring internal control processes, for example:

- review of documentation of transactions to determine whether dealers were properly authorised, and the transactions were within authorised limits;
- review of the performance of the counterparty confirmation process, to determine that confirmations are being obtained and, where necessary, investigated on a timely basis;
- review of suspense accounts to ensure proper investigation by management and timely clearance;
- review of variations in related profits and losses; and
- independent price verification.

### **The role of internal audit**

55. As part of the assessment of internal control, the auditor considers the role of any internal audit function. The knowledge and skills required to understand and audit an entity's use of complex financial instruments are generally quite different from those needed in auditing other parts of the business. The external auditor considers the extent to which any internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's complex financial instrument activities.

56. In many entities, internal audit forms an essential part of the risk control function that enables senior management and those charged with governance to review and evaluate the control procedures covering the use of complex financial instruments. The work performed by internal audit may assist the external auditor in understanding the accounting systems and internal controls and therefore assessing risk. Areas where the work performed by internal audit may be particularly relevant are:

- developing a general overview of the extent of use of complex financial instruments;

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<sup>13</sup> ISA (UK and Ireland) 315.96

- reviewing the appropriateness of policies and procedures and management’s compliance with them;
- reviewing the effectiveness of control activities;
- reviewing the accounting systems used to process complex financial instrument transactions;
- reviewing systems relevant to complex financial instrument activities;
- ensuring that objectives for complex financial instrument management are fully understood across the entity, particularly where there are operating divisions where the risk exposures are most likely to arise;
- assessing whether new risks relating to complex financial instruments, are being identified, assessed and managed;
- evaluating whether the accounting for complex financial instruments is in accordance with relevant legislation, regulations and applicable accounting standards and, if applicable, whether complex financial instruments accounted for using hedge accounting meet criteria to justify hedge accounting; and
- conducting regular reviews to:
  - provide management with assurance that complex financial instrument activities are being properly controlled; and
  - ensure that new risks and the use of complex financial instruments to manage these risks are being identified, assessed and managed.

57. Certain aspects of internal audit may be useful in determining the nature, timing and extent of external audit procedures. When the external auditor intends to use specific internal audit work, the external auditor evaluates that work to confirm its adequacy for the external auditor’s purposes. ISA (UK and Ireland) 610 “Considering the Work of Internal Audit” applies to the external auditor in considering the work of internal audit.

## **RISK ASSESSMENT**

58. ISA (UK and Ireland) 315 establishes requirements and guidance on the auditor’s assessment of the risks of material misstatement. ISA (UK and Ireland) 330

“The Auditor’s Procedures in Response to Assessed Risks” requires, in order to reduce audit risk to an acceptably low level, that the auditor determines overall responses to assessed risks at the financial statement level, and designs and performs further audit procedures to respond to assessed risks at the assertion level<sup>14</sup>.

59. Examples of considerations that might affect the auditor’s assessment of the risks of material misstatement related to complex financial instruments include:

- *Economics and business purpose of the entity’s complex financial instrument activities.* Complex financial instrument activities include those where the primary aim is to reduce or eliminate risk (hedging or asset/liability management), and positions where the primary aim is to maximise income (investment). The risks associated with each of these activities will differ significantly;
- *The degree of complexity of a complex financial instrument’s features.* Generally, the more complex a financial instrument, the more difficult it is to determine its value. The values of certain complex financial instruments, such as exchange-traded options, are available from independent pricing sources such as financial publications and broker-dealers not affiliated with the entity. Determining the value can be particularly difficult, however, if a transaction has been customised to meet individual user needs. When complex financial instruments are not traded regularly, or are traded only in markets without published or quoted market prices, management may use a valuation model to determine value. The risk of material misstatement for the valuation assertion of complex financial instruments will reflect the degree of complexity of the such instruments;
- *Whether the transaction giving rise to the complex financial instrument involved the exchange of cash.* Some complex financial instruments, for example many derivatives, do not involve an exchange of cash at the inception of the transaction, or may involve contracts that have irregular or end of term cash flows. There is an increased risk that such contracts will not be identified, or will be only partially identified and recorded in the financial statements,

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<sup>14</sup> ISA (UK and Ireland) 330.3

increasing the risk for the completeness assertion about those complex financial instruments;

- *An entity's experience with the complex financial instrument.* Use of complex financial instruments without relevant expertise within the entity increases risk. In addition, management may be more likely to overlook infrequent transactions for relevant accounting and disclosure issues;
- *Whether the complex financial instrument includes an embedded derivative.* Management may be less likely to identify embedded derivatives, which increases the risk for the completeness assertion about those derivatives;
- *Whether external factors affect the assertion.* For example, the increase in credit risk associated with entities operating in declining industries increases the risk for the valuation assertion about those complex financial instruments. In addition, significant changes in, or volatility of, interest rates increase the risk for the valuation of complex financial instruments whose value is significantly affected by interest rates;
- *Whether the complex financial instrument is traded on national exchanges or across borders.* Complex financial instruments traded in cross-border exchanges may be subject to increased risk because of differing laws and regulations, exchange rate risk, or differing economic conditions. These conditions may contribute to the risk for the rights and obligations assertion or the valuation assertion.

