

## PROPOSED INTERNATIONAL AUDITING PRACTICE STATEMENT 1000 SPECIAL CONSIDERATIONS IN AUDITING FINANCIAL INSTRUMENTS CONTENTS

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[This will be amended based on the IAASB’s discussion of the authority attaching to IAPSs at the June IAASB meeting.]

[Proposed] International Auditing Practice Statement (IAPS) 1000, *Special Considerations in Auditing Financial Instruments*, should be read in the context of the [proposed amended] *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* (the Preface), which sets out the application and authority of IAPSs. The [proposed amended] Preface explains that IAPSs are issued to provide practical assistance to auditors in implementing ISAs and to promote good practice. IAPSs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor’s responsibility to comply with the requirements of all ISAs relevant to the audit. Auditors should determine whether any IAPS is relevant to the circumstances of the audit and, if so, obtain an understanding of its content. Depending on the nature of the topic(s) covered, an IAPS may assist the auditor in:

- (a) Obtaining an understanding of the circumstances of the entity, and in making judgments

about the identification and assessment of risks of material misstatement;

- (b) Making judgments about how to respond to assessed risks, including judgments about procedures that may be appropriate in the circumstances; or
- (c) Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.

While this IAPS highlights the requirements of certain ISAs, reading this IAPS is not a substitute for reading the ISAs themselves and there may be other requirements in the ISAs that are relevant.

## Scope of this IAPS

1. The purpose of this International Auditing Practice Statement (IAPS) is to provide background information and guidance to the auditor regarding special considerations when auditing financial instruments. Financial instruments may be used by financial and non-financial entities of all sizes for a variety of purposes. Some entities have large holdings and transaction volumes while other entities may only engage in a few financial instrument transactions. This IAPS is relevant to all of these situations.
2. Certain ISAs may be particularly relevant to audits of financial instruments. For example:
  - (a) ISA 540<sup>1</sup> deals with the auditor's responsibilities relating to auditing accounting estimates, including accounting estimates related to financial instruments measured at fair value; and
  - (b) ISA 315<sup>2</sup> and ISA 330<sup>3</sup> deal with identifying and assessing risks of material misstatement and responding to those risks.
3. The applicable financial reporting framework may require the entity to measure financial instruments at fair value or disclose fair value information for financial instruments carried at amortized cost.
- 3a. The guidance on valuation in this IAPS is particularly relevant for financial instruments measured or disclosed at fair value, while the guidance on areas other than valuation applies equally to financial instruments either measured at fair value or amortized cost. This IAPS is also applicable to both financial assets and financial liabilities, as the auditing considerations for both are generally the same, except that measurement of credit risk for financial liabilities can be particularly challenging.
- 3b. An audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities. Such responsibilities subsume making fair value measurements. This IAPS does not impose responsibilities on management or those charged with governance and does not override laws and regulation that govern their responsibilities.
- 3c. This IAPS has been written in the context of general purpose fair presentation financial reporting frameworks, but may also be useful, as appropriate in the circumstance, in other financial reporting frameworks such as special purpose financial reporting frameworks.

## Nature of Financial Instruments Addressed by this IAPS

4. Different definitions of financial instruments may exist among financial reporting frameworks. For example, International Financial Reporting Standards (IFRS) define a financial instrument as any contract that gives rise to a financial asset of one entity and a

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<sup>1</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>2</sup> ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>3</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

financial liability or equity instrument of another entity.<sup>4</sup> Financial instruments may be cash, the equity of another entity, the right to receive or deliver cash or exchange financial assets or liabilities, contracts settled in an entity's own equity instruments, certain contracts on non-financial items, or certain contracts issued by insurers that do not meet the definition of an insurance contract. This definition encompasses a wide range of financial instruments from simple loans and deposits to complex derivatives, structured products, and some commodity contracts.

5. This IAPS covers both financial assets and financial liabilities. However, it does not deal with the simplest financial instruments such as cash, simple loans, trade accounts receivable and trade accounts payable, nor does it deal with unlisted equity. [See Issue B – Agenda Item 4-A]
6. Also, this IAPS does not deal with all accounting issues relevant to financial instruments, such as hedge accounting, profit or loss on inception (often known as “Day 1” profit or loss), offsetting, risk transfers and loan loss provisioning. Although these subject matters can relate to how an entity's accounting for financial instruments, a discussion of the many potential complexities of these concepts is beyond the scope of this IAPS. [See Issue C – Agenda Item 4-A]
7. This IAPS is aimed at financial instruments that are complex, though much of the material may also be useful in considering the audit implications of simpler financial instruments. The complexity of a financial instrument often lies in the way in which future cash flows are determined. All financial instruments represent the right or obligation to pay or receive future cash flows. Examples of complexity can be:
  - (a) A very high volume of individual cash flows, where a lack of homogeneity requires analysis of each one or a large number of grouped cash flows to evaluate, for example, credit risk (for example, Collateralized Debt Obligations (CDOs)).
  - (b) Complex formulas for determining the cash flows.
  - (c) Uncertainty or variability of future cash flows, such as option contracts or financial instruments with lengthy contractual terms.

The higher the variability of cash flows to changes in market conditions, the more complex and uncertain the fair value measurement of the financial instrument is likely to be. In addition, sometimes financial instruments that ordinarily are relatively easy to value become complex to value because of particular circumstances, for example, instruments for which the market has become inactive or which have lengthy contractual terms. In addition, the accounting for financial instruments under certain financial reporting frameworks or certain market conditions may be complex.

- 7a. Another source of complexity is the volume of financial instruments held or traded. While a “plain vanilla” interest rate swap may not be complex, an entity holding a large number of them may use a sophisticated information system to identify, value and transact with these instruments

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<sup>4</sup> International Accounting Standard (IAS) 32, *Financial Instruments: Presentation*, paragraph 11

8. Originators of financial instruments are continuously developing new products and, as a result, it is not possible to provide an exhaustive list of all such instruments. For the purposes of this IAPS, financial instruments include, but are not limited to:
  - Derivatives (including forward contracts, swaps, caps, floors, swaptions, credit default options, credit default swaps, and other option contracts);
  - Repurchase agreements; and
  - Structured products—Some of these products may include embedded derivatives and can combine a number of financial instruments to achieve a desired overall effect (for example, CDOs, Asset Backed Securities (ABSs), and structured debt).
9. Financial instruments are susceptible to estimation uncertainty, which is defined in ISA 540 as “the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.”<sup>5</sup> The nature and reliability of information available to support the valuation of financial instruments varies widely, which thereby affects the degree of estimation uncertainty associated with their measurement. The degree of estimation uncertainty affects, in turn, the risks of material misstatement related to financial instruments, including their susceptibility to unintentional or intentional management bias. The importance of disclosures regarding the basis of measurement increases as the measurement uncertainty of the financial instruments increases. Many of the financial instruments referred to in paragraph 8 are required to be presented in the financial statements at fair value. Derivatives and structured products become more complex when they are a combination of individual financial instruments.

#### **Types of Entities to which this IAPS May Be Relevant**

10. Regardless of their size, all entities may be subject to risks of material misstatement when using financial instruments. For example, entities may not have accurately recorded all financial instrument transactions, or may not have valued these instruments properly in accordance with the applicable financial reporting framework.
11. The use of financial instruments varies by entity. For example, some entities may take positions in financial instruments to assume and benefit from risk. Other entities may use financial instruments to reduce risk by hedging or managing exposures. The guidance in this IAPS is intended to be helpful in audits of entities with different levels of use of financial instruments ranging from:
  - Entities with high levels of trading and use of financial instruments (for example, banks with complex dealing rooms, insurance companies and non-financial sector entities with treasury departments); to
  - Entities with relatively few transactions involving financial instruments (for example, an entity that wishes to hedge a relatively low number of foreign currency transactions or obtains a few instruments for investment purposes).

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<sup>5</sup> ISA 540, paragraph 7(c)

## **Section I—Background Information about Financial instruments**

### **Purpose of Using Financial instruments**

12. Many financial instruments, such as those arising from derivatives contracts, generally exist for:
- Hedging purposes (i.e., to change an existing risk profile to which an entity is exposed). This includes:
    - The forward purchase or sale of currency to fix a future exchange rate;
    - Converting future interest rates to fixed or floating through the use of swaps; and
    - The purchase of option contracts to provide an entity with protection against a particular price movement, including contracts which may contain embedded derivatives; and
  - Trading purposes (i.e., to enable an entity to take a risk position to benefit from long term investment returns or from short term market movements).

In addition, a financial instrument arising from a derivative contract may be a financial asset or a financial liability at different times and subject to different circumstances and can move from a financial asset to a financial liability very quickly. Such volatility can also dramatically affect an entity's credit risk exposure to its counterparties.

### **Risks of Using Financial instruments**

13. The use of financial instruments has become more commonplace and the accounting requirements to provide fair value and other information about them in financial statement presentations and disclosures have changed significantly in recent years. Management and those charged with governance may not:
- Fully understand the risks of using financial instruments;
  - Have the expertise to value them appropriately in accordance with the applicable financial reporting framework; or
  - Have sufficient controls in place over financial instrument activities.
14. The knowledge and experience of management and those charged with governance is an important element of the control environment at entities of all sizes. The use of financial instruments without relevant expertise (e.g., valuation and accounting expertise) within the entity may result in the entity unknowingly assuming a significant amount of risk (e.g., credit risk, market risk, and liquidity risk, among others), and increase the risks of material misstatement in the financial statements. The inability of management to fully appreciate the risks inherent in a complex financial instrument can have a direct effect on their ability to manage these risks appropriately, and may ultimately threaten the viability of the entity.
15. The use of financial instruments can reduce exposures to certain business risks, for example changes in exchange rates, interest rates and commodity prices, or a combination of those

risks. On the other hand, the inherent complexities also may result in increased business risk, in particular if entities are inappropriately hedging risks and inadvertently creating additional risks by doing so. This may in turn increase risks of material misstatement and present new challenges to management and auditors. Table 1 lists the principal types of risk related to financial instrument activities to which entities may be exposed.

Table 1: *Types of Risks to which Entities May Be Exposed through the Use of Financial Instruments*

The principal types of risk are listed below. This list is not meant to be exhaustive and different terminology may be used to describe these risks or classify the components of individual risks.

- (a) Credit (or counterparty) risk, which is the risk that one party to a financial instrument will cause a financial loss to another party by failing to discharge an obligation. Credit risk includes settlement risk and is often associated with default. Settlement risk is the related risk that one side of a transaction will be settled without consideration being received from the customer or counterparty.
- (b) Market risk, which is the risk that the fair value or future cash flow of a financial instrument will fluctuate because of changes in market prices, in an adverse way not anticipated by the entity when it entered into the transaction. Examples of market risk include currency risk, interest rate risk, commodity and equity price risk, and volatility risk.
- (c) Liquidity risk, which relates to the risk that an entity will be unable to fund increases in assets and meet obligations as they become due.
- (d) Operational risk, which relates to the specific processing required for financial instruments. Operational risk may increase as the complexity of a financial instrument increases, and poor management of operational risk may increase other types of risk. Operational risk includes:
  - (i) The risk that confirmation and reconciliation controls are inadequate resulting in incomplete or inaccurate recording of financial instruments;
  - (ii) The risks that there is inappropriate documentation of hedged transactions and insufficient monitoring of these transactions;
  - (iii) 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 reflect the economics of the overall trade, and which are therefore potentially incorrectly recorded, processed or risk managed;
  - (iv) The risk that undue reliance is placed by staff on the accuracy of valuation techniques or processing, without adequate review, and transactions are therefore incorrectly valued or risk managed;
  - (v) The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events, including the risk of fraud from both internal and external sources; and



- (vi) The risk that there is inadequate or non-timely maintenance of valuation techniques used to measure financial instruments.

Operational risk also includes legal (enforceability) risk, which is the risk relating 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 or incorrect 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 financial instruments.

**[See Issue F of Agenda Item 4-A]** The risk of fraud may be increased if, for example, an employee in a position to perpetrate a financial fraud understands both the financial instruments and the processes for accounting for them, but management and those charged with governance have a lesser degree of understanding.

An entity may undertake a number of financial instrument transactions with a single counterparty, and may enter into an agreement to offset these transactions (often known as “master netting arrangements”). Such an agreement may be relevant in assessing the risks.

Further, understanding the term of financial instruments may assist in identifying instruments which can be both assets and liabilities throughout the term, depending on the valuation. Such instruments may be subject to both own credit risk and counterparty risk.

### Controls Relating to Financial instruments

16. ISA 315 establishes requirements for the auditor to understand the entity and its environment, including its internal control. Obtaining an understanding of the entity and its environment, including the entity’s internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding obtained establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit. The volume of the financial instrument transactions at an entity typically determines the nature and extent of controls that may exist at an entity and an understanding of how financial instruments are monitored and controlled assists the auditor in determining the nature, timing and extent of audit procedures. Table 2 describes internal controls that may exist in an entity that deals in a high volume of financial instrument transactions.
17. Key elements of processes and internal control relating to an entity’s financial instrument transactions include:
  - Setting an approach to define the amount of risk exposure that the entity is willing to accept when engaging in financial instrument transactions (this may be referred to as its “risk appetite”), including policies for investing in financial instruments, and the control framework in which the financial instrument activities are

conducted;

- Establishing processes for the authorization of new types of financial instrument transactions which consider the accounting, regulatory, legal, market and operational risks that are associated with such instruments;
- Processing financial instrument transactions, including confirmation and reconciliation of cash and asset holdings to external statements, and the payments process;
- Segregation of duties between those investing in the financial instruments and those responsible for valuing such instruments;
- Valuation processes, including the use of third-party expertise;
- Risk management; and
- Monitoring of controls.

Table 2: *Internal Controls Relating to Financial instruments that May Exist within the Entity*

The extent of an entity's use of financial instruments and the degree of complexity of the instruments are important determinants of the necessary level of sophistication of the entity's internal control. For example, smaller entities may use less structured products and simple processes and procedures to achieve their objectives. 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 following provides background information and examples of internal controls that may exist in an entity that deals in a high volume of financial instrument transactions, whether for trading or investing purposes. The examples are not meant to be exhaustive and entities may establish different control environments and processes depending on their size, the industry in which they operate, and the extent of their financial instrument transactions.

Management and, where appropriate, those charged with governance are responsible for designing and implementing a system of internal control necessary to enable the preparation of financial statements in accordance with the applicable financial reporting framework with respect to financial instruments. An entity's internal control may be effective when management and those charged with governance have:

- (a) Established an appropriate control environment, including a commitment to competence, participation by those charged with governance, a clear organizational structure, assignment of authority and responsibility, and human resource policies and procedures. In particular, clear rules are needed on the extent to which those responsible for financial instrument activities are permitted to participate in the trading markets. Such rules have regard to any legal or regulatory restrictions on using financial instruments. For example, certain public sector entities may not have the power to conduct business using derivative financial instruments;
- (b) Established a risk assessment process relative to the size of the entity and the complexity of

its financial instruments (for example, in some entities a formal risk management function may exist);

- (c) Established information systems that provide those charged with governance with an understanding of the nature of the financial instrument activities and the associated risks;
- (d) Designed and implemented a system of internal control to:
  - Provide reasonable assurance that the entity's use of financial instruments is within its risk management policies; and
  - Ensure that the entity is in compliance with applicable laws and regulations; and
  - Monitor risk and financial control;
- (e) Considered the integrity of the entity's accounting and financial reporting systems to ensure the reliability of management's financial reporting of financial instrument activities.

