FAQ

FOUNDATION FOR AUDIT QUALITY

Enhancing professional excellence

Audit procedures over derivative valuations

30 March 2022

Speakers for today

Namrata Baskar

Ajit Viswanath

Definition of a derivative

A derivative is **a financial instrument whose value changes in relation to changes in a variable**, such as an interest rate, commodity price, credit rating, or foreign exchange rate.

Types of derivatives

Product	Nature
Forwards	Forwards are negotiated between two parties to purchase and sell a specific quantity of a financial instrument, foreign currency or commodity at a price specified at origination of the contract, with delivery and settlement at a specified future date.
Options	Options allow, but do not require, the holder (or purchaser) to buy (call) or sell (put) a specific or standard commodity or financial instrument, at a specified price during a specified period (an American option) or at a specified date (a European option).
Swaps	Swaps are forward-based contracts in which two parties agree to swap streams of payments over a specified period of time. An example is an interest-rate swap in which one party agrees to make payments based on a fixed rate and the other party agrees to make payments based on a variable rate.
Futures	Futures are forward-based standardised contracts to make or take delivery of a specified financial instrument, foreign currency, or commodity at a specified future date or during a specified period at a specified price or yield.

Approaches to auditing derivatives

There are two approaches that can be taken to auditing the valuation of derivatives:

- Independent re-performance; or
- Following the client’s methodology.

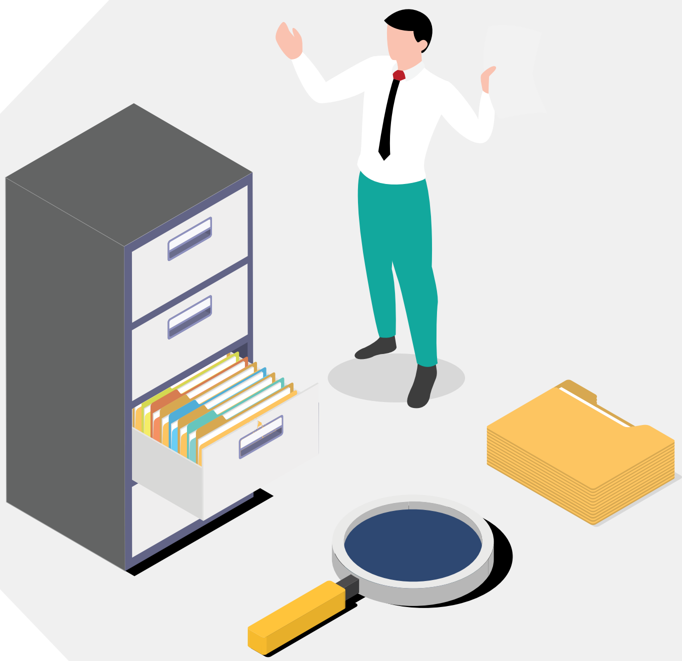
Independent re-performance:

Where an auditor chooses the independent re-performance approach the auditor performs the following:

- Independently builds a valuation model
- Independently sources the economic inputs from the market
- Agrees the non-economic inputs back to term sheets from the client.

Where an auditor chooses to follow the client's methodology, the auditor performs the following steps:

- Understand the client's valuation methodology, assesses the client’s model validation and implementation controls
- Understands the source of economic inputs used by the client and agrees the inputs used back to the client’s source. Assesses the appropriateness of the market sources used by the client.
- Agrees the non-economic inputs back to term sheets from the client.



*Please note in an audit that also has an IFC opinion independent reperformance alone will not be sufficient as we will need to test the clients controls around valuation.

Independent re-performance

FAQ
FOUNDATION FOR AUDIT QUALITY
Enhancing professional excellence

Key considerations
Economic inputs - Inputs required based on the instrument type and model - Source of the inputs - Accessibility of information (certain sources maybe a subscription based source) - Level 3 inputs
Model - Use of internal/external experts by the auditor - Selection of the model to be used
Non-economic inputs - Sourcing of term sheets from the client

Follow the client’s methodology

Key considerations:

Audit procedures over the accuracy of non-economic inputs used in the valuation. Considerations include where this information is sourced from and what controls the client has over inputting this information in the system.