60. Complex financial instruments may have the associated risk that a loss might exceed the amount, if any, of the value of the complex financial instrument recognised on the balance sheet. For example, a sudden fall in the market price of a commodity may force an entity to realise losses to close a forward position in that commodity. In some cases, the potential losses may be enough to cast significant doubt on the entity's ability to continue as a going concern. ISA (UK and Ireland) 570 "Going Concern" establishes requirements and provides guidance on the auditor's responsibility in the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements. The entity may perform sensitivity analyses or value-at-risk analyses to assess the hypothetical effects on complex financial instruments subject to market risks. The auditor may consider

these analyses in evaluating management’s assessment of the entity’s ability to continue as a going concern.

### **Fraud risk factors.**

61. ISA (UK and Ireland) 240 addresses ‘The auditor’s responsibility to consider fraud in an audit of financial statements.’ The nature and use of some complex financial instruments may increase the likelihood of fraud risk factors related to them. For example, incentives for fraudulent financial reporting may exist where incentive compensation schemes are dependent on returns made from the use complex financial instruments and the complexity of the instruments and related transactions may make it difficult to monitor the quality of the returns. Fraud risks may also increase when economic conditions are difficult (see paragraphs 120 – 122).

### **Significant risks**

62. ISA (UK and Ireland) 315 requires that, as part of the risk assessment, the auditor determines which of the risks identified are, in the auditor’s judgment, “significant risks” that require special audit consideration<sup>15</sup>. For such significant risks the auditor is required, to the extent the auditor has not already done so, to evaluate the design of the entity’s related controls, including relevant control activities, and determine whether they have been implemented<sup>16</sup>.

63. Further, when the auditor determines there is a significant risk related to fair value, ISA (UK and Ireland) 545 requires that the auditor should evaluate whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures<sup>17</sup>. This evaluation includes consideration of whether these assumptions reflect current market conditions and information.

64. Particular difficulties giving rise to significant risks may develop where there is severe curtailment or even cessation of trading in particular complex financial

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<sup>15</sup> ISA (UK and Ireland) 315.108. In exercising this judgment, the auditor excludes the effect of identified controls related to the risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration.

<sup>16</sup> ISA (UK and Ireland) 315.113

<sup>17</sup> ISA (UK and Ireland) 545. 39

instruments. For example, in these circumstances, complex financial instruments that have previously been valued using market prices may need to be valued on a mark-to-model basis (see paragraphs 114 – 117).

### **RELIANCE ON CONTROL ACTIVITIES**

65. ISA (UK and Ireland) 330 requires that when the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor performs tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit<sup>18</sup>. The auditor is also required to perform tests of relevant controls to obtain audit evidence about their operating effectiveness when the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures.

#### **Tests of controls**

66. In reaching a decision on the nature, timing and extent of testing of control activities, the auditor considers factors such as:

- the importance of the complex financial instrument activities to the entity;
- the nature, frequency and volume of complex financial instrument transactions;
- the potential effect of any identified weaknesses in control procedures;
- the types of control activities being tested;
- the frequency of performance of these control activities; and
- the evidence of performance.

67. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. In circumstances where the entity undertakes only a limited number of complex financial instrument transactions, or that the magnitude of these instruments is especially significant to the entity as a whole, a

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<sup>18</sup> ISA (UK and Ireland) 330.23

substantive approach, sometimes in combination with tests of control, may be more appropriate.

68. The population from which items are selected for detailed testing is not limited to the accounting records. Tested items may be drawn from other sources, for example counterparty confirmations and trader tickets, so that the possibility of overlooking transactions in the recording procedure can be tested.

69. Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. However, ISA (UK and Ireland) 330 indicates that that the auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient. Key procedures may include evaluating, for a suitably sized sample of transactions, whether:

- complex financial instruments have been used in accordance with the agreed policies, guidelines and within authority limits;
- appropriate decision-making processes have been applied and the reasons behind entering into selected transactions are clearly understandable;
- the transactions undertaken were within the policies for complex financial instrument transactions, including terms and limits and transactions with foreign or related parties;
- the transactions were undertaken with counterparties with appropriate credit risk;
- complex financial instruments are subject to appropriate timely measurement, and reporting of risk exposure, independent of the dealer, including regular review and challenge of the valuation of transactions, the appropriateness of valuation models and variations in profit and loss;
- counterparty confirmations have been sent;
- incoming confirmations from counterparties have been properly matched and reconciled;
- early termination and extension of transactions are subject to the same controls as new transactions;

- designations, including any subsequent changes in designations, are properly authorised;
- designations, including any subsequent changes in designations, as hedging are properly authorised;
- transactions have been properly recorded and are entered completely and accurately in the accounting records, and correctly processed in any subsidiary ledger through to the financial statements; and
- adequate security has been maintained over passwords necessary for electronic fund transfers.