As in any control system it is sometimes necessary to duplicate controls at different control levels (for example, preventative, detective and monitoring) to avoid the risk of material misstatement.

### **The Entity's Control Environment**

#### *Commitment to Competence*

The degree of complexity of some financial instrument activities may mean that only a few individuals within the entity fully understand those activities or have the expertise necessary to value the instruments on an ongoing basis. Significant use of financial instruments, without relevant expertise within the entity, increases the risk of material misstatement.

#### *Participation by Those Charged with Governance*

Those charged with governance oversee and concur with management's establishment of the entity's overall risk appetite and provide oversight over the entity's financial instrument activities. An entity's policies for the purchase, sale and holding of financial instruments are aligned with its attitude toward risk and the expertise of those involved in financial instrument activities. In addition, an entity may establish governance structures and control processes aimed at:

- (a) Communicating investment decisions and assessments of all material measurement uncertainty to those charged with governance; and
- (b) Evaluating the entity's overall risk appetite when engaging in financial instrument transactions.

#### *Organizational Structure*

Financial instrument activities may be run on either a centralized or a decentralized 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 financial instrument activities may increase with greater decentralization of control activities. This may especially be true where an entity is based in different locations, some perhaps in other countries.

#### *Assignment of Authority and Responsibility*

##### *Investment and Valuation Policies*

Providing direction, through clearly stated policies approved by those charged with governance, for the purchase, sale, and holding of financial instruments, enables management to establish an effective approach to taking and managing business risks. These policies are most clear when they state the entity's objectives with regard to its risk management activities and the investment and hedging alternatives available to meet these objectives and reflect the:

- (a) Level of the entity's management expertise;
- (b) Sophistication of the entity's internal control and monitoring systems;
- (c) Entity's asset/liability structure;
- (d) Entity's capacity to maintain liquidity and absorb losses of capital;
- (e) Types of financial instruments that management believes will meet its objectives; and
- (f) Uses of financial instruments that management believes will meet its objectives, for example, whether derivatives may be used for speculative purposes or only for hedging purposes.

Management may design policies aligned with its valuation capabilities and may establish controls to ensure that these policies are adhered to by those employees responsible for the entity's valuation. These may include:

- (a) Processes for the design and validation of methodologies used to produce valuations, including how measurement uncertainty is addressed; and
- (b) Policies regarding maximizing the use of observable inputs and the types of information to be gathered to support valuations of financial instruments.

In smaller entities, dealing in financial instruments may be rare and management's knowledge and experience limited. Nevertheless, establishing policies over financial instruments helps an entity to determine its risk appetite and consider whether investing in particular financial instruments achieves a stated objective.

##### *Human Resource Policies and Practices*

Entities may establish policies requiring key employees dealing with financial instruments to take mandatory time off from their duties. This type of internal control is used as a means of preventing and detecting fraud, in particular if those engaged in trading activities are creating false trades or inaccurately recording transactions.

### **The Entity's Risk Assessment Process**

An entity's risk assessment process exists to establish how management identifies business risks that derive from its use of financial instruments, including how management estimates the significance of the risks, assesses the likelihood of their occurrence and decides upon actions to manage them.

The entity's risk assessment process forms the basis for how management determines the risks to be managed. Risk assessment processes exist with the objective of ensuring that management:

- (a) Understands the risks inherent in a complex financial instrument before they enter into it, including the objective of entering into the transaction and its structure (e.g., the economics and business purpose of the entity's financial instrument activities);
- (b) Performs adequate due diligence commensurate with the risks associated with particular financial instruments;
- (c) Monitors their outstanding positions to understand how market conditions are affecting their exposures;
- (d) Has procedures in place to reduce or change risk exposure if necessary and for managing reputational risk; and
- (e) Subjects these processes to rigorous supervision and review.

Table 1 provides examples of risks related to financial instruments to which entities may be exposed.

The structure implemented to monitor and manage exposure to risks should:

- (a) Be appropriate and consistent with the entity's attitude toward risk as determined by those charged with governance;
- (b) Specify the approval levels for the authorization of different types of 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 financial instrument activities, demonstrating management's commitment to competence;
- (c) Set 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;
- (d) Provide for the independent and timely monitoring of the financial risks and control activities;
- (e) Provide for the independent and timely reporting of exposures, risks and the results of financial instrument activities in managing risk; and
- (f) Evaluate management's track record for assessing the risks of particular financial instruments.

The types and levels of risks an entity faces are directly related to the types of financial instruments with which it deals, including the complexity of these instruments and the volume of financial instruments transacted.

#### *Risk Management Function*

Some entities, for example large financial institutions with a high volume of financial instrument transactions, may be required by law or regulation, or may choose, to establish a formal risk management function. This function is independent of those responsible for undertaking and managing financial instrument transactions. The function is responsible for reporting on and monitoring financial instrument activities, and may include a formal risk committee established by those charged with governance. Examples of key responsibilities in this area may include:

- (a) Implementing the risk management policy set by those charged with governance (including analyses of the risks to which an entity may be exposed);
- (b) Designing risk limit structures and ensuring these risk limits are implemented in practice;
- (c) Developing stress scenarios and subjecting open position portfolios to sensitivity analysis, including reviews of unusual movements in positions; and
- (d) Reviewing and analyzing new financial instrument products.

Financial instruments may have the associated risk that a loss might exceed the amount, if any, of the value of the complex financial instrument recognized on the balance sheet. For example, a sudden fall in the market price of a commodity may force an entity to realize losses to close a forward position in that commodity due to collateral, or margin, requirements. In some cases, the potential losses may be enough to cast significant doubt on the entity's ability to continue as a going concern. The entity may perform sensitivity analyses or value-at-risk analyses to assess the future hypothetical effects on financial instruments subject to market risks. However, value-at-risk analyses may not fully consider all the risks that may affect the entity.

The volume and sophistication of financial instrument activity and relevant regulatory requirements will influence the entity's consideration of whether to establish a formal risk management function and how the function may be structured. In entities that have not established a separate risk management function, for example entities with a relatively few number of financial instruments or financial instruments that are less complex, reporting on and monitoring financial instrument activities may be a component of the accounting or finance function's responsibility or management's overall responsibility, and may include a formal risk committee established by those charged with governance

#### *The Entity's Information Systems*

The key objective of an entity's information systems is that they are capable of capturing and recording all the transactions accurately, settling them, valuing them, and producing information to enable the financial instruments to be risk managed and for controls to be monitored. Difficulties can arise in entities that engage in a high volume of financial instruments, in particular if there is a multiplicity of systems that are poorly integrated and have manual interfaces without adequate controls.

Certain financial instruments may require a large number of accounting entries. As the sophistication or level of the financial instrument activities increases, it is necessary for the sophistication of the information system to also increase. Specific issues which can arise in respect to financial instruments include:

- (a) Information systems, in particular for smaller entities, not having the capability or not being appropriately configured to process financial instrument transactions, especially when the entity does not have any prior experience in dealing with financial instruments. This may result in an increased number of manual transactions;
- (b) The potential diversity of systems required to process more complex transactions, and the need for regular reconciliations between them, in particular when the systems are not interfaced or may be subject to manual intervention;
- (c) 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;
- (d) A lack of review of systems exception logs, external confirmations and broker quotes, where available, to validate the entries generated by the systems;
- (e) Difficulties in controlling and evaluating the key inputs to systems for valuation of financial instruments, particularly where those systems are maintained by the group of traders known as the front office or a third-party service provider and/or the transactions in question are non-routine or thinly traded;
- (f) Failure to evaluate the design and calibration of complex valuation techniques used to process these transactions initially and on a periodic basis;
- (g) The potential that management has not set up a library of valuation techniques, with controls around access, change and maintenance of individual valuation techniques, in order to maintain a strong audit trail of the accredited versions of valuation techniques and in order to prevent unauthorized access or amendments to those valuation techniques;
- (h) The disproportionate investment that may be required in risk management and control systems, where an entity only undertakes a limited number of financial instrument transactions, and the potential for misunderstanding of the output by management if they are not used to these types of transactions;
- (i) The potential requirement for third-party systems provision, for example from a service organization, to record, process, account for or risk manage appropriately financial instrument transactions, and the need to reconcile appropriately and challenge the output from those providers; and
- (j) Additional security and control considerations relevant to the use of an electronic network when an entity uses electronic commerce for financial instrument transactions.

Information systems relevant to financial reporting serve as an important source of information

for the quantitative disclosures in the financial statements. However, entities may also develop and maintain non-financial systems used for internal reporting and to generate information included in qualitative disclosures, for example regarding risks and uncertainties or sensitivity analyses.

### **The Entity's Control Activities**

Control activities over financial instrument transactions are designed to prevent or detect problems that hinder an entity from achieving its objectives. These objectives may be either operational, financial reporting, or compliance in nature. Control activities over financial instruments are designed relative to the complexity and volume of transactions of financial instruments and will generally include an appropriate authorization process, adequate segregation of duties, and other policies and procedures designed to ensure that the entity's control objectives are met. This IAPS focuses on control activities related to completeness, accuracy and existence, valuation, and presentation and disclosure.

#### *Authorization*

Authorization can affect the financial statement assertions both directly and indirectly. For example, even if a transaction is executed outside an entity's policies, it nonetheless may be recorded and accounted for accurately. However, unauthorized transactions could significantly increase risk to the entity, thereby significantly increasing the risk of material misstatement since they would be undertaken outside the system of internal control. To mitigate this risk, an entity will often establish a clear policy as to what transactions can be traded by whom and adherence to this policy will then be monitored by an entity's back office. Monitoring trading activities of individuals, for example by reviewing unusually high volumes or significant losses incurred, will assist management in ensuring compliance with the entity's policies, including the authorization of new types of transactions, and evaluating whether fraud has occurred.

The function of an entity's deal initiation records is to identify clearly the nature and purpose of individual transactions and the rights and obligations arising under each complex financial instrument contract, including the enforceability of the contracts. In addition to the basic financial information, such as a notional amount, complete and accurate records at a minimum typically include:

- (a) The identity of the dealer;
- (b) The identity of the person recording the transaction (if not the dealer), when the transaction was initiated (including the date and time of the transaction), and how it was recorded in the entity's information systems; and
- (c) The nature and purpose of the transaction, including whether or not it is intended to hedge an underlying commercial exposure.

#### *Segregation of Duties*

Segregation of duties and the assignment of personnel is an important control activity. Financial instrument activities may be categorized into a number of functions, including:



- (a) Executing the transaction (dealing). In entities with a high volume of financial instrument transactions, this may be done the front office;
- (b) Initiating cash payments and accepting cash receipts (settlements);
- (c) Sending out trade confirmations and reconciling the differences between the entity's records and replies from counterparties, if any;
- (d) Recording of all transactions correctly in the accounting records;
- (e) Monitoring risk limits. In entities with a high volume of financial instrument transaction, this may be performed by the risk management function; and
- (f) Monitoring positions and valuing financial instruments.

Where an entity is too small to achieve proper segregation of duties, the role of management and those charged with governance in monitoring financial instrument activities is of particular importance.

A feature of some entity's internal control is independent price verification (IPV) function. This department is responsible for separately verifying the price of some financial instruments, and may use alternative data sources, methodologies and inputs. The IPV provides an independent and objective look at the pricing that has been developed in another part of the entity.

Ordinarily, the middle or back office is responsible for establishing policies on valuation and ensuring adherence to the policy. Entities with a greater use of financial instruments may undertake perform daily valuations of their financial instrument portfolio and examine the contribution to profit or loss of individual financial instrument valuations as a test of the reasonableness of valuations [Relocated from paragraph 50].

### **Monitoring of Controls**

Entities' ongoing monitoring activities are designed to detect and correct any deficiencies in the effectiveness of internal controls over transactions for financial instruments and their valuation. It is important that there is adequate supervision and review of financial instrument activity within the entity. This includes:

- (a) All controls being subject to review, for example:
  - A detailed review of the application of particular controls. An example would be the review by a supervisor of bank or custodian reconciliations; or
  - The monitoring of operational statistics such as the number of reconciling items or the difference between internal pricing and external pricing sources;
- (b) The need for robust information technology (IT) controls and monitoring and validating their application; and
- (c) The need to ensure that information resulting from different processes and systems is adequately reconciled. For example, there is little benefit in a valuation process if the

output from it is not reconciled properly into the general ledger.

In larger entities, sophisticated computer information systems generally keep track of financial instrument activities, and are designed to ensure that settlements occur when due. More complex computer systems may generate automatic postings to clearing accounts to monitor cash movements, and controls over processing are put in place with the objective of ensuring that 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 financial instruments have not been used within authorized 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 financial instrument transactions. Accordingly, management often may put additional procedures in place to increase the likelihood that all transactions will be recorded, as discussed in Table 4.

### **Presentation and Disclosure about Financial instruments**

18. Management's responsibilities include the preparation of the financial statements in accordance with the applicable financial reporting framework.<sup>6</sup> Some financial reporting frameworks require disclosures in the financial statements to enable users of the financial statements to make meaningful assessments of effects of the entity's financial instrument activities, including the risks and uncertainties associated with these financial instruments. Accordingly, ISAs do not treat disclosures as being of less importance than items on the face of the financial statements.
19. Most frameworks require the disclosure of quantitative and qualitative information (including accounting policies) relating to financial instruments. The accounting requirements for fair value accounting estimates in financial statement presentations and disclosures are extensive in most financial reporting frameworks and encompass more than just valuation of the financial instruments. In preparing financial statement disclosures, management complies with the requirements of the applicable financial reporting framework in their jurisdictions. For example, qualitative disclosures about financial instruments provide important contextual information about the characteristics of the financial instruments and their future cash flows that may help inform investors about significant risks.

Table 3: *Categories of Disclosures*

Disclosure requirements can typically be characterized in three main categories:

- (a) Quantitative disclosures that are derived from the amounts included in the financial statements—for example, categories of financial assets and liabilities;
- (b) Quantitative disclosures that require significant judgment—for example, sensitivity analysis for each type of market risk to which the entity is exposed; and
- (c) Qualitative disclosures—for example, those that describe the entity's objectives,

<sup>6</sup> See paragraphs 4 and A2 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

policies and procedures for managing each type of risk arising from financial instruments and the methods used to measure the risks.

