The Audit of Financial Instruments for which Audit Evidence is Hard to Obtain

This article considers a problem faced by auditors in firms of all sizes: the audit of financial instruments for which audit evidence is hard to obtain. It raises a lot of questions to which it provides partial answers, and seeks to raise awareness of the issues in the hope of generating debate.

We deal with two ends of a spectrum: at the smaller end, we looks at the 'other' financial instruments that FRS 102 has forced onto the balance sheet, such as the 'floating to fixed' interest rate swaps widely sold by banks to many entities, including smaller entities prior to 2008, that now have high negative values.[1] At the larger end, it deals with the complex instruments tailored for specific clients for specific purposes sold by boutiques to larger entities. The salient issue is the *availability of sufficient, appropriate audit evidence,* because there is often no market for either type of instrument, and the only evidence can often appear to be the bank's own valuation.

This article does not cover credit risk, which is also an important element in the valuation of financial instruments and the audit thereof.

Smaller entities: auditing the fair value of interest rate caps, collars and swaps

FRS 102 requires that most 'other' (i.e. non-basic) financial instruments should appear at fair value on the balance sheet, often as a liability. Basic instruments are shown at amortised cost, with some exceptions. The first and possibly most important issue facing many organisations will be deciding which financial instruments are basic, and which are 'other'. The first issues facing auditors are likely to be whether they agree with the entity's assessment, and the need to provide an appropriate level of support to help those responsible reach a conclusion on the status of their financial instruments. But where in owner-managed businesses the audited entity does not have the skills to make an assessment, and the audit firm assists, a self-review threat arises that must also be addressed.

'Other' instruments will include many over-the-counter (OTC) interest rate swaps, and cap and collar arrangements. Those that were sold by banks prior to 2008 were often used in association with the purchase of land and buildings. Some have lengthy terms - particularly in the context of social housing - in excess of 30 years in some cases. They were sold on terms that assumed that interest rates would rise. But interest rates have fallen meaning that these instruments are heavily out of the money. Moreover, there is no external market for them and those holding them cannot afford the high exit costs. It became clear during the Audit and Assurance Faculty's Autumn 2014 road shows on the future of UK GAAP that smaller audit firms are expecting problems in obtaining sufficient appropriate audit evidence to support the valuation of these instruments.

Until now, despite the fact that these contracts have been out of the money for some time, company law has only required the disclosure of their nature and fair value in the notes - unless they were classified as onerous contracts under FRS 12.[2] Information about such instruments may not always have been disclosed in the past which complicate the issue further.

[1] Floating to fixed swaps would now have high positive values.
[2] In some cases instruments may have been mis-sold, but that is another issue.

FRS 102 brings them on to the balance sheet at fair value and while some argue that the standard of evidence required for notes and balance sheet disclosures is and always has been the same, the fact is that firms are likely look more carefully at these items than they have done before. Irrespective of past practice, auditors will not simply be able to assume that the bank has valued these instruments appropriately. Evidence from a bank is from outside the client and as such is more reliable than internally generated evidence, but it is not necessarily independent. Bank reports for audit purposes (and confirmation of receivables) are used to corroborate existing client figures. But this is not the case with valuations of financial instruments, where the *only* evidence if from the bank itself. And whereas the make-up of a bank balance confirmed by the bank, and the balance confirmed by debtors is often transparent and auditable in detail, these valuations are not, because a single figure is provided with no supporting assumptions, data or models.

Auditors will need to develop an approach that satisfies the need for independent evidence. So what should they be doing?

While the absence of a market is by no means an insurmountable obstacle when it comes to auditing these valuations, it can represent a major headache for a smaller audit firm with limited experience in the area.

Ethical standards and the provision of accountancy services by auditors
It is important to remember that the entity is responsible for the valuation and for determining the appropriate accounting treatment and entries even when those responsible for the preparation of accounts look to their auditors for guidance. Auditors are prohibited by ES 5 from providing valuation services to audit clients where there is a significant degree of subjective judgement and the effect is material, and many smaller entity audits involve consideration of the issue of 'informed management'.

Where valuations are material, ISA 540 on the audit of accounting estimate requires auditors to obtain evidence by, either:

- assessing and testing management's process for developing the bases and assumptions underlying the valuations, and engaging experts internally or externally if necessary;
- developing their own range of estimates;
- obtaining independent third party evidence; or
- considering whether post balance sheet events provide audit evidence regarding the accounting estimate.