70. Examples of tests of controls to consider include:

- reading minutes of meetings of those charged with governance of the entity (or, where the entity has established them committees or similar groups that have oversight over transactions in complex financial instruments) for evidence of that body's periodic review of complex financial instrument activities, adherence to established policies, and periodic review of hedging effectiveness;
- comparing complex financial instrument transactions, including those that have been settled to the entity's policies to determine whether the entity is following those policies. For example, the auditor might:
  - test that transactions have been executed in accordance with authorisations specified in the entity's policy;
  - test that any pre-acquisition sensitivity analysis dictated by the investment policy is being performed;
  - test transactions to determine whether the entity obtained required approvals for the transactions and used only authorised brokers or counterparties;
  - inquire of management about whether complex financial instruments and related transactions are being monitored and reported upon on a timely basis and read any supporting documentation;
  - test recorded purchases of complex financial instruments, including their classification and prices, and the entries used to record related amounts;

- test the reconciliation process. The auditor might test whether reconciling differences are investigated and resolved on a timely basis, and whether the reconciliations are reviewed and approved by supervisory personnel. For example, organisations that have a large number of complex financial instrument transactions may require reconciliation and review on a daily basis;
- test the controls for unrecorded transactions. The auditor might examine the entity's third-party confirmations and the resolution of any exceptions contained in the confirmations;
- test the controls over the security and back-up of data. In addition, the auditor may consider the procedures the entity adopts for maintenance and testing of the disaster recovery and business continuity plans.

### ***SUBSTANTIVE PROCEDURES***

71. The assessed risk of material misstatement cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. ISA (UK and Ireland) 330 requires that, irrespective of the assessed risk of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance and disclosure<sup>19</sup>. Further, when the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor is required to perform substantive procedures that are specifically responsive to that risk.

### **Materiality**

72. ISA (UK and Ireland) 320 "Audit Materiality" requires the auditor to consider materiality when determining the nature, timing and extent of audit procedures<sup>20</sup>. Determining materiality involves both quantitative and qualitative considerations. While planning the audit, materiality may be difficult to assess in relation to some complex financial instruments given some of their characteristics, as they may have little effect on the balance sheet, even though significant risks may arise from them. Materiality is considered at both the overall financial statement level and in relation to

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<sup>19</sup> ISA (UK and Ireland)330.49

classes of transactions, account balances and disclosures. The risk of material misstatement for the valuation assertion of complex, financial instruments may vary with the degree of complexity of such instruments. Greater potential for effect on the financial statements also exists when the exposure limits for entering into complex financial instrument transactions are high.

### **Types of substantive procedures**

73. Substantive audit procedures are performed to obtain audit evidence to detect material misstatements in the financial statements, and are generally of two types:

- (a) analytical procedures; and
- (b) other substantive procedures, such as tests of details of transactions and balances, review of minutes of directors' meetings and enquiry.

74. In designing substantive tests, the auditor considers:

- *Appropriateness of accounting.* A primary audit objective often addressed through substantive procedures is determining the appropriateness of an entity's accounting for complex financial instruments;
- *Involvement of a service organisation.* When planning the substantive procedures for complex financial instruments, the auditor considers whether another organisation holds, services or both holds and services the entity's complex financial instruments;
- *Interim audit procedures.* When performing substantive procedures before the balance sheet date, the auditor considers market movement in the period between the interim testing date and year-end. The value of complex financial instruments may fluctuate greatly in a relatively short period. As the amount, relative significance, or composition of an account balance becomes less predictable, the value of testing at an interim date becomes less valuable;
- *Routine vs. non-routine transactions.* Many financial transactions are negotiated contracts between an entity and its counterparty. To the extent that complex financial instrument transactions are not routine and outside an entity's normal activities, a substantive audit approach may be the most effective means of

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<sup>20</sup> ISA (UK and Ireland) 320.8

achieving the planned audit objectives. In instances where complex financial instrument transactions are not undertaken routinely, the auditor plans and performs audit procedures having regard to the entity's possible lack of experience in this area;

- *Procedures performed in other audit areas.* Procedures performed in other financial statement areas may provide evidence about the completeness of complex financial instrument transactions. These procedures may include tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.

### **Analytical procedures**

75. ISA (UK and Ireland) 520 "Analytical Procedures" requires the auditor to apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit<sup>21</sup>.

Analytical procedures also may be applied at other stages of the audit. Analytical procedures as a substantive procedure in the audit of complex financial instrument activities may give information about an entity's business but, by themselves, are generally unlikely to provide sufficient evidence with respect to assertions related to complex financial instruments. The complex interplay of the factors from which the values of these instruments are derived often masks any unusual trends that might arise.

76. Some personnel responsible for complex financial instrument activities compile detailed analytical reviews of the results of all complex financial instrument activity. They are able to capture the effect of complex financial instrument trading volumes and market price movements on the financial results of the entity and compile such an analysis because of their detailed day-to-day involvement in the activities. Similarly, some entities may use analytical techniques in their reporting and monitoring activities. Where such analysis is available, the auditor may use it to understand further the entity's complex financial instrument activity. In doing so, the auditor seeks satisfaction that the information is reliable and has been correctly extracted from the underlying accounting records by persons sufficiently objective to be confident that the information fairly reflects the entity's operations.

