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**Abstract** *The Auditing Practices Board (APB), the audit standard setting body for the UK and the Republic of Ireland, has published a Consultation Draft of a Practice Note "Auditing derivative financial instruments". Here the project director at the APB explains the thinking behind the guidance and explains how auditors should assess the different issues raised by the use of financial instruments.*

The use of derivative financial instruments is now commonplace within entities. They are used by companies and other entities for purposes such as managing current or anticipated risks relating to operations and financial position; for example, reducing exposures to changes in exchange rates, interest rates and commodity prices. They may also be used for taking open or speculative positions to benefit from anticipated market movements. Some entities may be involved in derivatives not only from a corporate treasury perspective but also, or alternatively, in association with the production or use of a commodity.

### **"The use of derivative financial instruments is now commonplace"**

The purpose of the Practice Note is to provide guidance to auditors in planning and performing auditing procedures for financial statement assertions related to derivative financial instruments. The Practice Note focuses primarily on auditing derivatives held by end users (an end user being defined as 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 speculating). The accounting systems and internal control issues associated with writing or trading derivatives may be different from those associated with using derivatives and are not covered by the Practice Note.

the extent of the auditors' responsibilities;  
risk assessment;  
the skills the audit team need;  
the importance of internal controls over derivatives;  
outsourcing; and  
the need for auditors to apply judgment when evaluating audit evidence.

The Practice Note explains that the auditors' responsibility related to derivative financial instruments, in the context of the audit of the financial statements taken as a whole, is limited to considering whether management's assertions related to derivatives result in financial statements prepared in all material respects in accordance with relevant legislation, regulations and applicable accounting standards. The auditors do not have a responsibility to provide assurance on the adequacy of the entity's risk management related to derivative activities, or the controls over those activities.

### **"Guidance to auditors in planning and performing"**

It is management's responsibility to monitor the entity's exposure to the risks of using derivatives and to implement suitable systems to manage and control those risks. As part of this, management should establish clear rules on the



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extent to which those responsible for derivative activities are permitted to participate in the derivative markets, and provide suitable guidelines to ensure that derivative activities are only undertaken to fulfil the entity's needs.

The risks that attach to an entity's derivative activities will impact the auditors' assessment of audit risk. Auditors need to identify whether an entity has derivative activities and, if it does, consider factors such as the knowledge and experience of management in dealing with derivatives, the objectives for the entity's use of derivatives and the complexity of the derivatives. Audit risk may be relatively low where derivatives are simple in nature.

### **“Management should establish clear rules”**

Whilst, as mentioned above, derivatives may be used by entities to manage certain business risks, it is important to be aware that the inherent characteristics of derivative activities and derivative financial instruments, which are often complex, may result in increased business risk in some entities.

Particular characteristics of derivatives that leverage the risks associated with them may include:

- 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 derivative that is recognised in the financial statements, particularly in the UK and the Republic of Ireland, where the financial reporting framework does not currently require derivatives to be recorded at fair value in the financial statements.

Significant use of derivatives, particularly complex derivatives, without relevant expertise within the entity increases audit risk. Often, it is the case that only a few individuals within an entity fully understand the derivative activities, particularly where they are complicated. In entities that engage in few derivative activities, management may lack experience with even relatively simple derivative transactions. Furthermore, the complexity of various contracts or agreements makes it possible for an entity to inadvertently enter into a derivative transaction, particularly where such a derivative is embedded in another contract. Circumstances such as these are likely to prompt auditors to question whether there is adequate management control,

and affect the nature, extent and timing of audit testing considered necessary.

Another factor affecting risk assessment is that materiality may be difficult for auditors to assess in relation to derivative transactions, particularly given some of their characteristics as described above. Materiality cannot be based on recorded balance sheet values alone, as derivatives may have little impact on the balance sheet even though significant risks may arise from them.

The Practice Note emphasises that members of the audit engagement team must have the necessary skill and knowledge to plan and perform auditing procedures related to the particular derivatives transactions undertaken by the entity. Where necessary, the engagement team will obtain the assistance of an expert in derivatives, from within or outside the audit firm, to plan and perform the auditing procedures. Situations where the use of an expert may be desired include when the derivatives are very complex, when simple derivatives are used in complex situations, the entity is engaged in active trading of derivatives, or the valuation of the derivatives are based on complex pricing models.

Effective control procedures over derivatives generally will 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.

### **“Materiality cannot be based on recorded balance sheet values alone”**

Auditors may perform tests of controls to obtain audit evidence about the effectiveness of the: (a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and (b) operation of the internal controls throughout the period. Where they determine that they are able to rely on an assessment of the entity's internal controls, the auditors may choose to reduce the extent of their substantive procedures. Internal audit, where it exists, often forms an essential part of the risk control function that enables senior management to review and evaluate the control procedures covering the use of derivatives.

The Practice Note explains that as part of the assessment of internal control, auditors consider the activities of any internal audit the entity may have and the extent to which it has the knowledge and skill to cover, and has in fact covered, the entity's derivatives activities. Where they consider it appropriate, and subject to a satisfactory

evaluation, the external auditors may choose to use the internal audit work to reduce their own audit procedures.

Some entities may use service organisations to initiate the purchase or sale of derivatives or maintain records of derivative transactions for the entity. The Practice Note explains that this may have positive or negative implications for the consideration of audit risk. On the one hand, the use of a service organisation may strengthen controls over derivatives. For example, a service organisation's personnel may have more experience with derivatives 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.

The Practice Note explains that evaluating audit evidence for assertions about derivatives often 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 concerning conditions expected to exist a long time. In these circumstances, 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 derivative and applicable accounting

principles, including underlying criteria, that are both extremely complex.

## **“Evaluating audit evidence for assertions about derivatives”**

A particular matter auditors need to evaluate is whether derivatives accounted for using hedge accounting meet criteria to justify hedge accounting, as this affects the recognition of gains and losses. The nature and extent of the evidence obtained by auditors will vary depending on the nature of the hedged items and the hedging instruments, but will generally include:

- whether the derivative was designated as a hedge at the inception of the transaction;
- the nature of the hedging relationship;
- the entity's risk management objective and strategy for undertaking the hedge;
- the entity's assessment of the effectiveness of the hedge; and
- where the derivative is hedging a future transaction, the entity's assessment of the certainty of that future transaction.

Auditors will also consider whether circumstances have changed since the initiation of a transaction such that it no longer meets the criteria for hedge accounting.

The Practice Note can be found on the APB's web site ([www.apb.org.uk](http://www.apb.org.uk)). The APB would welcome views from auditors and others with an interest in this area on all aspects of the consultation draft. ■