Assessing management's process

Unfortunately, it will often be difficult, if not impossible, for auditors to check the process used to develop the estimate. Banks will not provide the relevant information. The valuations provided by banks that sold the instruments in the first place do not amount to independent third party evidence, and the absence of an external market means that truly independent third party evidence is limited.

Independent third party evidence

Independent market valuations *are* available however, for a fee, even where there is no external market and despite the fact that banks will not provide details of the data, assumptions or models on which the valuation is based, such as the forward curves they use.

Tools such as discount/forward curves can be obtained from entities such as Bloomberg, and they are at least independent of the issuing bank, although auditors still need to show that they have at least considered their competence and independence. For fixed/floating instruments linked to a bank's own base rate, the difference between an independent valuation and the issuing bank's valuation may to be small in many cases. However, the audit of inflation and base rate swaps is more challenging. Forecast inflation is inherently difficult to predict and as such, there can be larger differences between the bank's curves and those provided by Bloomberg or others. Nevertheless, expected inflation *can* be calculated mathematically if there are other instruments in issue linked to it, for which some information is available. This means that calculations *can* be performed for instruments based on the Retail Price Index (RPI), for example, because of the existence of RPI-linked gilts. Instruments linked to the Consumer Price Index (CPI) are more difficult because there are no other such instruments in issue for which information is available (actuaries also have problems valuing pension schemes linked to the CPI). Similarly, base rate swaps indexed to a bank's own base rate (such as the RBS or HSBC base rate) are difficult to value because the banks do not publish their own forecast base rate data.

Alternatively, pricing providers such as Markit and Reuters who obtain or aggregate market data independently may also provide valuations. Again, auditors still need to show that they have considered the competence and independence of such providers but perhaps more importantly, the cost of subscriptions to these providers can be substantial for sporadic or low volume use which smaller firms may well struggle to justify. In some cases, the may be few if any acceptable alternatives, unfortunately.

Developing an estimate

Common valuation methods for relatively simply option pricing models are available on the internet but not for all interest rate derived models. And even if auditors can satisfy themselves that such tools are fit for purpose, the market data required to value a swap is not generally given away for free. Even if reasonable estimates can be made regarding the assumptions and data the banks are using, regarding interest rates for example, which should in theory enable auditors to develop estimates of their own, the issues are complex. For swaps, the problem is often with the data. The valuation may be a relatively straightforward discounted cash flow exercise, but it cannot be performed without adequate data. For options, including caps and floors, there are often complex calculation challenges as well as issues with the availability of data. In any case, many firms may be unable to develop their own estimate because of a lack of relevant technical skills.

If auditors are unable to obtain adequate independent evidence on a material item, they will need to consider qualifying their audit opinion. If the client is unwilling to bear the cost of a necessary independent valuation, auditors then need to determine whether this constitutes an imposed limitation in audit scope and potentially, the implications for re-appointment.

Auditing complex financial instruments held by larger entities

At the other end of the spectrum, there are on-going difficulties associated with the audit of more complex financial instruments tailored for specific entities for specific purposes, generally sold by specialist boutiques to larger entities.

The recent PCAOB consultation on the audit of estimates and fair values refers to this issue in some detail.[3] Once again, auditors are being provided with valuations by counterparties who sold the instrument to the entity in the first place, and no supporting information for the

[3] The Public Company Accounting Oversight Board (PCAOB) sets auditing standards for the audits entities listed on the SEC in the USA.

valuation is made available to the entity or its auditors. In such cases, this may be because of the way the instrument is set up. Market participants provide data to the counterparty on a confidential basis and that information is aggregated to provide an overall market price to market participants. The counterparty cannot provide this information to auditors, even if it wanted to. The models used are often proprietary, and the counterparty will not release details of the assumptions used. Once again - what should auditors do?

Pricing and valuation teams in larger firms

Some firms have pricing and valuation expertise that they can draw on to help provide evidence to support such valuations. Some of these teams were originally set up as valuation advisory services to meet client needs, such as IFRS conversion, and are now used internally when audit engagement partners deem it necessary.[4] Some teams are housed within bigger teams that also provide valuations of intangibles such as brands, know-how, customer relationships and intellectual property. Some firms have a specialist financial instruments assurance team that might sit alongside or within banking or capital markets audit groups, or within corporate finance functions.