77. Analytical procedures may be useful in evaluating certain risk management policies over complex financial instruments, for example, credit limits. Analytical procedures also may be useful in evaluating the effectiveness of hedging activities. For example, if an entity uses complex financial instruments in a hedging strategy, and large gains or losses are noted as a result of analytical procedures, the effectiveness of the hedge may become questionable and accounting for the transaction as a hedge may not be appropriate. However, if analytical procedures are to be used in this way it is important that the auditor has a clear understanding of the objectives of management for the use of complex financial instruments.

78. Where no such analysis is compiled and the auditor wants to do one, the effectiveness of the analytical review often depends upon the degree to which management can provide detailed and disaggregated information about the activities undertaken. Where such information is available, the auditor may be able to undertake a useful analytical review. If the information is not available, analytical procedures will be effective only as a means of identifying financial trends and relationships in simple, low volume, environments. This is because, as volume and complexity of operations increase, unless detailed information is available, the factors affecting revenues and costs are such that meaningful analysis by the auditor often proves difficult, and the value of analytical procedures as an audit tool decreases. In such situations, analytical procedures are not likely to identify inappropriate accounting treatments.

## ***SUBSTANTIVE PROCEDURES RELATED TO ASSERTIONS***

### **Existence and occurrence**

79. Substantive tests for existence and occurrence assertions about complex financial instruments may include:

- confirmation with the holder of or the counterparty to the financial instrument;
- inspecting the underlying agreements and other forms of supporting documentation, including confirmations received by an entity, in paper or electronic form, for amounts reported;

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<sup>21</sup> ISA (UK and Ireland) 520.2

- inspecting supporting documentation for subsequent realisation or settlement after the end of the reporting period; and
- inquiry and observation.

### **Rights and obligations**

80. Substantive tests for rights and obligations assertions about complex financial instruments may include:

- confirming significant terms with the holder of, or counterparty to, the financial instrument; and
- inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form.

### **Completeness**

81. Substantive tests for completeness assertions about complex financial instruments may include:

- asking the holder of or counterparty to the complex financial instrument to provide details of all complex financial instruments and transactions with the entity. In sending confirmations requests, the auditor determines which part of the counterparty's organisation is responding, and whether the respondent is responding on behalf of all aspects of its operations;
- sending zero-balance confirmations to potential holders or counterparties to complex financial instruments to test the completeness of such instruments recorded in the financial records;
- reviewing brokers' statements for the existence of complex financial instrument transactions and positions held;
- reviewing counterparty confirmations received but not matched to transaction records;
- reviewing unresolved reconciliation items;
- inspecting agreements, such as loan or equity agreements or sales contracts, for embedded derivatives;

- inspecting documentation for activity subsequent to the end of the reporting period; and
- reading other information, such as minutes of those charged with governance, and related papers and reports on complex financial instrument activities received by the governance body.

## **Valuation**

82. ISA (UK and Ireland) 545 establishes requirements and guidance on auditing fair value measurements and disclosures. Tests of valuation assertions are designed according to the valuation method used for the measurement or disclosure.

Substantive procedures to obtain evidence about the valuation of complex financial instruments may include:

- inspecting documentation of the purchase price;
- confirming with the holder of or counterparty to the financial instrument;
- reviewing the creditworthiness of counterparties to the transaction; and
- obtaining evidence corroborating the valuation of complex financial instruments measured or disclosed.

83. The method for determining value may vary depending on factors such as inactive markets and liquidity discounts, control premiums, and commissions and other costs that would be incurred when disposing of a complex financial instrument. The method for determining value also may vary depending on the type of asset or liability.

84. Quoted market prices for complex financial instruments that are listed on exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges or pricing services based on sources such as these. Quoted market prices for other complex financial instruments may be obtained from broker-dealers who are market makers in those instruments. If quoted market prices are not available for a complex financial instrument, valuation estimates may be obtained from third-party sources based on proprietary models or from an entity's internally developed or acquired models. If information about the value is provided by a counterparty to the instrument, the auditor considers whether such information is

objective. In some instances, it may be necessary to obtain valuation estimates from additional independent sources (see paragraphs 116 and 117).

85. Quoted market prices obtained from publications or from exchanges are generally considered to provide sufficient evidence of the value of those complex financial instruments. Nevertheless, using a price quote to test valuation assertions may require a special understanding of the circumstances in which the quote was developed. For example, quotations provided by the counterparty to an option to enter into a complex financial instrument may not be based on recent trades and may be only an indication of interest. In some situations, the auditor may determine that it is necessary to obtain valuation estimates from broker-dealers or other third-party sources. The auditor also may determine that it is necessary to obtain estimates from more than one pricing source. This may be appropriate if the pricing source has a relationship with an entity that might impair its objectivity.

