

## **Appendix**

### **Examples of Controls Relating to Financial Instruments**

The following provides background information and examples of 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. Further information on the use of trade confirmations and clearing houses is contained in paragraphs 25–26 of this Guidance Statement.

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 Competent Use of Financial Instruments*

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. 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.

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### *Organisational Structure*

Financial instrument activities may be run on either a centralised or a decentralised basis. Such activities and related decision making depend heavily on the flow of accurate, reliable, and timely management information. The difficulty of collecting and aggregating such information increases with the number of locations and businesses in which an entity is involved. The risks of material misstatement associated with financial instrument activities may increase with greater decentralisation 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 management's 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:

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- (a) Processes for the design and validation of methodologies used to produce valuations, including how measurement uncertainty is addressed; and
- (b) Policies regarding maximising 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, both front office and back office, to take mandatory time off from their duties. This type of 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.

*Use of Service Organisations*

Entities may also use service organisations (for example asset managers) to initiate the purchase or sale of financial instruments, to maintain records of transactions for the entity or to value financial instruments. Some entities may be dependent on these service organisations 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 organisation, the auditor may not be able to obtain sufficient appropriate audit evidence to rely on controls at that service organisation. See ASA 402, which establishes requirements for the auditor to obtain sufficient appropriate audit evidence when an entity uses the services of one or more service organisations.

The use of service organisations may strengthen or weaken the control environment for financial instruments. For example, a service organisation'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 organisation also may allow for greater segregation of duties. On the other hand, the service organisation may have a poor control environment.

### **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 financial instrument before they enter into it, including the objective of entering into the transaction and its structure (for example, 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.

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 authorisation 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 objective and timely monitoring of the financial risks and control activities;

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- (e) Provide for the objective 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 separated from 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 analysing 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 financial instrument recognised on the balance sheet. For example, a sudden fall in the market price of a commodity may force an entity to realise losses to close a forward position in that commodity 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 analysis does not fully reflect the extent of the risks that may affect the entity; sensitivity and scenario analyses also may be subject to limitations.

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The volume and sophistication of financial instrument activity and relevant regulatory requirements will influence the entity's consideration 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 relatively few 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 system is that it is 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 with 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 which may further increase the risk of error;
- (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;

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- (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 models used to process these transactions initially and on a periodic basis;
- (g) The potential that management has not set up a library of models, with controls around access, change and maintenance of individual models, in order to maintain a strong audit trail of the accredited versions of models and in order to prevent unauthorised access or amendments to those models;
- (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 organisation, 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 report. 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.

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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 authorisation process, adequate segregation of duties, and other policies and procedures designed to ensure that the entity's control objectives are met. Process flow charts may assist in identifying an entity's controls and lack of controls. This Guidance Statement focuses on control activities related to completeness, accuracy and existence, valuation, and presentation and disclosure.

### *Authorisation*

Authorisation 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, unauthorised 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 gains or losses incurred, will assist management in ensuring compliance with the entity's policies, including the authorisation 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 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.



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*Segregation of Duties*

Segregation of duties and the assignment of personnel is an important control activity, particularly when exposed to financial instruments. Financial instrument activities may be segregated 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 by 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 transactions, this may be performed by the risk management function; and
- (f) Monitoring positions and valuing financial instruments.

Many organisations choose to segregate the duties of those investing in financial instruments, those valuing financial instruments, those settling financial instruments and those accounting/recording 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 entities' internal control is an 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 assumptions. The IPV provides an 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 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.

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### *Completeness, Accuracy, and Existence*

Regular reconciliation of the entity's records to external banks' and custodians' records 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.

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.

### **Monitoring of Controls**

The entity's ongoing monitoring activities are designed to detect and correct any deficiencies in the effectiveness of 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, 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.

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Computer systems may be designed to produce exception reports to alert management to situations where financial instruments have not been used within authorised limits or where transactions undertaken were not within the limits established for the chosen counterparties. However, even a sophisticated computer system may not ensure the completeness of the recording of financial instrument transactions. Accordingly, management frequently put additional procedures in place to increase the likelihood that all transactions will be recorded.