The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- A summary of significant accounting policies.
- Relevant assumptions used.
- The method of estimation used, including any applicable valuation technique.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Disclosures that give information about the significance of financial instruments to an entity's financial position and performance and may be required by the applicable financial reporting framework may include:

- Disclosures about the carrying amounts of financial assets and liabilities;
- Disclosures about reclassifications of financial assets;
- Disclosures about the carrying amounts of financial assets that have been pledged as collateral, including the terms and conditions;
- Disclosures about the recognition of profits or losses at the initiation of the complex financial instrument transactions (referred to as “day 1 profits or losses”);
- Disclosures about net gains or net losses on particular categories of financial assets and financial liabilities;
- Disclosures about movements in and out of level 3 of the fair value hierarchy; and
- Disclosures about non-linear financial instruments and the factors that affect their valuation.

Entities may also be required under certain financial reporting frameworks 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.

The more sensitive the valuation is to movements in a particular variable, the more likely it is that disclosure will be necessary to indicate the uncertainties surrounding the valuation. Certain financial reporting frameworks may also require disclosure of sensitivity analyses, including the effects of changes in assumptions used in the entity's valuation methodology.

Some financial reporting frameworks require disclosure of 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. This disclosure may be contained in the notes to the financial statements, or in management's discussion and analysis within its annual report. The extent of disclosure depends on the extent of the entity's exposure to risks arising from financial instruments. This includes qualitative disclosures about:

- The exposures to risk and how they arise, including the possible effects on an entity's future liquidity and collateral requirements;
- The entity's objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- Any changes in the above two bullet points from the previous period.

Other qualitative disclosures that may be required by certain financial reporting frameworks include:

- The judgments made in applying the entity's accounting policies that have the most significant effect on the amounts recognized 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.

In addition, qualitative disclosures are often used to add value to quantitative disclosures in the financial statements by providing analysis and interpretation, for example to provide more information about valuation techniques and inputs to fair value measurements.

As noted in Table 5 (following paragraph 49 of this IAPS), some financial reporting frameworks may establish a fair value hierarchy that reflects the significance of the inputs used in making the measurements. They may also require the entity to disclose whether changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly and, if so, how the effect of a change in assumptions was calculated. There may also be a requirement to disclose the effect of correlation between unobservable inputs if such correlation is relevant when estimating the effect on the fair value measurement of using those different levels of inputs. While these disclosures may be quantitative in nature in that an amount is calculated, the selection of reasonably possible alternative assumptions is often a subjective process.

For example, the additional disclosures required for financial instruments with fair value measurements that are in level 3 of the hierarchy are aimed at informing users of financial statements about the effects of those fair value measurements that use the most subjective inputs. Because the inputs to these fair value measurements reflect the entity's own assumptions about assumptions that market participants would use, including assumptions about risks, it is critical that disclosures are comprehensive and meaningful.

## Section II—Audit Considerations Relating to Financial instruments

### Planning Considerations<sup>7</sup>

20. Certain factors may make auditing financial instruments particularly challenging. For example:
- It may be difficult for both management and the auditor to understand the nature of financial instruments and what they are used for, and the risks to which the entity is exposed.
  - Markets can change quickly, placing pressure on management to manage their exposures effectively.
  - Evidence supporting valuation may be difficult to obtain.
  - Individual payments associated with certain financial instruments may be significant, which may increase the risk of misappropriation of assets.
  - The amounts recorded in the financial statements relating to financial instruments may not be significant, but there may be significant risks and exposures associated with these financial instruments.
  - A few employees may exert significant influence on the entity's financial instruments transactions, in particular where their compensation arrangements are tied to revenue from financial instruments, and there may be possible undue reliance on these individuals by others within the entity.

These factors may cause risks and relevant facts to be obscured, which may affect the auditor's assessment of the risks of material misstatement, and latent risks can emerge rapidly, especially in adverse market conditions.

- 20a. Auditing financial instruments poses particular challenges for auditors in evaluating if they have the professional knowledge and skill with financial instruments at a level sufficient to provide a competent service. See paragraph 30 for examples of the types of matters that are relevant to providing a competent service in relation to financial instruments. The IESBA Code includes the fundamental principle of professional competence and due care imposes an obligation on a professional accountant in public practice to provide only those services that the professional accountant in public practice is competent to perform. In some circumstances, the auditor may need to obtain the services of an auditor's expert. [See Issue F of Agenda Item 4-A]
21. ISA 540 requires the auditor to obtain an understanding of the requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures and any regulatory requirements.<sup>8</sup> The requirements of the applicable financial reporting framework regarding financial instruments may themselves be complex and require extensive disclosures.

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<sup>7</sup> ISA 300, *Planning an Audit of Financial Statements*, deals with the auditor's responsibility to plan an audit of financial statements.

<sup>8</sup> ISA 540, paragraph 8(a)

21a. Accordingly, the focus of the auditor in planning the audit is particularly on:

- Understanding the financial instruments in which the entity has invested or to which it is exposed, and their purpose and risks;
- Understanding and evaluating the system of internal control (see Table 2) in light of the entity's financial instrument transactions, including whether a lack of effective internal control increases the possibility of fraud or error;
- Understanding management's process for valuing financial instruments, including whether management has used an expert;
- Understanding the accounting and disclosure requirements;
- Understanding the information systems that fall within the scope of the audit; and
- Determining whether specialized skills and knowledge are needed in the audit.

*Professional Skepticism* [See Issue F of **Agenda Item 4-A**]

22. Professional skepticism is important to the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes questioning and challenging contradictory audit evidence, being alert to conditions that may indicate possible misstatement due to error or fraud, a critical assessment of audit evidence including documents presented to the auditor. It is important also in assessing the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances.
23. Application of professional skepticism is important in all circumstances, and the need for professional skepticism increases with the complexity of financial instruments, for example in regard to:
- Evaluating whether sufficient appropriate audit evidence has been obtained, which can be particularly challenging in inactive markets or when valuation techniques are used.
  - Evaluating management's judgments, and the potential for management bias, in applying the entity's applicable financial reporting framework, in particular management's choice of valuation techniques, use of assumptions in valuation techniques, and addressing circumstances in which the auditor's judgments and management's judgments differ.
  - Drawing conclusions based on the audit evidence obtained, for example assessing the reasonableness of valuations prepared by management's experts and evaluating whether disclosures in the financial statements achieve fair presentation.
24. [Deleted]

*Understanding the Financial instruments*

25. It is important to obtain an understanding of the instruments in which the entity has invested or to which it is exposed, including the characteristics of the instruments. The characteristics of financial instruments may obscure certain elements of risk and exposure. This understanding can help an auditor to identify whether important aspects of a transaction are missing or inaccurately recorded, whether a valuation appears appropriate, whether the risks inherent in them are fully understood and managed by the entity and whether the financial instruments are appropriately classified into current and non-current assets and liabilities.
26. Examples of matters that the auditor may consider when obtaining an understanding of the entity's financial instruments include:
- What financial instruments the entity is exposed to;
  - What they are used for;
  - Management's and, where appropriate, those charged with governance's understanding of the financial instruments, their use and the accounting requirements;
  - Their exact terms and characteristics so that their implications can be fully understood and, in particular where transactions are linked, the overall impact of the financial instrument transactions; and
  - How they fit into the entity's overall risk management strategy.

Inquiries of the internal auditors, the risk management function, if such a function has been established by the entity, and discussions with those charged with governance may inform the auditor's understanding.

- 26a. In some cases, a contract for a non-financial instrument (such as a purchase of a commodity ) may contain a derivative. Some financial reporting frameworks permit or require such "embedded" derivatives to be separated from the host contract in some circumstances. Understanding management's process for identifying, and accounting for, embedded derivatives may assist the auditor in understanding the risks to which the entity is exposed.

#### *Fraud Risk Factors*<sup>9</sup>

27. Incentives for fraudulent financial reporting by employees may exist where compensation schemes are dependent on returns made from the use of financial instruments. Understanding how an entity's compensation policies interact with its risk appetite and the incentives that this may create for its management and traders may be important in assessing the risk of fraud.
28. Difficult financial market conditions may give rise to increased incentives for management or employees to engage in fraudulent financial reporting: to protect personal bonuses, to hide management error, to avoid breaching regulatory, liquidity or borrowing

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<sup>9</sup> See ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, for requirements and guidance dealing with fraud risk factors.

limits or to avoid reporting losses. For example, 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 concerned about the solvency of the business.

29. Misappropriation of assets and fraudulent financial reporting may often involve override of controls that otherwise may appear to be operating effectively. This can be override of controls over valuation assumptions and detailed process controls that allow losses and theft to be hidden.

*Using Those with Specialized Skills and Knowledge in the Audit*<sup>10</sup>

30. Specialized skills or knowledge may be needed, for example, in the areas of:
- Understanding the structure of financial instruments used by the entity, and their characteristics, including their level of complexity.
  - Risk analysis, in particular the risks inherent in a complex financial instrument. Using specialized skills and knowledge helps in checking whether all aspects of the complex financial instrument and related structures have been captured in the financial statements, and evaluating whether adequate disclosure in accordance with the applicable financial reporting framework has been made where disclosure of risks is required.
  - Valuation. When fair value is determined by a complex valuation technique; when markets are inactive and inputs are difficult to obtain; when unobservable inputs are used; or when management has used an expert.
  - Information technology. In entities with a high volume of financial instruments, the information technology may be highly complex, for example when significant information about those financial instruments is transmitted, processed, maintained or accessed electronically. In addition, it may include relevant services provided by a service organization.
  - Accounting. The applicable financial reporting framework may be complex, including circumstances where there are areas known to be subject to differing interpretations or practice is inconsistent or developing.

In addition, understanding the legal, regulatory, and tax implications resulting from the

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<sup>10</sup> When such a person's expertise is in auditing and accounting, regardless of whether the person is from within or external to the firm, this person is considered to be part of the engagement team and is subject to the requirements of ISA 220, *Quality Control for an Audit of Financial Statements*. When such a person's expertise is in a field other than accounting or auditing, such person is considered to be an auditor's expert, and the provisions of ISA 620, *Using the Work of an Auditor's Expert*, apply. ISA 620 explains that distinguishing between specialized areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment, but notes the distinction may be made between expertise in methods of accounting for financial instruments (accounting and auditing expertise) and expertise in complex valuation techniques for financial instruments (expertise in a field other than accounting or auditing).



financial instruments, including whether the contracts are enforceable by the entity (for example, reviewing the underlying contracts), may require specialized skills and knowledge. Accordingly, more than one individual or organization with specialized skills may be involved, in order to assist in various stages of the audit.

31. The nature and use of particular types of financial instruments, the complexities associated with their valuation and disclosure, and market conditions may also lead to a need for the engagement team to consult<sup>11</sup> with other accounting and audit professionals, from within or outside the firm, with relevant technical accounting or auditing expertise and experience, taking into account factors such as:
- The capabilities and competence of the engagement team, including the experience of the members of the engagement team;
  - The attributes of the financial instruments used by the entity;
  - The identification of unusual circumstances or risks in the engagement, as well as the need for professional judgment, particularly with respect to materiality and significant risks; or
  - Market conditions.

## **Assessing and Responding to the Risks of Material Misstatement**

### *Overall Considerations Relating to Financial Instruments*

32. The complexity of the financial instrument, and the other factors referred to above, influence the auditor's approach to identifying and assessing the risks of material misstatement associated with financial instruments in accordance with ISA 315 and to designing and implementing responses to address these risks in accordance with ISA 330. In an audit of financial statements in accordance with ISAs, risks of material misstatement are identified and assessed at the assertion level for classes of transactions, account balances and disclosures.<sup>12</sup> Doing so directly assists in determining the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This IAPS focuses on the assertions<sup>13</sup> on which the entity is likely to focus its control objectives in order to reduce the risks of material misstatement related to financial instruments. Those assertions are:
- (a) Completeness, accuracy, and existence;
  - (b) Rights and obligations;
  - (c) Valuation; and

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<sup>11</sup> ISA 220, paragraph 18(b), requires the engagement party to be satisfied that members of the engagement team have undertaken specific consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm.

<sup>12</sup> ISA 315, paragraph 25

<sup>13</sup> ISA 315, paragraph A111, lists assertions used by the auditor to consider the different types of potential misstatements.

(d) Presentation and disclosure, including classification in the financial statements.

Given the nature of financial instruments, particularly complex financial instruments, there are likely to be areas of significant risks of material misstatement related to these assertions, especially valuation.

33. The nature of risks can differ between entities with a large volume of financial instruments and those with only a few financial instrument transactions. For example:
- Typically an institution with large volumes of financial instruments will have a dealing room type environment in which there are specialist traders and segregation of duties between those traders and the back office (which refers to the operations function that data-checks trades that have been conducted, ensuring that they are not erroneous, and transacting the required transfers). In such environments, the traders will typically initiate contracts verbally over the phone or via an electronic trading platform. Capturing relevant transactions and accurately recording financial instruments in such an environment is significantly more challenging than for an entity with only a few financial instruments, whose existence and completeness can be confirmed with a bank confirmation to a few banks.
  - On the other hand, entities with specialist traders and back offices will typically have considerably more access to the market, and therefore possess more valuation indicators and expertise than a smaller entity, whose main business is not trading financial instruments.
34. The auditor's assessment of the identified risks at the assertion level in accordance with ISA 315 includes evaluating the design and implementation of internal control. It provides a basis for considering the appropriate audit approach for designing and performing further audit procedures in accordance with ISA 330, including both substantive procedures and tests of controls. The approach taken is influenced by the auditor's understanding of internal control relevant to the audit, including the strength of the control environment, the size and complexity of the entity's operations and whether the auditor's assessment of risks of material misstatement include an expectation that controls are operating effectively.
- 34a. The auditor may find that understanding the process by which management obtains its understanding of the financial instruments assists in identifying and assessing the risks of material misstatement.