86. It is management's responsibility to estimate the value of the financial instrument. If an entity values the complex financial instrument using a valuation model, the auditor's judgment is not substituted for that of the entity's management. The auditor may test assertions about the valuation determined using a model by procedures such as:

- assessing the reasonableness and appropriateness of the model. The auditor determines whether the market variables and assumptions used are reasonable and appropriately supported. Furthermore, the auditor assesses whether market variables and assumptions are used consistently, and whether new conditions justify a change in the market variables or assumptions used. 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 market conditions, particularly in relation to similar complex financial instruments. Accordingly, the auditor may consider it necessary to involve an expert in assessing the model;
- calculating the value, for example, using a model developed by the auditor or by an expert engaged by the auditor. The re-performance of valuations using the auditor's own models and data enables the auditor to develop an independent

expectation to use in corroborating the reasonableness of the value calculated by the entity;

- comparing the valuation with recent transactions;
- considering the sensitivity of the valuation to changes in the variables and assumptions, including market conditions that may affect the value; and
- inspecting supporting documentation for subsequent realisation or settlement of the complex financial instrument transaction after the end of the reporting period to obtain further evidence about its valuation at the balance sheet date.

87. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- the model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
  - the model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters and sensitivities.
  - the consistency and completeness of the model's inputs with market practices.
  - the model's output, including sensitivities, as compared to actual transactions.
- appropriate change control policies and procedures exist.
- the model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- the model is adequately documented, including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

88. In some circumstances, management may use a broker quote to support a fair value measurement; however, when the quote is obtained from the institution that initially sold the instrument, this evidence may be less objective and may need to be supplemented with evidence from one or more other brokers or information from a pricing service. Because pricing services and brokers use methods of valuation that often are not known to management or the auditor, in order to understand the nature of such information the auditor may need to obtain an understanding of how such information was developed. For example, was the value based on private trades, trades of similar instruments, or was the value based on a cash flow model or some combination of inputs? Inquiry into the nature of a broker quote is directed at its reliability and its consistency with the objective of fair value measurement.

89. Where hedge accounting techniques are used, the auditor gathers audit evidence to determine whether management's designation of a complex financial instrument as a hedge is appropriate. The nature and extent of the evidence obtained by the auditor will vary depending on the nature of the hedged items and the hedging instruments. Generally, the auditor obtains evidence as to:

- (a) whether the complex financial instrument was designated as a hedge at the inception of the transaction;
- (b) the nature of the hedging relationship;
- (c) the entity's risk management objective and strategy for undertaking the hedge;
- (d) the entity's assessment of the effectiveness of the hedge; and
- (e) where the complex financial instrument is hedging a future transaction, the entity's assessment of the certainty of that future transaction.

If sufficient audit evidence to support management's use of hedge accounting is not available, the auditor may have a scope limitation.

90. Changes in the entity's circumstances, or market conditions where trading in particular types of complex financial instruments may be severely curtailed, may also give rise to valuation difficulties and require changes in valuation approaches (see paragraphs 110 - 117).

### ***Use of management's expert***

91. Entities may obtain valuation reports containing valuations of complex financial instruments for which there is no observable market directly from third parties such as banks or other financial institutions. In such cases, the auditor may decide to obtain confirmation of the valuations direct from the third party, applying the requirements and guidance in ISA (UK and Ireland) 505, “External confirmations”.

92. If the third party applies particular expertise, for example in the use of models, in making an estimate which the entity uses in preparing its financial statements, the third party is considered a management’s expert and the requirements and guidance in ISA (UK and Ireland) 620 “Using the work of an expert” are relevant. If, on the other hand, the third party merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is not considered to be evidence produced by an expert (the auditor considers the relevance and reliability of the information, but the requirements of ISA (UK and Ireland) 620 specific to using the work of an expert do not apply).

93. In assessing whether the valuation reports supplied by an expert provide sufficient appropriate audit evidence for the valuations, the auditor considers:

- the competence and objectivity of the third party bank/other financial institution, for example: their independence from the entity; their reputation and standing in the market; their experience with the particular types of instruments; and their understanding of the relevant financial reporting framework applicable to the valuations; and
- the appropriateness of the valuations and sensitivities, including assessing the appropriateness of the model(s) used and the key market variables and assumptions used in the model(s).

94. Management of the entity may not have access to details of the model(s) used, and the key assumptions. In such cases, the auditor considers whether is necessary and possible to obtain information directly, with management’s authority, from the third party. The auditor also considers whether a report on the third party’s internal controls by their auditors is available covering control objectives applicable to the valuations (see paragraph 29).

95. If the auditor concludes that sufficient evidence cannot be obtained from the above procedures, for example where the third party uses internally developed models and software and does not allow access to information on the models, the auditor considers whether evidence can be obtained by re-performing the valuation using a model developed by the auditor, and applying market variables and assumptions that management and the auditor consider appropriate.

### **Presentation and disclosure**

96. Management need to consider the disclosure of information (including accounting policies) relating to complex financial instruments when preparing and presenting the financial statements that show a true and fair view.