These teams are often centralised and they have different names, and sit in different places within the firms. The PCAOB consultation referred to above makes extensive references to 'national-level pricing desks'.

Teams can be sizeable and their services are in demand. Staffed by auditors, ex-bankers and other valuation specialists, they sometimes have access to external specialist expertise. They sometimes build their own valuation models in order to develop comparisons with the otherwise seemingly unsupportable valuations provided by the issuing parties.

Many firms have policies covering the nature, timing and extent of involvement of such teams or individuals in audits. Such policies often determine the circumstances in which involvement is necessary but leave it to the engagement partner to determine the nature of the involvement, and/or to conclude on the issue. At a high level, policies may cover 'sensitive' valuations or situations in which complex financial models are important to the financial statements or the business model. Policies may advise use of the team where the client is within the financial services sector or has a significant corporate treasury function, for example, or if the audited entity is a 'user of complex financial instruments', defined as one that uses derivatives, measures any instruments at fair value or applies hedge accounting perhaps. Some policies are more specific and require the involvement of the team for specific types of instrument, such as structured credit derivatives, trades with bespoke payoffs or anything described as 'exotic'.

Policies often involve the classification of different levels of financial instruments for which different evidence-gathering methods are employed, such as checking a client prices to prices from independent third party providers, developing valuations based on other observable inputs, and developing bespoke valuations when inputs are unobservable. The tools and methodologies available to such teams may well be engineered to cope with several different sets of GAAP requirements and may involve both in-house and third-party technology and market data.

Even if firms do not establish national-level pricing desks to provide valuation expertise for audit purposes within a team structure, many firms employ individual internal valuation experts or engage the services of a reputable third party to act as an external valuation

[4] In other cases, it seems to have worked the other way round, when an existing internal valuation service develops a revenue generating client offering.

expert. It is important that firms understand the capacity in which they engage their valuation expertise. For each audit, the engagement partner is required to assess the independence of any *external experts* in accordance with the firm's policies. *Auditor's internal experts*, on the other hand, may be treated as a member of the audit team, subject, like every other member, to firm-wide policies and procedures which establish independence on a periodic basis and they do not therefore have to pass separate 'independence tests' for each audit. The FRC's Audit Quality Review Team (AQRT) has recently made observations on this issue.

So how do these teams and individuals get involved in audits and what do they do, other than develop models and valuations?

Involvement in the audit consists of more than simply providing evidence to the audit team. The risk assessment may be critical in determining the extent to which the team or individual should be involved, but help from that very team may well be needed in order to perform a proper risk assessment, in understanding whether a valuation is likely to be material, for example, or whether an approach to valuation is likely to be particularly sensitive or volatile. Discussions about the audit plan may cover the proposed approach to testing assertions relating to financial instruments, particularly the valuation assertion, and evaluating the quality of internal controls and the balance of controls testing and substantive procedures.

Where valuations are performed or ranges developed by the team or individual, they may be compared to those recorded by the entity. Where a difference lies outside a pre-determined acceptable threshold, further investigations are performed such as discussions with the client about the models, inputs and assumptions.

Firms in the middle

Many firms are likely to fall somewhere in the middle of the spectrum and have a number of clients with 'other' financial instruments but very few which hold portfolios of complex instruments. Such firms need to think about whether they need policies and procedures requiring an internal central review of valuations for all audit clients holding any derivatives or complex financial instruments.

Such policies and procedures often address:

- situations in which audit teams may undertake their own valuations - such as where there is a market - and how teams might go about it - by checking that client valuations agree to publicly available valuations, for example. In such cases, a subsequent central review may be undertaken to ensure that there is nothing in the documentation that the audit team, client or counterparty have missed;

- non-standard valuations should be referred centrally to valuation experts, and in which cases valuations might be referred to external experts.

Conclusions?

It is often important to obtain valuations on a timely basis whenever possible. The information needed to perform valuations may be real-time (or virtually so) and obtaining retrospective valuations may not be possible.

There are no straightforward answers to the questions that are arising for the audit of financial instruments for which evidence is hard to obtain in the context of the move to the new UK GAAP, but it is important that firms, their clients, regulators and standard-setters are aware of the issues and neither ignore the issues nor develop unrealistic expectations about what can be done to address them.