#### Factors in Determining Whether to Test Controls

35. The nature and extent of internal control that exists at an entity influences the auditor's determination of the nature, timing and extent of tests of controls and substantive procedures. An expectation that controls are operating effectively may be more common when dealing with a financial institution with well-established internal controls, and therefore controls testing may be an effective means of obtaining audit evidence. When an entity has a trading function, substantive tests alone may not provide sufficient appropriate audit evidence due to the volume of contracts and the different systems used. Tests of controls, however, will not be sufficient on their own as the auditor is required by ISA 330 to design and perform substantive procedures for each material class of

transactions, account balance and disclosure.<sup>14</sup> Conversely, when auditing an entity with just a small number of financial instruments or when controls are weak, a substantive testing approach may be more effective, though the auditor would still need to obtain an understanding of internal control relevant to the audit.<sup>15</sup>

36. Entities with a large volume of trading and use of financial instruments may have more sophisticated controls and the auditor may be more likely to test controls in obtaining evidence about the completeness, accuracy, and existence of the transactions, having considered whether the controls, such as those described in Table 2, are in place at the entity.
37. In those entities with relatively few financial instrument transactions:
  - Management and those charged with governance may have only a limited understanding of financial instruments and how they affect the business;
  - The entity may only have a few different types of instruments with little or no interaction between them;
  - There is unlikely to be a complex control environment (for example, the controls described in Table 2 may not be in place at the entity);
  - Management may use pricing information from third party pricing sources to value their instruments; and
  - Management may engage third-party experts to value such instruments.
38. When an entity has relatively few transactions involving financial instruments, it may be relatively easy for the auditor to obtain an understanding of the entity's objectives for using the financial instruments and the characteristics of the instruments. In such circumstances, much of the audit evidence is likely to be substantive in nature, the auditor may perform the majority of the audit work at year-end, and third-party confirmations are likely to provide evidence in relation to the completeness, accuracy, and existence of the transactions.
39. In reaching a decision on the nature, timing and extent of testing of controls, the auditor may consider factors such as the monitoring of controls and:
  - Whether sufficient appropriate audit evidence can be obtained by performing substantive procedures alone. ISA 330 requires the auditor to design and perform tests of controls if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level;<sup>16</sup>
  - The strength of internal controls, including whether internal controls are appropriately designed to respond to the risks associated with an entity's volume of financial instrument transactions and whether there is a governance framework over the entity's financial instrument activities;
  - The importance of particular controls to the overall control objectives and processes

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<sup>14</sup> ISA 330, paragraph 18

<sup>15</sup> ISA 315, paragraph 12

<sup>16</sup> ISA 330, paragraph 8(b)

in place at the entity, including the sophistication of the information systems to support financial instrument transactions;

- Identified deficiencies in control procedures;
- The issues the control objectives are intended to address, for example, controls related to the exercise of judgments compared with controls over supporting data. Substantive tests are more likely to be effective than relying on controls related to the exercise of judgments;
- The competency of those involved in the control activities, for example whether the entity has adequate capacity, including during periods of stress, and ability to establish and verify valuations for the financial instruments to which it is exposed;
- The frequency of performance of these control activities;
- The level of precision the controls are intended to achieve;
- The evidence of performance
- The timing of key financial instrument transactions, for example, whether they are close to the period end; and
- The nature, frequency and volume of financial instrument transactions.

[Paragraphs 39a-39b relocated from paragraphs 78-79]

- 39a. Entities may also use service organizations (for example asset managers) to initiate the purchase or sale of financial instruments or maintain records of transactions for the entity. Some entities may be dependent on these service organizations to provide the basis of reporting for the financial instruments held. However, if management does not have an understanding about the controls in place at a service organization, the auditor may not be able to obtain sufficient appropriate audit evidence to rely on controls at that service organization. See ISA 402, which establishes requirements for the auditor to obtain sufficient appropriate audit evidence when an entity uses the services of one or more service organizations.
- 39b. The use of service organizations may strengthen or weaken the control environment for financial instruments. For example, a service organization's personnel may have more experience with financial instruments than the entity's management or may have more robust internal control over financial reporting. The use of the service organization also may allow for greater segregation of duties. On the other hand, the service organization may have a poor control environment.

#### Substantive Procedures

40. Designing substantive tests includes consideration of:
- Significant risks relating to financial instruments that have been identified;
  - Availability of evidence—For example, when the entity uses a service organization, evidence concerning the relevant financial statement assertions may not be available from the entity if another organization holds, services or both holds and services the

entity's financial instruments;<sup>17</sup>

- Analytical procedures<sup>18</sup>—While analytical procedures undertaken by the auditor can be effective as risk assessment procedures to provide the auditor with information about an entity's business, they are usually less effective as substantive procedures because the complex interplay of the factors from which the values of these instruments are derived often masks any unusual trends that might arise.
- Non-routine transactions—Many financial transactions are negotiated contracts between an entity and its counterparty. To the extent that financial instrument transactions are not routine and outside an entity's normal activities, a substantive audit approach may be the most effective means of achieving the planned audit objectives. In instances where financial instrument transactions are not undertaken routinely, the auditor's responses to assessed risk, including designing and performing audit procedures, have regard to the entity's possible lack of experience in this area; and
- Procedures performed in other audit areas—Procedures performed in other financial statement areas may provide evidence about the completeness of financial instrument transactions. These procedures may include tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.

#### Dual-Purpose Tests

41. The auditor may design a test of controls to be performed concurrently with a test of details. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. The auditor may often use dual-purpose tests for financial instruments since typically the auditor is testing management's process for valuation, and substantive tests related to completeness, accuracy, and existence are often similar to controls performed by the entity. In practice, it may be difficult to distinguish between a test of controls and a substantive test. For example:
  - (a) The auditor may examine the entity's written documentation for a financial instrument to determine whether it has been approved (controls test) and to provide substantive audit evidence of the transaction (substantive test).
  - (b) In the circumstance where a third party pricing source is used as part of the entity's valuation of a financial instrument, the auditor may examine the documentation to see that the third party pricing source was approved for use in the entity's valuation

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<sup>17</sup> See ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*, paragraph 15.

<sup>18</sup> ISA 315, paragraph 6(b), requires the auditor to apply analytical procedures as risk assessment procedures to assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. ISA 520, *Analytical Procedures*, paragraph 6, requires the auditor to use analytical procedures in forming an overall conclusion on the financial statements. Analytical procedures may also be applied at other stages of the audit.

processes (controls test) and also verify that the correct valuation was used in the general ledger (substantive test).

A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

#### Timing of the Auditor's Procedures<sup>19</sup>

42. After assessing the risks associated with financial instruments, the engagement team determines the timing of planned tests of controls and substantive audit procedures. The timing of planned audit procedures varies depending on a number of factors, including the frequency of the control operation, the significance of the activity being controlled, and the related risk of material misstatement. For less complex financial instruments, it may be effective to select an interim date to perform tests of controls which may help reduce the amount of substantive audit procedures. The interim date conclusion is revisited, and procedures performed, as of year-end to determine whether such conclusion remains appropriate. For more complex financial instruments, it may be effective to perform tests of controls and substantive audit procedures relative to selected elements of management's valuation as of that date. In those circumstances, further procedures are performed for purposes of forming a conclusion on valuation as of year-end.<sup>20</sup> As management and those charged with governance may be more focused on valuations at the year-end, the effectiveness of controls may be more robust in that period.
43. More routine controls, such as IT controls and authorizations for new products, may be tested as of an interim date. For example, to test the operating effectiveness of controls over new product approval, the auditor may gather evidence of the appropriate level of management sign-off on a new complex financial instrument for an interim period, in particular whether a signed contract has been maintained, and whether the details of the complex financial instrument have been appropriately captured in a summary sheet.
44. Auditors may also test valuation techniques as of an interim date (for example, an option pricing valuation technique), for example by evaluating the theory of the valuation technique, testing its mathematical accuracy, and testing the inputs used in the valuation technique. Auditors, or auditor's experts engaged by the auditor, may also independently develop a valuation technique at interim to compare to the valuation technique used by management as of an interim date.
45. At year-end, the auditor's focus is likely to be on the areas of more significant judgment, in particular relating to valuation and presentation and disclosure. Substantive procedures are likely to be performed at year-end because:
  - Valuations can change significantly in a short period of time, making it difficult to compare and reconcile interim balances with comparable information at the balance sheet date;

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<sup>19</sup> Paragraphs 12 and 22–23 of ISA 330 establish requirements when the auditor performs procedures at an interim period and explains how such audit evidence can be used.

<sup>20</sup> Paragraphs A55–A58 of ISA 330 provide guidance on using audit evidence obtained during an interim period.

- An entity may engage in an increased volume of financial instrument transactions between an interim period and year-end;
- Manual journal entries may only be made after the end of the accounting period; and
- Non-routine or significant transactions may take place late in the accounting period.

*Considerations for Specific Assertions Relating to Financial instruments*

**Completeness, Accuracy, and Existence of Financial instruments**

46. There are controls that entities can implement to help reduce the risk of incomplete or inaccurate recording of transactions, and procedures auditors can perform to address this risk. Many of the auditor's procedures to identify the existence and occurrence will also serve to identify completeness, and may also assist in establishing proper cut-off. This is because financial instruments arise from legal contracts and, by verifying the accuracy of the recording of the transaction, the auditor can also verify its existence, completeness and occurrence at the same time and confirm that transactions are recorded in the proper period.
- 46(a) However, some financial instruments pose particular challenges for auditors. For example, if transactions regarding financial instruments such as derivatives or guarantees have not been recorded, their absence may be difficult to detect as they may not have a large initial investment. Further, confirmations may not identify the existence of embedded derivatives as they often contained in contracts for non-financial instruments which may not be included in confirmation procedures.

Table 4: *Controls over Completeness, Accuracy, and Existence*

**Trade Confirmations and Clearing Houses**

Generally, for transactions undertaken by financial institutions, the terms of financial instruments are documented in confirmations exchanged between counterparties and legal agreements. Clearing houses serve to monitor the exchange of confirmations by matching trades and settling them. A central clearing house is associated with an exchange and entities that clear through clearing houses typically have processes to manage the information delivered to the clearing house.

Not all transactions are settled through such an exchange. However, in many other markets there is an established practice of agreeing the terms of transactions before settlement begins. To be effective, this process needs to be run independently of those who trade the financial instruments to minimize the risk of fraud. In other markets, transactions are confirmed after settlement has begun and sometimes confirmation backlogs result in settlement beginning before all terms have been fully agreed. This presents additional risk because the transacting entities need to rely on alternative means of agreeing trades. These may include:

- Enforcing rigorous reconciliation controls between the records of those trading the financial instruments and those settling them (strong segregation of duties between the two are important), combined with strong supervisory controls over those trading the

financial instruments to ensure the integrity of the transactions;

- Reviewing summary documentation from counterparties that highlights the key terms even if the full terms have not been agreed; and
- Thorough review of traders' profits and losses to ensure that they reconcile to what the back office has calculated.

### **Reconciliations with Banks and Custodians**

Some components of financial instruments, such as bonds and shares, are held in independent depositories. In addition, most financial instruments result in payments of cash at some point and often these cash flows begin early in the contract's life. These cash payments and receipts will pass through an entity's bank account. Regular reconciliation of the entity's records to external banks and custodians enables the entity to ensure transactions are properly recorded. Appropriate segregation of duties between those transacting the trades and those reconciling them is important, as is a rigorous process for reviewing reconciliations and clearing reconciling items.

It should be noted that not all financial instruments result in a cash flow in the early stages of the contract's life or are capable of being recorded with an exchange or custodian. Where this is the case, reconciliation processes will not identify an omitted or inaccurately recorded trade and confirmation controls are more important. Even where such a cash flow is accurately recorded in the early stages of an instrument's life, this does not ensure that all characteristics or terms of the instrument (e.g., maturity, early termination option, etc.) have been recorded accurately.

In addition, cash movements may be quite small in the context of the overall size of the trade or the entity's own balance sheet and may therefore be difficult to identify. The value of reconciliations is enhanced when finance or other back office staff review entries in all general ledger accounts to ensure that they are valid and supportable. This process will help identify if the other side to cash entries relating to financial instruments has not been properly recorded. Reviewing suspense and clearing accounts is important regardless of the account balance, as there may be offsetting reconciling items in the account.

In entities with a high volume of financial instrument transactions, reconciliation and confirmation controls may be automated and, if so, adequate IT controls need to be in place to support them. In particular, controls are needed to ensure that data is completely and accurately picked up from external sources (such as banks and custodians) and from the entity's records and is not tampered with before or during reconciliation, and that the criteria on which entries are matched are sufficiently restrictive to prevent inaccurate clearance of reconciling items.

### **Other Controls over Completeness, Accuracy, and Existence**

The complexity inherent in some financial instruments means that it will not always be obvious how they should be recorded in the entity's systems. In such cases, management may set up control processes to monitor policies that prescribe how particular types of transactions are measured, recorded and accounted for. These policies are typically established and reviewed in advance by suitably qualified personnel who are capable of understanding the full effects of the financial instruments being booked.



Some transactions may be cancelled or amended after initial execution. Application of appropriate controls relating to cancellation or amendment can mitigate the risks of material misstatement due to fraud or error. In addition, an entity may have a process in place to reconfirm trades that are cancelled or amended.

In financial institutions with a high volume of trading, a senior employee typically reviews daily profits and losses on individual traders' books to evaluate whether they are reasonable based on the employee's knowledge of the market. Doing so may enable management to determine that particular trades were not completely or accurately recorded, or may identify fraud by a particular trader. It is important that there are transaction authorization procedures that support the more senior review.

Controls may also be established that require traders to identify whether a complex financial instrument may have unique features, for example embedded derivatives. In such circumstances, there may be a separate function that evaluates complex financial instrument transactions at their initiation (which may be known as a product control group), working in connection with an accounting policy group to ensure the transaction is accurately recorded. While smaller entities may not have product control groups, an entity may have a process in place relating to the review of complex financial instrument contracts at the point of origination in order to ensure they are accounted for appropriately in accordance with the applicable financial reporting framework.

The above describes controls that may be in place in a trading room environment, while an entity that does not have this environment may not have all these controls but may confirm their transactions. Doing so may be relatively straightforward in that the entity may only transact with one or two counterparties.

#### Procedures relating to completeness, accuracy, and existence of financial instruments

47. Procedures that may provide audit evidence to support the completeness, accuracy, and existence assertions include:
- Remaining alert during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of financial instruments that management has not previously identified or disclosed to the auditor. Such records and documents may include, for example:
    - Minutes of meetings of those charged with governance.
    - Specific invoices and correspondence with the entity's professional advisors.
  - External confirmation<sup>21</sup> of bank accounts, trades, and custodian statements. This can be done by direct confirmation with the counterparty (including the use of bank letters), where a reply is sent to the auditor directly. Alternatively this information

<sup>21</sup> ISA 505, *External Confirmations*, deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of ISA 330 and ISA 500, *Audit Evidence*. See also the Staff Audit Practice Alert, *Emerging Practice Issues Regarding the Use of External Confirmations in an Audit of Financial Statements*, issued in November 2009.

may be obtained from the counterparty's systems through a data feed. Where this is done, controls to prevent tampering with the computer systems through which the information is transmitted may be considered by the auditor in evaluating the reliability of the evidence from the confirmation. External confirmations, however, often do not provide adequate audit evidence with respect to the valuation assertion though they may assist in identifying any side agreements.

- Reconciliation of external data with the entity's own records. This may necessitate evaluating IT controls around and within automated reconciliation processes and to evaluate whether reconciling items are properly understood, followed up and dealt with.
- Reading individual contracts and reviewing support documentation of the entity's financial instrument transactions, including accounting records, thereby verifying existence and rights and obligations. For example, an auditor may read individual contracts associated with financial instruments and review supporting documentation, including the accounting entries made when the contract was initially recorded, and may also subsequently review accounting entries made for valuation purposes. Doing so allows the auditor to evaluate whether the complexities inherent in a transaction have been fully identified and reflected in the accounts. Legal arrangements and their associated risks need to be considered by those with suitable expertise to ensure that rights exist.
- Reviewing journal entries, and the internal control over the recording of such entries. This may assist in for example:
  - Determining if entries have been made by employees other than those authorized to do so; and
  - Identifying unusual end-of-period journal entries, which may be relevant to fraud risk. **[See Issue F of Agenda Item 4-A]**
- Testing controls, for example by reperforming controls described in Table 4.
- Reviewing the entity's complaints management systems.
- Reviewing master netting arrangements.