97. Consideration of disclosures about the risks and uncertainties related to complex financial instruments is also important. For example, to comply with IFRS 7 and FRS 29, entities are required to disclose information that enables users of the financial statements to evaluate the nature and extent of the risks arising from financial instruments to which the entity is exposed at the reporting date<sup>22</sup>. IAS 1, “Presentation of Financial Statements,” includes a requirement to disclose:

- the judgements made in applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements;
- information about the assumptions concerning the future; and
- other major sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment in the carrying amount of assets and liabilities within the next financial year.

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<sup>22</sup> This includes qualitative disclosures about:

- a) the exposures to risk and how they arise;
- (b) the entity's objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- (c) any changes in (a) or (b) from the previous period.

Entities are also required to give quantitative disclosures such as:

- summary data about the exposures at the reporting date, and
- Market risk information such as a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date.

Where appropriate, management are expected to have regard to related guidance and recommendations that may have been produced by relevant bodies (e.g. the IASB's Expert Advisory Panel, The Committee of European Securities Regulators (CESR) and the Financial Stability Forum).

98. The auditor's conclusion as to whether the complex financial instruments are presented in conformity with relevant legislation, regulations and applicable financial reporting framework is based on the auditor's judgment as to whether:

- the accounting policies selected and applied are in conformity with the relevant financial reporting framework;
- disclosure is adequate to ensure that the entity is in full compliance with the current disclosure requirements of relevant legislation, regulations and applicable financial reporting framework under which the financial statements are being reported;
- the information presented in the financial statements is classified and summarised in an appropriate and meaningful manner; and
- the financial statements show a true and fair view.

99. Further, under UK company law<sup>23</sup>, in relation to the use of financial instruments by the company, the directors' report is required to give an indication of:

- (a) the financial risk management objectives and policies of the company, including the policy for hedging each major type of forecasted transaction for which hedge accounting is used, and
- (b) the exposure of the company to price risk, credit risk, liquidity risk and cash flow risk,

unless such information is not material for the assessment of the assets, liabilities, financial position and profit or loss of the company.

100. As part of complying with ISA (UK and Ireland) 315, the auditor will have obtained information regarding the entity's risk assessment process and control

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<sup>23</sup> SI 2008/410 – The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 7.6

activities. The auditor checks that the narrative disclosures required by the accounting framework are consistent with this information, in particular with regard to:

- the entity's objectives and strategies for using complex financial instruments;
- the entity's control framework for managing its risks associated with complex financial instruments; and
- the risks and uncertainties associated with the complex financial instruments;

and are consistent with the amounts included for complex financial instruments in the primary financial statements. If disclosures are made with which the auditor is not familiar the auditor obtains supporting evidence for them, including considering supporting papers and obtaining such written representations from management as the auditor considers appropriate.

### ***ADDITIONAL CONSIDERATIONS ABOUT HEDGING ACTIVITIES***

101. To account for a complex financial instrument transaction as a hedge, some financial reporting frameworks, for example, IAS 39 and FRS 26, require that management, at the inception of the transaction, designate the instrument as a hedge and contemporaneously formally document: (a) the hedging relationship, (b) the entity's risk management objective and strategy for undertaking the hedge, and (c) how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flow that is attributable to the hedged risk. IAS 39 and FRS 26 also require that management have an expectation that the hedge will be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.

102. The auditor gathers audit evidence to determine whether management complied with the applicable hedge accounting requirements of the financial reporting framework, including designation and documentation requirements. In addition, the auditor gathers audit evidence to support management's expectation, both at the inception of the hedge transaction, and on an ongoing basis, that the hedging

relationship will be highly effective<sup>24</sup>. The nature and extent of the documentation prepared by the entity will vary depending on the nature of the hedged items and the hedging instruments. If sufficient audit evidence to support management's use of hedge accounting is not available, the auditor considers the implications for the auditor's report.

### **EVALUATING AUDIT EVIDENCE**

103. ISA (UK and Ireland) 330 requires that based on the audit procedures performed and the audit evidence obtained, the auditor evaluates whether the assessments of the risks of material misstatement at the assertion level remain appropriate<sup>25</sup>. ISA (UK and Ireland) 330 states that, for example, the extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a material weakness in internal control.

104. Evaluating audit evidence for assertions about complex financial instruments requires considerable judgment because the assertions, especially those about valuation, may be based on highly subjective assumptions or be particularly sensitive to changes in the underlying assumptions. For example, valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or about conditions expected to exist a long time. Accordingly, competent persons could reach different conclusions about valuation estimates or estimates of valuation ranges. Considerable judgment also may be required in evaluating audit evidence for assertions based on features of the complex financial instrument and applicable accounting principles, including underlying criteria, that are both extremely complex. ISA (UK and Ireland) 540 "Audit of Accounting Estimates" provides guidance to the auditor on obtaining and evaluating sufficient audit evidence to support significant accounting estimates contained in financial statements, and ISA (UK and Ireland) 545 provides further guidance on obtaining and evaluating sufficient audit evidence to support fair values. ISA (UK and Ireland) 620 provides guidance on the use of the work of an expert in performing substantive tests.