Audit procedures over the model/ methodology used by the client. Considerations should include; who develops the model, is there a different team that validates the model, is the model implemented in a spreadsheet or a system, what control does the client have around the implementation of the model and changes to the model, how often are models revalidated, who has access to the gold copy of the model and who can make changes to the model.

Audit procedures over economic inputs: Considerations should include; where does the client source market data from, i.e. the appropriateness of the source, how is it sourced and what are the controls around this, how is the market data input into the system / spreadsheet (for example is it an automated feed, an upload of a spreadsheet or a manual input), does the client have a process to validate the accuracy of the market inputs used.

Dealing with differences

FAQ
FOUNDATION FOR AUDIT QUALITY
Enhancing professional excellence

When following the independent re-performance approach, there may be differences between the client's valuation and the auditor's valuation. These differences could arise because of one of the following reasons:

- **Differences in non-economic inputs used:** As this is not a judgemental input, a check back to the underlying trade ticket will easily enable the auditor to identify if the error is with the client's valuation or the auditor's valuation.
- **Differences in economic inputs:** Where the client and the auditor use different sources of economic inputs, there could be small variations in the inputs. Where the variations are minor and both the auditor's source and the client's sources are commonly accepted market sources, then usually no further work should need to be performed. The auditor should ensure that the client's source is appropriate in this instance. However, if the client is using a source that is not an accepted market source, there may be a genuine difference that would need to be corrected for.
- **Differences in models:** A difference in the valuation that is not caused either by a difference in the non-economic or economic differences would be because of a difference in the model. In this case, the auditor needs to work with the client to understand the reason for the difference and therefore assess whether a change is required in either the client's model or the auditor's model.

Please note, there could be small difference that arise when running the same model using the same inputs due to the nature of the model. Therefore, when independently valuing derivatives, experts usually set an acceptable difference upfront and differences below this amount are not further investigated. The more complex the instrument the higher the tolerable threshold is likely to be.

Disclosure considerations

Specific disclosure requirements apply for derivative instruments (more extensive under Ind AS)

Disclosures will require detailed workings to be prepared by management or experts appointed by management (for example, sensitivity analysis for level 3 financial instruments).

As auditors, we are required to perform both tests of controls and substantive procedures over disclosures.

Presentation requirement for offsetting requires additional attention to ensure that the entity has both the ability and the intention to settle receivables and payables on a net basis.

Thank You

Feedback/queries can be sent to: FAQ@faqonline.org

FAQ on social media		
Twitter	LinkedIn	Facebook

Please note that this information has been issued to provide general guidance and information and should not be relied on as being definitive or all-inclusive. As with all other FAQ resources, this information is not a substitute for the authoritative literature, including Standards on Auditing and other engagement and quality controls standards and Guidance Notes, issued by the Institute of Chartered Accountants of India (ICAI) or other relevant body . Readers are urged to refer to relevant rules and standards. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The FAQ makes no representations, warranties, or guarantees of any kind, express or implied, about the completeness, accuracy, reliability, suitability of it for any purpose, and assumes no responsibility for, the content or application of the material contained herein. The FAQ expressly disclaims all liability whatsoever for any loss or damages including without limitation, indirect or consequential loss or damage arising out of the use of, reference to, or reliance on this material. This information does not represent an official position of the FAQ, its board, governing body or its members.

The Foundation for Audit Quality is an autonomous, non-partisan and not-for-profit organization.
Registered office: J 98, Second Floor, J Block, Mayfield Gardens, Sector 51, Gurgaon, Haryana 122018

https://www.faqonline.org

This document is for e-communication only

Image & graphics courtesy: Cover Page: https://www.freepik.com/ ; Illustration/ infographics: https://www.freepik.com/