#### Valuation of Financial instruments

48. Many financial instruments are classified to be measured at fair value for the purpose of balance sheet presentation, calculating profit or loss, and disclosure. This would include any embedded derivative feature that would be required to be recorded at fair value. Under most financial reporting frameworks, the objective of fair value measurement is to arrive at the price at which an orderly transaction would take place between market participants<sup>22</sup> at the measurement date; that is, it is not a forced liquidation or a distressed sale. In meeting this objective, all relevant available market information is taken into account.

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<sup>22</sup> As a result, fair value is market-based and reflects the assumptions that market participants would use in pricing the asset or liability, rather than entity-specific.

49. Fair value measurements of financial assets and financial liabilities may arise both at the initial recording of transactions and later when there are changes in value. Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks. For example, such changes may be recorded as profit or loss, or may be recorded in the statement of comprehensive income. Depending on the applicable financial reporting framework, the whole complex financial instrument or only a component of it (for example, an embedded derivative) may be required to be measured at fair value.

[Table relocated to paragraph 49a.]

Fair Value Hierarchy [Relocated from Table 5]

- 49a. In a fair presentation financial reporting framework, financial instruments are often categorized by the level of measurement uncertainty attaching to the inputs to the valuation methodology used. This usually means that the volume and detail of the required disclosures increases as the level of measurement uncertainty increases. The distinction between the levels in the hierarchy may be a matter of judgment.
- 49b. Some financial reporting frameworks, for example IFRS and U.S. Generally Accepted Accounting Principles (GAAP), establish a fair value hierarchy to develop increased consistency and comparability for disclosures within and between entities. The hierarchy classifies valuation methodology inputs into levels:
- Level 1 inputs—Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
  - Level 2 inputs—Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). If the financial asset or financial liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the financial asset or financial liability. Level 2 inputs include the following:
    - Quoted prices for similar financial assets or financial liabilities in active markets.
    - Quoted prices for identical or similar financial assets or financial liabilities in markets that are not active.
    - Inputs other than quoted prices that are observable for the financial asset or financial liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, credit risks, loss severities, and default rates).
    - Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).
  - Level 3 inputs—Inputs for the financial asset or financial liability that are not based on observable market data (unobservable inputs). Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market

activity for the asset or liability at the measurement date.

Understanding management’s methodology for valuing its financial instruments

50. ISA 540 requires the auditor to obtain an understanding of how management makes accounting estimates and the data on which accounting estimates are based.<sup>23</sup> Management’s responsibility for the preparation of the financial statements includes applying the requirements of the applicable financial reporting framework to the valuation of financial instruments. Management’s approach to valuation also takes into account the selection of an appropriate valuation methodology and the level of the evidence expected to be available. To meet the objective of a fair value measurement, an entity develops a valuation methodology to measure the fair value of financial instruments that considers all relevant market information that is available. A thorough understanding of the complex financial instrument being valued allows an entity to identify and evaluate the relevant market information available about identical or similar instruments that should be incorporated into the valuation methodology.
51. Such information to be considered includes, for example:
- Prices from recent transactions in the same or a similar instrument;
  - Quotes from third party pricing sources;
  - Indices; and
  - Other observable inputs to valuation techniques.
52. An entity uses such information to measure the fair value of its financial instruments by assessing all available information and applying it as appropriate. The valuation methodology may be simple and may consist of the use of observable prices (level 1), or may be more complex, and involve the use of one or more valuation techniques to calculate assumptions or inputs used in a valuation, or the output of the valuation. Valuation techniques can be used for any financial instrument that involves inferring a price for the instrument from market and other data. Unless a complex financial instrument is traded on an exchange or other market, it is possible that a valuation technique will be used in its valuation. Valuation techniques may also be used to calculate inputs to other valuation techniques, such as prepayment speeds and discounted cash flows. Risks of material misstatement relating to valuation of financial instruments primarily relate to the risk that an inappropriate valuation technique(s) was used, and the risk that the entity has not used the appropriate information to support its valuations, including assumptions and inputs to any valuation techniques (for example, if level 1 information is available but not used). The auditor evaluates available evidence and understands both the hierarchy and the risk of management bias in classifying instruments in the hierarchy. In particular, Level 2 instruments vary from those which use easily obtained valuation inputs to those which are closer to Level 3 inputs.

[Table relocated to paragraph 60a-60e]

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<sup>23</sup> ISA 540, paragraph 8(c)

## Measurement uncertainty

53. Valuing financial instruments is not a precise science. For this reason, management's valuation methodology for a complex financial instrument typically addresses measurement uncertainty. As noted in paragraph 9, measurement uncertainty is an aspect of estimation uncertainty. Uncertainties over the reliability of market quotes, the validity of valuation techniques and the accuracy of their calibration to actual market activity will exist, particularly for financial instruments that are not actively traded.
54. Certain financial reporting frameworks may require or permit the entity to adjust for measurement uncertainties, in order to adjust for risks that a market participant would make in the pricing to take account of the uncertainties of the risks associated with the pricing or cash flows of the financial instrument. For example, if such an instrument was sold, a buyer would reduce their price to reflect these uncertainties and the risks that (s)he was thereby assuming. Estimating the level of adjustment required for such factors involves a high level of judgment and will reflect the perspective of a market participant and the applicable financial reporting framework. Consideration of all the factors taken into account in the valuation process and the use of experience and judgment will assist the auditor in evaluating the amount of the adjustment for measurement uncertainty, if any. The auditor may need to engage individuals with specialized skills or knowledge to assist in doing this.
55. When using a valuation technique, it is necessary to periodically calibrate the valuation technique to observable market information to ensure that the valuation technique reflects current market conditions and to identify any potential deficiencies in the valuation technique. As market conditions change, it may become necessary either to change the valuation technique(s) used or to make additional adjustments to valuation technique valuations.
56. **[See Issue D in Agenda Item 4-A]** In some financial reporting frameworks these adjustments may be permitted or required. For example, it may be necessary to adjust prices obtained using a valuation technique for factors that the valuation technique cannot take into account in order to reflect assumptions that market participants would use, for example:
  - Credit-risk adjustments. Some valuation techniques do not take into account credit risk, including counterparty risk.
  - Liquidity adjustments. Some valuation techniques calculate a mid-market price, even though the financial reporting framework may require use of a liquidity adjusted amount such as a bid/offer spread, which may also need to reflect transaction costs.
  - Valuation methodology adjustments. Adjustments may be used to calibrate the valuation technique to observable market information. A value measured using a valuation technique that does not take into account all factors that market participants would consider in pricing the complex financial instrument does not represent an estimate of a current transaction price on the measurement date, and therefore may need to be adjusted separately to comply with the applicable financial reporting framework.

Arbitrary adjustments are usually not permitted in most financial reporting frameworks. Adjustments are not appropriate if they adjust the measurement and valuation of the complex financial instrument away from fair value as defined by the applicable financial reporting framework, for example for conservatism.

57. It is expected that management will document its valuation policies and methodology used for a particular complex financial instrument, including rationale for the valuation technique(s) used, the selection of assumptions in the valuation methodology, and the entity's consideration of whether adjustments for measurement uncertainty are necessary. This documentation provides evidence used by the auditor in determining the nature, timing, and extent of procedures on valuation.

#### Observable and unobservable inputs

58. The nature and reliability of information available to support valuation of financial instruments varies depending on the observability of inputs to its measurement, which is influenced by the nature of the market (e.g., the level of market activity and whether it is through an exchange or over-the-counter (OTC)). Accordingly, there is a continuum of evidence used to support valuation, and it becomes more difficult for management to obtain information to support a valuation when management is dealing with level 3 inputs or when markets become inactive.
59. When observable inputs are not available, an entity uses unobservable inputs that reflect the assumption that market participants would use when pricing the financial asset or the financial liability, including assumptions about risk. Unobservable inputs are developed using the best information available in the circumstances. In developing unobservable inputs, an entity may begin with its own data, which is adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (for example, an entity-specific synergy), and the entity is able to quantify these adjustments.
60. When the market for a complex financial instrument is no longer active, an entity often measures fair value using a valuation methodology that involves a valuation technique. The use of a valuation technique within an entity's valuation technique aims to maximize the use of observable inputs and minimize the use of unobservable inputs in order to estimate the price at which an orderly transaction would take place between market participants on the measurement date. Regardless of the valuation methodology used, an entity takes into account current market conditions and includes appropriate risk adjustments that market participants would make, such as for credit and liquidity.

Table 7: *Effects of Inactive Markets*

Valuation is more complicated when the markets in which financial instruments or their component parts are traded are inactive or where no price is observable. There is no clear point at which an active market becomes inactive, though financial reporting frameworks may provide guidance on this issue.

Characteristics of an inactive market include a significant decline in the volume and level of

trading activity, available prices vary significantly over time or among market participants or the prices are not current. However, these factors alone do not necessarily mean that a market is no longer active. An active market is one in which transactions are taking place regularly on an arm's length basis. "Regularly" is a matter of judgment and depends on facts and circumstances of the market for the complex financial instrument being measured at fair value.

When markets are inactive, measuring financial instruments becomes more difficult because of the lack of observable trades and other market data. Prices quoted may be stale (that is, out of date) or may not represent prices at which market participants may trade. Accordingly, valuations are based on level 2 and level 3 inputs. Under such circumstances it is generally desirable for entities to have:

- A valuation policy that includes a process for determining whether level 1 inputs are available;
- An understanding of how particular prices or inputs from external sources used as inputs to valuation techniques were calculated in order to assess their reliability. For example, in an active market, a broker quote is likely to reflect actual transactions, but, as the market becomes less active, the broker may rely more on proprietary valuation techniques to determine prices;
- An understanding of how deteriorating business conditions affect the counterparty, as well as whether deteriorating business conditions in entities similar to the counterparty may indicate that the counterparty may have a decreased ability to meet its obligations (i.e., the risk of nonperformance);
- Policies for adjusting for valuation uncertainties. Such uncertainties can include lack of liquidity, uncertainties arising from calibration of the valuation technique and nonperformance credit risks; and
- The capability to calculate the range of realistic outcomes given the uncertainties involved, for example by performing a sensitivity analysis.

Where there is no current observable market price, it will be necessary for the entity to gather other price indicators to use in a valuation technique to value the complex financial instrument. Price indicators may include:

- Recent transactions, including transactions after the balance sheet date in the same instrument. Consideration is given to whether an adjustment needs to be made for changes in market conditions between the measurement date and the date the transaction was made, as these transactions are not necessarily indicative of the market conditions that existed at the balance sheet date. In addition it is possible that the transaction represents a forced transaction and is therefore not indicative of a price in an orderly trade. Indicators of a forced transaction may include:
  - A legal requirement to transact, for example a regulatory mandate.
  - A necessity to dispose of an asset immediately to create liquidity, resulting in insufficient time to market the asset to be sold.
  - The existence of a single potential buyer as a result of the legal or time restrictions

imposed;

- Current or recent transactions in similar instruments, often known as “proxy pricing”. Adjustments will need to be made to the price of the proxy to reflect the differences between them and the instrument being priced and to take account of differences in liquidity between the two instruments; and
- Indices for similar instruments. As with transactions in similar instruments, adjustments will need to be made to reflect the difference between the instrument being priced and the index used.

Particular difficulties may develop where there is severe curtailment or even cessation of trading in particular financial instruments. In these circumstances, financial instruments that have previously been valued using market prices may need to be valued using a valuation technique, and changing the manner in which the financial instruments are valued may be a difficult process for management, in particular when management does not possess expertise in valuation techniques.

Valuation techniques **[Relocated from Table 6] [See Issue D of Agenda Item 4-A]**

- 60a. Valuation techniques are used to value financial instruments, including financial instruments where the price cannot be directly observed in the market. Valuation techniques can be as simple as a spreadsheet or a commonly used bond pricing formula or involve complex, bespoke software tools to value financial instruments with level 3 inputs. Many valuation techniques are based on discounted cash flow calculations.
- 60b. Valuation techniques may be used both to value financial instruments and to calculate inputs to a valuation technique. For example, markets might quote only for certain standard transactions such as those with one, three and five year maturities. For example, a financial instrument with an original maturity of five years will therefore only have a directly observable quote on three days during its life, because for the remainder of the time, its terms do not match one, three or five years. In addition many transactions are not directly quoted in the market place but are constructed through adjustments for risks such as interest rate, currency, equity or commodity risk.

An example of an Asset Backed Security

- 60ba. Some fair value estimates may require the use of subjective valuation assumptions and complex or proprietary valuation techniques. For example, some structured asset backed securities may require the use of subjective estimates to derive a set of expected cash flows. The expected cash flows are then discounted to derive an estimated fair value. Understanding these types of securities involves considering (a) the underlying collateral (such as mortgages, credit card receivables, auto loans etc) and (b) the terms of the security.
- 60bb. The underlying collateral is used to estimate the timing and amounts of cash flows, for example, mortgage or credit card interest and principle payments. These cash flows may be affected by prepayments of the underlying collateral and by potential default risk and resulting estimated loss severities. Prepayment estimates, if applicable, are generally



based, in part, on evaluating market interest rates for similar collateral to the rates on the collateral underlying the security. For example, if market interest rates for mortgages have declined then the underlying mortgages in a security may experience higher prepayment rates than originally expected. Estimating potential default and loss severity involves close evaluation of the underlying collateral and borrowers to estimate default rates. For example, when the underlying collateral comprises residential mortgages, loss severities may be affected by estimates of residential housing prices over the term of the security.

60bb. Understanding the terms of the securities includes evaluating contractual cash flow rights, such as the order of repayment, and any default events. The order of repayment, often known as seniority, refers to terms which require that some classes of security holders (senior debt) are repaid before others (subordinated debt). The rights of each class of security holder to the cash flows, frequently referred to as the cash flow “waterfall,” together with estimates of the timing and amount of cash flows are used to derive a set of estimated cash flows for each class of security holder. In many cases, there may be a market standard model or calculator that is used to determine the cash flow waterfall where the user inputs the required estimates or assumptions.

60bc. For example, in responding to the risks of material misstatement for such a security, the auditor may consider performing some of the following audit procedures:

- Examining contractual documentation to understand the terms of the security, the underlying collateral and the rights of each class of security holder;
- Inquiring about management’s process of estimating cash flows;
- Evaluating the reasonableness of estimates and assumptions, such as prepayment rates, default rates and loss severities;
- Obtaining an understanding of the model or calculator used to determine the cash flow waterfall;
- Comparing the results of the fair value estimate with other securities with similar underlying collateral and terms.
- Reperforming calculations.