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<sup>24</sup> If the hedging relation is no longer effective, the hedging instrument ceases to qualify for treatment as a hedge.

<sup>25</sup> ISA (UK and Ireland) 330.66

## **MANAGEMENT REPRESENTATIONS**

105. ISA (UK and Ireland) 580 “Management Representations” requires the auditor to obtain appropriate representations from management, including written representations on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist<sup>26</sup>. Depending on the volume and degree of complexity of complex financial instrument activities, management representations about complex financial instruments may include:

- management’s objectives with respect to complex financial instruments, for example, whether they are used for hedging, asset/liability management or investment purposes;
- the financial statement disclosures concerning complex financial instruments, for example:
  - the records reflect all complex financial instrument transactions;
  - the assumptions and methodologies used in the complex financial instrument valuation models are reasonable;
  - all embedded derivative instruments have been identified;
- whether all transactions have been conducted at arm’s length and at market value;
- the terms of transactions;
- whether there are any side agreements associated with any complex financial instruments;
- whether the entity has entered into any written options;
- if applicable, the appropriateness of the basis used by management to overcome the presumption relating to the use of fair values; and
- whether subsequent events require adjustment to the valuations and disclosures included in the financial statements.

106. Sometimes, with respect to certain aspects of complex financial instruments, management representations may be the only audit evidence that reasonably can be expected to be available; however, ISA (UK and Ireland) 580 states that

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<sup>26</sup> ISA (UK and Ireland) 580.4

representations from management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the audit evidence the auditor expects to be available cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the auditor's report.

### **COMMUNICATIONS WITH THOSE CHARGED WITH GOVERNANCE**

107. As a result of obtaining an understanding of an entity's accounting and internal control systems and, if applicable, tests of controls, the auditor may become aware of matters to be communicated to those charged with governance. ISA (UK and Ireland) 260 requires the auditor to communicate to those charged with governance, on a timely basis to enable them to take appropriate action, material weaknesses in internal control identified during the audit<sup>27</sup>. With respect to complex financial instruments, those matters may include:

- the auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for complex financial instruments;
- material weaknesses in the design or operation of the information system or the control activities;
- a lack of management understanding of the nature or extent of the complex financial instrument activities or the risks associated with such activities;
- a lack of comprehensive and clearly stated policies for the purchase, sale and holding of complex financial instruments, including operational controls, procedures for designating complex financial instruments as hedges, and monitoring exposures; or
- a lack of segregation of duties.

108. ISA (UK and Ireland) 545 draws attention to the fact that because of the uncertainties associated with fair value measurements, the potential effect on the financial statements of any significant risks may be of governance interest. For example, the auditor considers communicating the nature of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being

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<sup>27</sup> ISA (UK and Ireland) 260.11-12(e) and .13

measured at fair value to the financial statements as a whole. In addition, the need for appropriate controls over commitments to enter into complex financial instrument contracts and over the subsequent measurement processes are matters that may give rise to the need for communication with those charged with governance.

### ***CONSIDERATIONS WHEN FINANCIAL MARKET CONDITIONS ARE DIFFICULT***

109. When financial market conditions are difficult, such that trading in complex financial instruments has been severely curtailed or even ceased, particular difficulties can arise in obtaining valuations for those complex financial instruments, especially when they are required to be measured at fair value.

#### **Valuation processes and disclosures**

110. The nature and reliability of information available to management to support the making of a fair value accounting estimate vary widely, and thereby affect the degree of estimation uncertainty associated with that fair value. If markets become inactive, market price information may become unavailable and estimates need to be made on the basis of other information, often using models, some of which incorporate inputs that are “unobservable.”<sup>28</sup> The degree of estimation uncertainty therefore increases and affects, in turn, the risks of material misstatement. What may in the past have been a routine valuation problem may become the source of a ‘significant risk’. In such circumstances there are limits to the information that management possesses or can obtain and that therefore may be available to the auditor as audit evidence. Nevertheless, whether inputs are observable or not, preparers need to have evidence to support them, and auditors need to obtain sufficient appropriate audit evidence recognizing that the evidence may be different from what has previously been available.

111. ISA (UK and Ireland) 545 deals with the overarching requirement for the auditor to obtain sufficient appropriate audit evidence about fair value measurements. Within ISA (UK and Ireland) 545, additional requirements apply the requirements in

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<sup>28</sup> “Observable inputs” are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. “Unobservable inputs” are inputs that reflect the reporting entity’s own assumptions

other ISAs (UK and Ireland) to the audit of fair value; in particular, those dealing with understanding the entity and its environment and assessing the risks of material misstatement, responding to assessed risks, using the work of an expert, obtaining management representations, and communicating with those charged with governance. Considerations relevant to these requirements are addressed in other parts of this Practice Note. Those that are particularly relevant when market conditions are difficult are further discussed below.

112. It may be appropriate for the auditor's understanding of relevant industry and regulatory factors in accordance with ISA (UK and Ireland) 315 to include inquiry of management as to whether there have been discussions with supervisors or other regulators during the year about valuation practices, and whether management has reviewed its processes in the light of those discussions<sup>29</sup>.

113. Challenges may exist for management when fair value accounting estimates have unobservable inputs, in particular as a result of inactive markets. Management may not have the expertise internally to value illiquid complex financial instruments, and there may be limited sources of information available to establish their values. It may be necessary for management to make assumptions, including assumptions relied upon by management based upon the work of an expert, to develop fair value measurements for illiquid complex financial instruments. Assumptions are integral components of more complex valuation methods, for example valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present.

114. Changes in markets may require changes in valuation approaches. Consistency is generally a desirable quality in financial information, but may be inappropriate if circumstances change. ISA (UK and Ireland) 545 gives the example of the introduction of an active market as an illustration of changed circumstances leading to a move from valuation by model to valuation by market price. However, as markets

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about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

<sup>29</sup> For example, a report prepared by the Financial Stability Forum (FSF), dated 7 April 2008, to the G7 Finance Ministers, strongly encouraged financial institutions to establish rigorous valuation processes and make robust valuation disclosures. It was suggested that "rigorous internal processes requiring critical judgment and discipline in the valuation of holding of complex or potentially illiquid securities" will benefit certain entities, better equipping them to deal with the challenges in the current market.

become inactive, the changes can be in the opposite direction. Even where models have been consistently used, there is a need to examine the continuing appropriateness of the models and assumptions. Further, models may have been calibrated in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress. Consequently, the degree of consistency of valuation approaches and the appropriateness of changes in approach or assumptions require audit attention.

115. A change in valuation approach does not, however, justify a change in the underlying measurement objective which must remain a fair value as defined in the financial reporting framework, and not a move, for example, to ‘intrinsic’ or ‘fundamental’ value.

116. Unless management is able to support its valuations, it will be difficult for the auditor to obtain sufficient appropriate audit evidence. However, as evidence about assumptions and the validity of models is necessarily less reliable than evidence of a market price taken from an active market, it may be necessary to look at more sources of evidence to accumulate sufficient appropriate evidence, as the quantity and quality of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required). For example, the auditor, or an auditor’s expert, may use an independent model to compare its results with those of the model used by management in order to evaluate whether the values determined by management’s model is reasonable.

117. In addition, the auditor may consider whether external sources provide audit evidence to which the auditor could benchmark an entity’s practices. For example, sources that track provisioning by institutions may provide the auditor with evidence as to whether the entity’s valuations are reasonable if it has invested in similar instruments.

### ***Amendments to GAAP***

118. Accounting standard setters may amend financial reporting standards that appear to be giving rise to particular difficulties. For example, in October 2008, the IASB issued amendments to IAS 39 and IFRS 7, and the ASB made corresponding

changes to FRS 26 and FRS 29, to permit the reclassification of certain financial assets, including:

- certain held-for-trading non-derivative financial assets out of the Fair Value Through Profit or Loss (FVTPL) category in rare circumstances; and
- certain financial assets to the loans and receivables category (and so measured on a cost basis) if the entity has the intention and ability to hold them for the foreseeable future or until maturity.

The amendments do not permit reclassification if an entity has applied an option to fair value financial instruments on initial recognition.

119. If an entity undertakes such a reclassification, the auditor considers whether that is appropriate and meets the criteria within the accounting standards. For example, the auditor obtains evidence regarding management's intent and ability to hold the financial asset to maturity. The auditor also considers whether the necessary associated disclosures relating to the classification have been given.

### **Fraud risks**

120. When financial market conditions are difficult the risk of fraudulent financial reporting may be increased. At times of market instability, unexpected losses may arise through failure to protect the entity from extreme fluctuations in market prices, from unanticipated weakness in asset prices, through trading misjudgments, or for other reasons. In addition, financing difficulties create pressures on management who are concerned about the solvency of the business. Such circumstances may give rise to incentives to engage in fraudulent financial reporting: to protect personal bonuses, to hide management error, to avoid breaching borrowing limits or to avoid reporting catastrophic losses.

121. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. This may include inappropriately adjusting assumptions and changing judgments used to estimate account balances, for example using assumptions for fair value accounting estimates that are inconsistent with observable marketplace assumptions. In illiquid markets, the increased use of models and lack of market comparisons may present opportunities for manipulation or override of amounts calculated by brokers or experts. Even

without fraudulent intent, there may be a natural temptation to bias judgments towards the most favorable end of what may be a wide spectrum. What is favorable is not always the position leading to the highest profit or lowest loss.

122. In auditing fair value accounting estimates, therefore, the auditor may need to consider whether the circumstances give rise to increased fraud risks. In reviewing the judgments and decisions made by management in the making of fair value accounting estimates, the auditor may identify indicators of possible management bias; if this is the case, the auditor may need to consider the implications for the rest of the audit.

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