60c. Depending on the circumstances, matters that the entity may address when establishing or validating a valuation model for a complex financial instrument, include whether:

- The valuation technique 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 valuation technique’s theoretical soundness and mathematical integrity, including the appropriateness of valuation technique parameters and sensitivities.
  - The consistency and completeness of the valuation technique’s inputs with market practices, and whether the appropriate inputs are available for use in the model.
- Appropriate change control policies and procedures, and security controls over the valuation technique, exist.

- The valuation technique is periodically calibrated, reviewed and tested for validity by an independent function. Doing so is a means of ensuring that the valuation technique's output is a fair representation of the value that marketplace participants would ascribe to a financial instrument.
- The valuation technique maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs.
- Adjustments are made to the output of the valuation technique, including in the case of fair value accounting estimates of financial instruments, to reflect the assumptions marketplace participants would use in similar circumstances.
- The valuation technique is adequately documented, including the valuation technique's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed. Any adjustments made to the output of the valuation technique are also documented.

#### Testing valuation techniques and inputs

- 60d. In determining the nature, timing and extent of audit procedures, the auditor may consider both testing of the valuation technique and testing the inputs to the valuation technique. When considering more complex financial instruments such as those at Level 3 of the fair value hierarchy, testing the valuation technique may be a useful source of audit evidence. However, when the valuation technique or calculation is both simple and generally accepted, such as some bond price calculations, audit evidence obtained from focusing on the inputs to the valuation technique may be a more useful source of evidence.
- 60e. Testing a valuation technique can be accomplished by two main approaches:
- (a) The auditor can develop their own valuation, and then compare the auditor's valuation with that of the entity (see paragraphs 103-104); or
  - (b) The auditor can consider management's valuation technique (see paragraphs 85-102), by considering the appropriateness of the valuation technique used by management, the reasonableness of the inputs to the valuation technique and mathematical accuracy of the valuation technique.

#### Source of inputs to a valuation methodology

61. Inputs represent assumptions used by management to support valuations.<sup>24</sup> Inputs to a valuation methodology may be obtained or calculated by the entity in a number of ways:
- From external sources, for example, exchanges, indices, and third party pricing sources;
  - By adjustment to external sources to reflect assumptions that would be used by marketplace participants; and

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<sup>24</sup> Paragraph A32 of ISA 540 notes that the term "inputs" may also be used to refer to the underlying data to which specific assumptions are applied.

- By using the outcome of one or more valuation techniques as an input to another valuation technique.
62. Assumptions are integral components in the valuation of financial instruments, as they are used as inputs to valuation valuation techniques. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary.
63. The best indicators of evidence of a complex financial instrument's fair value are found in contemporaneous transactions in an active market (i.e., level 1 inputs). In such cases, the valuation of a complex financial instrument may be relatively simple. Quoted market prices for financial instruments that are listed on exchanges or traded in liquid over-the-counter markets may be available from sources such as financial publications, the exchanges themselves or third party pricing sources. When using quoted prices, it is important that management understand the basis on which the quote is given to ensure that the price reflects current market conditions. Quoted prices obtained from publications or exchanges may provide sufficient evidence of value if:
- The prices are not out of date or “stale” (for example, if the quote is based on the last traded price and the trade occurred some time ago); and
  - The quotes are prices at which dealers would actually trade in reasonable volume.
64. However, in many cases financial instruments are not actively traded, but components of their valuations are based on observable data (such as interest rate curves, or the assets underlying options), for example, an interest rate swap. In such cases, management may take the available market data and adjust for risk factors such as counterparty risk. This moves the valuation from level 1 into levels 2 or 3, the assessment of which becomes more judgmental for both the entity and the auditor.
65. Exchange prices can be used as inputs to valuation valuation techniques to derive estimates for fair value of financial instruments. Theoretical prices for customized products may be created by breaking down financial instruments into a series of listed options or futures, weighted by standard expiry dates. Many financial instruments are likely to be correlated to security and derivative contracts already listed and traded on exchanges. However, management may need to take into account basis differences, credit risk, and other factors in arriving at a valuation.
66. Pricing information may also be obtained from third party pricing sources such as brokers or pricing services.<sup>25</sup> Quotes obtained from brokers are not always binding offers to trade and hence may not represent a price at which a transaction would actually take place (referred to as “indicative prices”). Understanding how the third party pricing sources calculated a price enables management to determine whether such data is suitable for use in its valuation methodology, including as an input to a valuation technique. For example, third party pricing sources may value financial instruments using proprietary valuation techniques, and it is important that management understands both the valuation technique and assumptions used.

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<sup>25</sup> For more information on third party pricing sources, see the October 2008 IASB Expert Advisory Panel report, *Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are no Longer Active*.

Pricing services may also poll a number of market participants and brokers anonymously to obtain prices, which are then averaged in some way to produce a “consensus price.” Pricing services may combine a number of approaches to arrive at a price.

67. An entity may also use pricing data from consensus pricing services as inputs to their valuation techniques. Consensus pricing services obtain pricing information about an instrument from several participating entities (subscribers). Each subscriber submits prices to the pricing service. The pricing service treats this information confidentially. The pricing service returns to each subscriber the consensus price, which is usually an arithmetical average of the data after a data cleansing routine has been employed.<sup>26</sup> For some markets, such as for exotic derivatives, consensus pricing services might constitute the best available data. However, many factors are considered when assessing the representational faithfulness of the consensus prices including, for example:

- Whether the prices submitted by the consensus subscribers reflect actual transactions or just indicative prices based on their own valuation techniques.
- The number of sources from which prices have been obtained.
- The quality of the sources used by the consensus pricing service.

Due to the nature of a consensus pricing service, other sources of evidence in addition to information from pricing services may be needed to support management’s valuation. In particular, this may be the case if the sources are providing indicative prices based on their own valuation techniques and management is unable to obtain an understanding of how these sources calculated their prices.

- 67a. **[See Issue E of Agenda Item 4-A]** A consensus price determined from a large number of high quality subscribers might provide a more representationally faithful price than a consensus of only a few subscribers. However, although a consensus price might be derived from a large number of different subscribers, if none is a leading participant in the relevant market then the consensus price might not be meaningful. For example, for some instruments in the commodities markets there are only a limited number of subscribers and those subscribers are leading market participants. However, consensus pricing services might receive submissions from many other subscribers. In such circumstances, it is possible that many of the submissions received by the pricing service will not reflect actual transactions and less reliance should be placed on these services when measuring fair value.
- 67b. Pricing services often have a formalized process for customers to challenge the prices received from the pricing services. These challenge processes usually require the customer to provide evidence to support an alternative price, with challenges categorized based on the quality of evidence provided. For example, a challenge based on a recent sale of that instrument that the pricing service was not aware of may be upheld, whereas a challenge

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<sup>26</sup> Some consensus pricing services may provide reports for users of its data to explain their controls over pricing data, that is, a report prepared in accordance with International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Service Organization*. Management may request, and the auditor may consider obtaining, such a report to develop an understanding of how the pricing data is prepared and evaluate whether the controls at the pricing service can be relied upon.

based on a customer's own valuation technique may be more heavily scrutinized. In this way, a pricing service with a large number of leading participants, both buy and sell side, may be able to constantly correct prices to more fully reflect the information available to market participants.

68. If broker quotes or quotes obtained from pricing services are not based on current prices of actively traded instruments, it will be necessary for management to evaluate whether the quotes were derived in a manner that is consistent with the applicable financial reporting framework. The entity's understanding of the prices includes:
- How the prices were determined—for example, whether the prices were determined by a valuation technique, in order to assess whether they are consistent with the fair value measurement objective;
  - Whether the prices are indicative prices, indicative spread, or binding offers; and
  - How frequently the prices are estimated by the third party pricing sources—in order to assess whether they reflect market conditions at the measurement date.

Understanding the bases on which third party pricing sources have determined their quotes in the context of the particular financial instruments held by the entity assists management in evaluating the relevance and reliability of this evidence to support its valuations.

69. If a price obtained by management comes from a counterparty (for example, the broker who sold the complex financial instrument to the entity) or another entity with a close relationship with the entity being audited, the price may not be reliable. In such cases, additional quotes are often obtained from counterparties or pricing services that do not have a close relationship to the entity. In these cases, the auditor may consider this in determining the nature, timing and extent of audit procedures to be performed.
70. It is possible that there will be disparities between price indicators from different providers. Understanding how the price indicators were derived, and investigating these disparities, assists management in corroborating the evidence used in developing its valuation of financial instruments in order to evaluate whether the valuation is reasonable. Simply taking the average of the quotes provided, without doing further research, may not be appropriate, because one price in the range may be the most representative of fair value and this may not be the average. To evaluate whether its valuations of financial instruments are reasonable, management may:
- Consider whether actual transactions represent forced transactions rather than transactions between willing buyers and willing sellers. This may invalidate the price as a comparison;
  - Analyze the expected future cash flows of the instrument. This could be performed as an indicator of the most relevant pricing data;
  - Depending on the nature of what is unobservable, extrapolate from observed prices to unobserved ones (for example, there may be observed prices for maturities up to ten years but not longer, but the ten year price curve may be capable of being extrapolated beyond ten years as an indicator). Care is needed to ensure that

extrapolation is not carried so far beyond the observable curve that its link to observable prices becomes too tenuous to be reliable;

- Compare prices within a portfolio of financial instruments to each other to make sure that they are consistent among similar financial instruments;
- Use more than one valuation technique to corroborate the results from each one, having regard to the inputs and assumptions used in each; and
- Evaluate movements in the prices for related hedging instruments and collateral.

In coming to its judgment as to its valuation, an entity may also consider other factors that may be specific to the entity's circumstances.

- 70a. [See Issue E of **Agenda Item 4-A**] Third party pricing sources provide entities with prices and price-related data for a variety of financial instruments, often performing daily valuations of large numbers of financial instruments. These valuations may be made by collecting market data and prices from a wide variety of sources, including market makers, and, in certain instances, using internal valuations techniques to derive estimated fair values. Third party pricing sources may have rigid controls around how estimates are developed and their customer often include a wide variety of parties, including buy and sell side investors, back and middle office functions, auditors and others.
- 70b. The auditor's approach to management's use of pricing services depends on the auditor's professional judgment as to whether the pricing service is a management's expert within the scope of ISA 500<sup>27</sup>.
- 70c. Whether or not the pricing service is a management's expert, paragraph 13(b) of ISA 540 requires the auditor, if testing management's process of making the accounting estimate, to evaluate whether the method of measurement used is appropriate in the circumstances and the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. Merely obtaining a price from one or more pricing service(s) is unlikely to be sufficient appropriate audit evidence.
- 70d. The following considerations may be relevant in obtaining sufficient appropriate audit evidence:
- Evaluating the competence, capabilities and objectivity of the pricing service. This would ordinarily include understanding the depth and breadth of their experience, services and customer base for each relevant asset class.
  - Obtaining an understanding of the work of that expert. Understanding how the pricing service generates the prices involves obtaining an understanding, at the asset class level, of:
    - The tools or models used to generate the prices and the sources of market information used to develop fair value estimates. For example, some government bond fair value estimates may be derived using widely observable

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<sup>27</sup> See paragraphs 8 and A35 of ISA 500.

market yield data and market standard net present value computations. Other asset classes, such as “private label” asset backed securities, may be illiquid and use non-transparent assumptions, such as default, discount and prepayment rates. Other asset classes may be evaluated using proprietary bespoke tools.

- The transparency of the assumptions and inputs used and the complexity of the tools used to estimate fair value should be evaluated;
  - The controls around valuations and evaluation of fair estimates should be considered.
- Evaluating the appropriateness of that expert’s work as audit evidence. At this point, the focus is on the appropriateness of the expert’s work at the level of the individual financial instrument. For a sample of the relevant instruments, it may be appropriate to develop an estimate independently, using different sources and inputs, then compare that estimate to that of the management’s expert. Other procedures may include:
    - Modelling different assumptions to derive estimates of assumptions in another valuation technique, then consider the reasonableness of those derived assumptions.
    - Compare management’s point estimates with the auditor’s point estimates to determine if management’s estimates are consistently higher or lower.

Ordinarily, the level of audit procedures to be applied increases as the level of estimation uncertainty increases. The use of Level 3, and some Level 2, inputs from the fair value hierarchy may be a useful guide to the level of estimation uncertainty.

- 70e. Broker estimates differ in many respects from pricing services. Brokers will usually only provide quotes to their clients, which may impair the independence of the broker, and may be unwilling to provide information about the process used to develop their quote. Broker quotes may be executable or indicative. Indicative quotes are a broker’s best estimate of fair value, whereas an executable quote shows that the broker is willing to transact at this price. Obtaining an understanding of:

- How the prices are developed; and
  - The controls around the estimates, including validation procedures,
- may assist in evaluating the usefulness of the quote as audit evidence

Credit risk

71. Understanding the credit risk is an important aspect of valuing both financial assets and financial liabilities. This valuation reflects the credit quality and financial strength of both the issuer and any credit support providers. In some financial reporting frameworks, the measurement of a financial liability assumes that it is transferred to a market participant on the measurement date; it is not assumed to be settled with the counterparty or otherwise extinguished. Where there is not an observable market price for a financial

liability, its value is typically measured using the same method as a counterparty would use to measure the value of the corresponding asset. Considerations in valuing complex financial liabilities are the same as valuing complex financial assets, with the exception of own credit risk, which may need particular attention.

72. **[See Issue F of Agenda Item 4-A]** In relation to the fair value of financial liabilities, changes in the entity's credit risk that may affect its value are known as the entity's own credit risk. This is the amount of change in fair value that is not attributable to changes in market conditions, and can often be difficult to measure. The fair value of a financial liability also reflects the non-performance risk associated with the liability. The role of credit risk in valuing financial liabilities increases in importance subsequent to initial recognition of a financial instrument, because a deterioration in an entity's own credit quality (leading to a lower fair value for its liabilities) may result in the entity reporting a gain in profit or loss. When an entity issues listed debt, the value of the liability is can be determined with reference to the market price of the debt. However, a derivative is more complex as there are interactions between the entity's own credit risk and counterparty risk. Own credit risk is often a complex area, and an auditor's expert may be able to provide assistance.

- 72(a). The requirements of the applicable financial reporting framework, including how own credit risk is calculated is an important assumption for the auditor to evaluate in testing the valuation of a financial liability. There are multiple valuation approaches in this area, for example, observations of: bond spreads, comparable corporate bond, derivative spreads or yield curves, and credit default swaps. Given the materiality of even small estimation errors in the calculation of own credit risk, understanding the valuation techniques, assumptions, methodologies and adjustments from benchmarks rates, such as the LIBOR, and any subordination of debt is important.

Use of management's experts and service organizations

73. The preparation of an entity's financial statements, including the valuation of financial instruments and the preparation of financial statement disclosures relating to these instruments, may require expertise that management does not possess. Entities may not be able to develop appropriate valuation methodologies, including valuation techniques used in valuation, and may rely on third-party valuation experts to arrive at a valuation or to prepare disclosures for the financial statements. This may particularly be the case in smaller entities or in entities that do not engage in a high volume of financial instruments transactions (for example, non-financial institutions with treasury departments). In such cases, management often engages third-party experts to provide assistance with valuation of its financial instruments.
- 73a. **[See Issue E of Agenda Item 4-A]** In some cases, management may value a financial instrument based on a third party pricing source without further inquiry. For example, an entity may account for changes in the fair value of a financial instrument by reference only to statements provided by brokers to their customers. In such cases, the auditor may encounter difficulties in obtaining an understanding of the process of the third party pricing source, and may prefer to develop their own estimate (see paragraphs 103-104).



74. Paragraph 8 of ISA 500 contains requirements for circumstances when management has engaged an expert. Where such expertise is in a field other than accounting or auditing, such as valuation, individuals or organizations possessing such expertise who are used by the entity to assist it in preparing the financial statements are referred to as management's experts. Management's experts may be employed by the entity (management's internal experts, for example, quantitative staff) or engaged by the entity (management's external experts, for example, third-party valuation specialists). The use of one or more management's experts may be fairly common, regardless of the size of the entity.
75. The use of a management's expert does not relieve management or those charged with governance of their responsibilities for the preparation of the financial statements. In measuring the entity's financial instruments, management may support its valuation with information from internal and external sources, the relevance and reliability of which will vary. Management's experts supplement, but do not replace, management's own process for valuation. Assumptions may be made or identified by a management's expert to assist management in valuing its financial instruments. Such assumptions, when used by management, become management's assumptions.
76. Understanding the methodology used by management's experts to develop assumptions, therefore, assists management in presenting the financial instruments in the financial statements at the proper value.
77. Third party pricing sources often have expertise in the application of valuation techniques to estimate the fair value of financial instruments for which there is no observable market and may offer such services to entities in addition to providing pricing data. For example, an entity may engage a third party pricing source to value an entity's complex financial instrument portfolio, typically by using proprietary valuation techniques. In such cases, the third party pricing source would likely be considered a management's expert. Entities that use pricing services on a contractual basis to provide routine pricing data used in an entity's valuation techniques may not necessarily be considered to be a management's expert. Regardless of whether such individuals or organizations are considered management's experts, management's understanding includes the process described in paragraph 68.
78. [Paragraphs 78-79 relocated to paragraph 36a-36b]
79. [Deleted]

#### Consistency of valuation technique across periods

80. Consistency is generally a desirable quality in financial information, but may be inappropriate if circumstances change. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by valuation technique, or may result in a change from one particular valuation technique to another. Reacting to changes in valuation techniques may be difficult if management does not have policies in place to consider the ramifications of changing market conditions, prior to their occurrence. Management may also not possess the expertise necessary to develop a valuation technique on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need

for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been calibrated in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.

81. The susceptibility to management bias increases with the subjectivity of the valuation. For example, management may tend to ignore observable marketplace assumptions or inputs and instead use their own internally-developed valuation technique if the valuation technique yields more favorable results. 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, rather than the point in the spectrum that might be considered to be most consistent with the applicable financial reporting framework. Changing the valuation methodology from period to period without a clear and appropriate reason for doing so may also be an indicator of management bias. Although some form of management bias is inherent in subjective decisions relating to the valuation of financial instruments, when there is intention to mislead, management bias is fraudulent in nature.

#### Procedures relating to understanding and testing the valuation of financial instruments

82. Table 5 discusses the establishment of a fair value hierarchy by some financial reporting frameworks. The objective of a fair value measurement is the same regardless of the level of the hierarchy. As the inputs become less observable, the degree of estimation uncertainty increases and affects the auditor's assessment of the risks of material misstatements. As estimation uncertainty increases, the availability of evidence to support a particular valuation decreases, requiring more judgment by both management and the auditor and may represent a significant risk, as it may be challenging for the auditor to substantiate the valuations of financial instruments with unobservable inputs.
83. In accordance with ISA 540,<sup>28</sup> the auditor considers the entity's valuation policies and methodology and supporting documentation for inputs and assumptions used in the valuation methodology. In some cases, the applicable financial reporting framework may prescribe the valuation technique for financial instruments, for example, a particular valuation technique to be used. In many cases, however, the applicable financial reporting framework does not prescribe the valuation methodology. When this is the case, matters that may be relevant to the auditor's understanding of management's methodology used to value financial instruments include, for example:
  - Whether management has a formal valuation policy and, if so, whether the valuation methodology used for a complex financial instrument is appropriately documented in accordance with that policy;
  - How management considered the nature of the complex financial instrument to be valued when selecting a particular methodology;
  - Whether there is a greater risk of material misstatement because management has internally developed a valuation technique to be used to value financial instruments

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<sup>28</sup> ISA 540, paragraph 8(c)

or is departing from a method commonly used to value the particular complex financial instrument;

- Whether those involved in developing and applying the valuation methodology have the appropriate skills and expertise to do so, including whether a management's expert may have been used; and
- Whether there are indicators of management bias in selecting the methodology to be used.

83(a) The auditor's understanding of the degree to which each valuation technique contributes to the risk of material misstatement may also assist in determining the valuation techniques on which to focus.

84. In testing how management values the complex financial instrument and in responding to the assessed risks of material misstatement in accordance with ISA 540,<sup>29</sup> the auditor undertakes one or more of the following options, taking account of the nature of the accounting estimates:

- (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- (b) Test how management made the accounting estimate and the data on which it is based (including valuation techniques used by the entity in its valuations).
- (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- (d) Develop a point estimate or a range to evaluate management's point estimate.

Paragraphs 85-102 deal primarily with the auditor's procedures to test how management made the accounting estimate and the data on which it is based and to develop a point estimate or range to evaluate management's point estimate.<sup>30</sup> While subsequent events may provide some evidence about the valuation of complex financial instruments, other factors may need to be taken into account to address any changes in market conditions subsequent to the balance sheet date<sup>31</sup> It is important that both management and the auditor evaluate the impact of updated information on the valuation up to the date of the auditors report

85. Audit procedures to test how management values its financial instruments may include:

- Reviewing and assessing the judgments made by management, for example by reviewing accounting position papers prepared by management;
- Considering whether there are any other relevant price indicators or factors to take into account, including requesting additional information that management may have collected but did not take into account in its valuation methodology;
- Assessing the mathematical accuracy of the methodology employed; and

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<sup>29</sup> ISA 540, paragraphs 12–14

<sup>31</sup> Paragraphs A63-A66 of ISA 540 provide examples of some of the factors that may be relevant.

- Testing data to source materials, including documentation to support inputs, after considering the reliability, completeness and accuracy of the source materials.

The auditor may consider using persons with specialized skills and knowledge to perform these audit procedures, in particular when management has used an expert to value the complex financial instrument. If such expertise is not available within the auditor's firm, the auditor may need to engage external auditor's experts.

86. When the auditor determines that testing how management made the accounting estimate is an appropriate response to the assessed risk of material misstatement in accordance with ISA 540,<sup>32</sup> the auditor tests the valuation techniques, assumptions and inputs, regardless of whether management develops the estimates themselves, uses third-party information, or utilizes a management's expert.
- 86a. **[See Issue E of Agenda Item 4-A]** The procedures to test management's use of third party prices and pricing-related data depends on the type of assets, the observability of inputs and the complexity of any models used. For example less extensive procedures may be needed to test the use of third party information about high quality corporate bonds that trade frequently than private label asset backed securities that trade infrequently. This is because, among other things, there is more observable data when a financial instrument trades. Examples of procedures the auditor may consider when testing management's use of prices and pricing-related data from the third-party pricing source include:
- Evaluate the competence, capability and objectivity of the third-party pricing source.
  - Inquire about how the third-party pricing source generates prices, and the controls that the third-party pricing source have in place over valuation and validation of the prices.
  - Obtain a service auditor's report that covers the controls over validation of the prices.
  - Evaluate the reasonableness of assumptions and inputs.
  - Evaluate the appropriateness of the model or valuation technique
  - Compare the prices and pricing-related data used by management with the data provided by the third-party pricing source.
- 86b. In some cases, management may value a financial instrument based on a third party pricing source without further inquiry or understanding of how the third-party pricing source generated the price or pricing-related data. For example, there is a risk that an entity may account for changes in the fair value of a financial instrument by reference only to statements provided by brokers to their customers even where the broker is a counterparty of the entity's transaction. Further, there is a risk that management and the auditor may not be able to gain an understanding of the process used to generate the price, including any controls over the process of how reliably consensus price is determined, or may not have access to the model,

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<sup>32</sup> ISA 540, paragraph 13(b)

including the assumptions and other inputs used. In such cases, alternative audit procedures may be required, and the auditor may decide to develop a point estimate or range to evaluate management's point estimate. Use of one or more prices or quotes from one or more third-party pricing source(s) may provide corroborative evidence, but is unlikely to provide sufficient appropriate audit evidence on its own..

87. When markets become inactive or dislocated, management's valuations may be more judgmental and less verifiable and, as result, may be less reliable. In such circumstances, the auditor may test the valuation technique by a combination of testing controls operated by the entity, evaluating the design and operation of the valuation technique, testing the assumptions and inputs used in the valuation technique, and comparing its output to a point estimate or range developed by the auditor or to other third-party valuation techniques.<sup>33</sup>
88. In addition, the auditor's industry knowledge, knowledge of market trends and understanding of other entities' valuations (having regard to confidentiality) and other relevant price indicators informs the auditor's testing of the valuations and the consideration of whether the valuations overall appear reasonable. If the valuations appear to be consistently overly aggressive or conservative, this may be an indicator of possible management bias.
89. Obtaining prices from multiple sources may be useful to see the range of prices. A wide range of prices indicates higher estimation uncertainty and may suggest that the complex financial instrument is sensitive to small changes in inputs and assumptions. A narrow range may indicate lower estimation uncertainty and may suggest less sensitivity to small changes in inputs and assumptions. Simply obtaining prices from multiple sources does not substitute for gaining an understanding of and testing inputs and assumptions that underlie the price used by the entity to value its position. In addition, what appear to be multiple sources of pricing information may be utilizing the same prices and therefore not really represent multiple prices that are independently determined. If management and the auditor have utilized the same third party pricing sources to obtain a price, utilizing an alternative source of pricing information may be useful
90. **[Relocated to paragraph 89]**
- 90(a). The selection of items for substantive testing is an area requiring significant judgment by the auditor, particularly when the entity's financial instruments vary in complexity, types of inputs and risk profiles. For example, while the auditor may use the notional or fair value of financial instruments to determine the sample size, the selection of items for testing may need to consider the risk profile of the instrument.

#### Significant risks

91. The auditor's risk assessment process may lead the auditor to identify one or more significant

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<sup>33</sup> ISA 540, paragraph 13(d) describes requirements when the auditor develops a point estimate or range to evaluate the entity's point estimate. Valuation techniques developed by third parties and used by the auditor may, in some circumstances be considered the work of an auditor's expert and subject to the requirements in ISA 620.

risks relating to the valuation of financial instruments, when any of the following circumstances exist:

- High estimation uncertainty related to the valuation of financial instruments (for example, those with unobservable inputs).<sup>34</sup>
  - Lack of sufficient evidence to support management's valuation of its financial instruments.
  - Lack of management understanding of its financial instruments or expertise necessary to value such instruments properly, including the ability to determine whether valuation adjustments to valuations from valuation techniques are needed.
  - Lack of management understanding of complex requirements in the applicable financial reporting framework relating to measurement and disclosure of financial instruments, and inability of management to make the judgments required to properly apply those requirements.
  - The significance of valuation adjustments made to valuation technique outputs when the applicable financial reporting framework requires or permits such adjustments.
92. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA 330, ISA 540<sup>35</sup> requires the auditor to evaluate the following:
- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
  - (b) Whether the significant assumptions used by management are reasonable. Auditing the valuation of a complex financial instrument requires the auditor to use professional judgment, due to the estimation uncertainty associated with many financial instruments.

Evaluating valuation techniques used by the entity

93. When evaluating whether the valuation techniques used by an entity are appropriate in the circumstances, and whether controls over valuation techniques are in place and operating effectively (see Table 6), the factors considered by the auditor may include:
- The theoretical valuation techniques being used. For example, there are a number of option pricing valuation techniques and it is important that the uncertainty inherent in the assumptions underlying each one are understood and taken into account in the valuations;
  - Whether the valuation techniques are commonly used by other market participants

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<sup>34</sup> Where the auditor determines that the high estimation uncertainty related to the valuation of financial instruments gives rise to a significant risk, ISA 540 requires the auditor to perform substantive procedures and evaluate the adequacy of the disclosure of their estimation uncertainty. See ISA 540, paragraphs 11, 15 and 20.

<sup>35</sup> ISA 540, paragraph 15(a)-(b)

and have been previously demonstrated to provide a reliable estimate of prices obtained from market transactions;

- Whether the valuation techniques operate as intended and there are no flaws in their design, particularly under extreme conditions, and whether they have been independently validated. Indicators of flaws include Day 1 profits, inconsistent movements relative to benchmarks and usual changes in values;
- Whether the valuation techniques take account of the risks inherent in the financial instrument being valued, including counterparty creditworthiness, and own credit risk in the case of valuation techniques used to measure financial liabilities;
- Who developed the valuation techniques and whether their design could have been unduly influenced by traders or others who may not be objective;
- How the valuation techniques are calibrated to the market, including how sensitive the valuation techniques are to changes in variables and whether this reflects market behavior;
- Whether market variables and assumptions are used consistently and whether new conditions justify a change in the valuation techniques, market variables or assumptions used;
- Whether sensitivity analyses indicates that valuations would change significantly with only small or moderate changes in assumptions; and
- The competence and objectivity of those responsible for the development and application of the valuation techniques, including management's relative experience with particular valuation techniques that may be newly developed.

The auditor (or auditor's expert) may also independently develop one or more valuation techniques to compare its output with that of the valuation techniques used by management.

- 93a. Some entities may have an internal department responsible for developing valuation techniques to value certain instruments, particularly where level 3 inputs are involved. In such cases, a relevant consideration is the location of the valuation technique development function within the organization structure. For example, a valuation technique development function that is involved in assisting in pricing deals is less independent than one which is functionally and organizationally segregated from the front office.

Evaluating whether the assumptions and inputs used by management are reasonable

94. An assumption used in a valuation methodology may be deemed to be significant if a reasonably possible variation in the assumption would materially affect the measurement of the complex financial instrument.<sup>36</sup> Management may have considered alternative assumptions or outcomes by performing a sensitivity analysis. The extent of subjectivity associated with assumptions influences the degree of estimation uncertainty and may lead

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<sup>36</sup> See ISA 540, paragraph A107.

the auditor to conclude there is a significant risk, for example in the case of level 3 inputs (see paragraphs 91–92).

95. Audit procedures to test the assumptions used by management, including those used as inputs to valuation valuation techniques, are based on information available to the auditor at the time of the audit and may include evaluating:
- Whether management has the intent and ability to carry out certain courses of actions that affect its assumptions (if taking these intentions or plans into account is permitted by the applicable financial reporting framework);
  - Whether and, if so, how management has incorporated market inputs into the development of assumptions, as it is generally preferable to seek to maximize market-specific inputs and minimize entity-specific inputs;
  - Whether the assumptions are consistent with observable market conditions, and the characteristics of the financial asset or financial liability;
  - Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different marketplace assumptions exist;
  - Whether the inputs to the valuation techniques are complete and appropriate for the valuation technique, including whether sources of the inputs have changed during the period; and
  - Whether sensitivity analyses indicate that valuations would change significantly with only small or moderate changes in assumptions.

See paragraph A77 to A83 of ISA 540 for further considerations relative to evaluating the assumptions used by management.

96. In some cases, one particular assumption may be adjusted to account for the uncertainties in the valuation, rather than adjusting each assumption. In many cases, this is the discount rate used in the present value calculation, which is adjusted to reflect what willing buyers in the marketplace would pay. In such cases, an auditor's procedures may focus on the discount rate, by looking at an observable trade on a similar security to compare the discount rates used or developing an independent valuation technique to calculate the discount rate and compare with that used by management.
97. Where valuation of financial instruments is based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:
- The identification and characteristics of marketplace participants relevant to the complex financial instrument.
  - How valuation techniques are calibrated on initial recognition to determine the unobservable inputs.
  - Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
  - Whether it has incorporated the best input information available in the circumstances.



- Where applicable, how its assumptions take account of comparable transactions, financial assets or financial liabilities.
  - Sensitivity analysis of valuation techniques when unobservable inputs are used and whether adjustments have been made to address measurement uncertainty.
98. Where there is a lack of observable external evidence, it is particularly important that those charged with governance have been appropriately engaged to understand the subjectivity of management's valuations and the evidence that has been obtained to support these valuations. In such cases, it may be necessary for the auditor to evaluate whether there has been a thorough review and consideration of the issues, including any documentation, at all appropriate management levels within the entity, including with those charged with governance.
99. Finally, it is likely that in testing the inputs used in an entity's valuation methodology,<sup>37</sup> for example, where such inputs are classified in the fair value hierarchy, the auditor will also be obtaining evidence to support the disclosures required by the applicable financial reporting framework. For example, the auditor's substantive procedures to evaluate whether the inputs used in an entity's valuation methodology (that is, level 1, level 2 and level 3 inputs) are appropriate and testing of an entity's sensitivity analysis will be relevant to the auditor's evaluation of whether the disclosures achieve fair presentation.

Considerations when a management's expert or service organization is used by the entity

100. The use of a management's expert or service organization may have implications for the auditor, including the auditor's decision whether to involve persons with specialized skills or knowledge and the auditor's procedures to evaluate the sufficiency and appropriateness of evidence to support the financial instruments measured or disclosed in the financial statements.
101. For example, management of the entity may not have access to details of the valuation technique(s) used, and the key assumptions, used by third party pricing sources to value financial instruments. The auditor may not be able to obtain sufficient appropriate audit evidence in order to conclude about the reasonableness of the valuation of the financial instruments if management is unable to understand:
- The assumptions and other inputs used by the management's expert in valuing the financial instruments in order to evaluate whether these assumptions are appropriate; or
  - The design of the valuation technique in order to ensure it uses the measurement criteria of the applicable financial reporting framework.

In such circumstances, if the auditor is unable to obtain an appropriate understanding of management's expert's work, developing an auditor's point estimate or range may be useful (see paragraph 13(d) of ISA 540).

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<sup>37</sup> See, for example, paragraph 15 of ISA 540 for requirements relative to the auditor's evaluation of management's assumption regarding significant risks.

102. ISA 500 establishes requirements for the auditor when information to be used as audit evidence has been prepared using the work of a management's expert.<sup>38</sup> The extent of the auditor's procedures in relation to a management's expert and that expert's work depend on the significance of the expert's work for the auditor's purposes. Evaluating the appropriateness of management's expert's work assists the auditor in assessing whether the prices or valuations supplied by a management's expert provide sufficient appropriate audit evidence to support the valuations. Examples of procedures the auditor may perform include:
- Evaluating the competence, capabilities and objectivity of management's expert for example: their relationship with 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
  - Evaluating the appropriateness of the valuations and sensitivities developed by management's expert, including assessing the appropriateness of the valuation technique(s) used and the key market variables and assumptions used in the valuation technique(s).

#### Developing a range

103. An auditor may develop a valuation technique and adjust the inputs and assumptions used in the valuation technique to develop a range for use in evaluating the reasonableness of management's estimate of value. In accordance with ISA 540,<sup>39</sup> if the auditor uses assumptions, inputs, or a methodology that differs from management's, the auditor shall obtain an understanding of management's assumptions, inputs, and methodology sufficient to establish that the auditor's range takes into account relevant variables and to evaluate any significant differences from management's valuation.
104. If the auditor concludes that sufficient evidence cannot be obtained from the above procedures, for example where the third party uses internally developed valuation techniques and software and does not allow access to information on the valuation techniques, the auditor may not be able to obtain sufficient appropriate audit evidence about the valuation if the auditor is unable to perform other procedures to respond to the risks of material misstatement as explained in paragraph 13 of ISA 540, for example by developing a point estimate or a range to evaluate management's point estimate. ISA 705<sup>40</sup> describes the implications of the auditor's inability to obtain sufficient appropriate audit evidence.

#### Presentation and Disclosure of Financial instruments

105. Management's responsibilities include the preparation of the financial statements in accordance with the applicable financial reporting framework.<sup>41</sup> Some financial reporting

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<sup>38</sup> ISA 500, paragraph 8

<sup>39</sup> ISA 540, paragraph 13(d)

<sup>40</sup> ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*

<sup>41</sup> See paragraphs 4 and A2 of ISA 200.

frameworks require disclosures in the financial statements to enable users of the financial statements to make meaningful assessments of the effects of the entity's financial instrument activities, including the risks and uncertainties associated with these financial instruments. Accordingly, ISAs do not treat disclosures as being of less importance than items on the face of the financial statements.

106. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the presentation and disclosure of the various elements of financial statements and related disclosures. Assertions about presentation and disclosure encompass:

- (a) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
- (b) Completeness—all disclosures that should have been included in the financial statements have been included.
- (c) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
- (d) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

The auditor's procedures around auditing disclosures are designed in consideration of these assertions.

#### Procedures relating to the presentation and disclosure of financial instruments

107. Areas of particular importance in respect to financial instruments are:

- The financial risks and exposures inherent in financial instruments cannot always be effectively captured in a balance sheet and income statement. Financial reporting frameworks generally require additional disclosures regarding estimates and related risks and uncertainties to supplement and explain assets, liabilities, income, and expenses. The auditor's focus may need to be on the disclosures relating to risks and sensitivity analysis. Information obtained during the auditor's risk assessment procedures and testing of control activities may provide evidence in order for the auditor to conclude about whether the disclosures in the financial statements are in accordance with the requirements of the applicable financial reporting framework, for example about:
  - The entity's objectives and strategies for using financial instruments, including the entity's stated accounting policies;
  - The entity's control framework for managing its risks associated with financial instruments; and
  - The risks and uncertainties associated with the financial instruments.
- The information required to do this may come from systems outside traditional financial reporting systems, such as risk data. For example, market risk sensitivity disclosures may be derived from information systems that are not otherwise used to

generate information for inclusion in the financial statements. In order to test the adequacy of disclosures, the auditor may test the operating effectiveness of the controls over the data used in the preparation of disclosures in these systems, the process used to derive the disclosed information and the process by which management identifies the need for disclosures in the financial statements.

- In relation to financial instruments having significant risk,<sup>42</sup> even where the disclosures are in accordance with the applicable financial reporting framework, for example the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved and, accordingly, the financial statements may not achieve fair presentation. ISA 705 provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosures in the financial statements are inadequate or misleading.
- Auditors may also consider whether the disclosures are complete and understandable, for example, all relevant information may be included in the financial statements (or accompanying reports) but it may be insufficiently drawn together to enable users of the financial statements to obtain an understanding of the position or there may not be enough qualitative disclosure to give context to the amounts recorded in the financial statements. For example, even when an entity has included sensitivity analysis disclosures, the disclosure may not fully describe the risks and uncertainties that may arise because of changes in valuation, for example, possible effects on debt covenants, collateral requirements, and the entity's liquidity. ISA 260 contains requirements and guidance about communicating with those charged with governance, including the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

108. [Deleted]

109. Consideration of the appropriateness of presentation, for example on short-term and long-term classification, in substantive testing of financial instruments is relevant to the auditor's evaluation of the presentation and disclosure.

## **Other Relevant Audit Considerations**

### *The Role of the Internal Audit Function*

110. In many large entities, the internal audit function may perform work that enables senior management and those charged with governance to review and evaluate the entity's controls relating to the use of financial instruments. [Proposed] ISA 315 (Revised) requires the auditor to make inquiries of appropriate individuals within the internal audit function, if the function

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<sup>42</sup> ISA 540, paragraph 20, requires the auditor to perform further procedures on disclosures relating to accounting estimates that give rise to significant risks to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

exists, as part of the auditor's risk assessment procedures.<sup>43</sup> Inquiries with the appropriate individuals within the internal audit function may provide information to assist the external auditor in obtaining an understanding of the entity and its environment, including its use of financial instruments, and therefore in assessing the risks of material misstatement. The knowledge and skills required of an internal audit function to understand and perform procedures to provide assurance to management or those charged with governance on the entity's use of financial instruments are generally quite different from those needed for other parts of the business. The extent to which the internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's financial instrument activities, as well as the competence and objectivity of the internal audit function, is a relevant consideration in the external auditor's determination of whether the internal audit function is likely to be relevant to the overall audit strategy and audit plan.

111. Areas where the work of the internal audit function may be particularly relevant are:<sup>44</sup>

- Developing a general overview of the extent of use of financial instruments;
- Evaluating the appropriateness of policies and procedures and management's compliance with them;
- Evaluating the operating effectiveness of financial instrument control activities;
- Evaluating systems relevant to financial instrument activities;
- Assessing whether new risks relating to financial instruments are being identified, assessed and managed; and
- Conducting regular evaluations to:
  - Provide management and, where applicable, those charged with governance with assurance that financial instrument activities are being properly controlled; and
  - Ensure that new risks and the use of financial instruments to manage these risks are being identified, assessed and managed.

If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed in relation to financial instruments.<sup>45</sup> However, [proposed] ISA 610 (Revised) notes that, for a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level (in

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<sup>43</sup> [Proposed] ISA 315 (Revised), paragraph 6(a). In addition, paragraph 23 of [proposed] ISA 315 (Revised) requires the auditor to obtain an understanding of the nature of the internal audit function's responsibilities, how the function fits in the entity's organizational structure, and the activities performed, or to be performed.

<sup>44</sup> Work performed by functions such as the independent risk management function, model review functions, and product control, also be relevant to the auditor in these areas.

<sup>45</sup> Paragraphs 13–19 of [proposed] ISA 610 (Revised), *Using the Work of Internal Auditors*, establish requirements and provide guidance to the auditor in determining whether and to what extent to use the work of the internal audit function.

particular for significant risks), the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, it is less likely that the external auditor can make substantial use of the work of the internal audit function in obtaining sufficient appropriate audit evidence.

### *Written Representations*

112. ISA 540 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used making accounting estimates are reasonable.<sup>46</sup> ISA 580<sup>47</sup> requires that if, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. Depending on the volume and degree of complexity of financial instrument activities, written representations to support other evidence obtained about financial instruments may also include:

- Management's objectives with respect to financial instruments, for example, whether they are used for hedging, asset/liability management or investment purposes;
- Representations about the appropriateness of presentation of the financial statements, for example the recording of financial instrument transactions as sales or financing transactions;
- Representations about the financial statement disclosures concerning financial instruments, for example that:
  - The records reflect all financial instrument transactions; and
  - 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;
- The appropriateness of the valuations of financial instruments;
- Whether there are any side agreements associated with any financial instruments;
- Whether the entity has entered into any written options;
- Management's intent and ability to carry out certain actions;<sup>48</sup>
- Whether subsequent events require adjustment to the valuations and disclosures included in the financial statements.

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<sup>46</sup> ISA 540, paragraph 22. Paragraph 4 of ISA 580, *Written Representations*, states that written representations from management do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. If the auditor is otherwise unable to obtain sufficient appropriate audit evidence, this may constitute a limitation on the scope of the audit that may have implications for the auditor's report.

<sup>47</sup> Paragraph 13 of ISA 580.

<sup>48</sup> Paragraph A80 of ISA 540 provides examples of procedures that may be appropriate in the circumstances.

*Communication with Those Charged with Governance and Others*

113. Because of the uncertainties associated with the valuation of financial instruments, the potential effects on the financial statements of any significant risks are likely to be of governance interest. The auditor may communicate 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 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.
114. ISA 260<sup>49</sup> deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. With respect to financial instruments, matters to be communicated to those charged with governance may include:
- A lack of management understanding of the nature or extent of the financial instrument activities or the risks associated with such activities;
  - Significant deficiencies in the design or operation of the systems of internal control or risk management relating to the entity's financial instrument activities that the auditor has identified during the audit;<sup>50</sup>
  - Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to valuations performed by management or a management's expert, for example, where management is unable to obtain an understanding of the valuation methodologies, including the assumptions and inputs, used by the management's experts and such information is not made available to the auditor by management's expert;
  - Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
  - The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the measurement uncertainty associated with financial instruments;
  - The auditor's views about the appropriateness of the selection of accounting policies and presentation of financial instrument transactions in the financial statements;
  - The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for financial instruments; or
  - A lack of comprehensive and clearly stated policies for the purchase, sale and holding

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<sup>49</sup> ISA 260, *Communication with Those Charged with Governance*

<sup>50</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, establishes requirements and provides guidance on communicating deficiencies in internal control to management, and communicating significant deficiencies in internal control to those charged with governance. It explains that deficiencies in internal control may be identified during the auditor's risk assessment procedures in accordance with ISA 315 or at any other stage of the audit.

of financial instruments, including operational controls, procedures for designating financial instruments as hedges, and monitoring exposures.

The appropriate timing for communications will vary with the circumstances of the engagement; however, it may be appropriate to communicate significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion.

#### Communications with Regulators and Others

115. In some cases, auditors may be required,<sup>51</sup> or may consider it appropriate, to communicate directly with regulators or prudential supervisors, in addition to those charged with governance, regarding matters relating to financial instruments. Such communication may be useful throughout the audit. For example, in some jurisdictions, banking regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, and compliance with regulations. This coordination may be helpful to the auditor in identifying risks of material misstatement.

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<sup>51</sup> For example, ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires auditors to determine whether there is a responsibility to report identified or suspected non-compliance with laws and regulations to parties outside the entity. In addition, requirements concerning the auditor's communication to banking supervisors and others may be established in many countries either by law, by supervisory requirement or by formal agreement or protocol.



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