

## AU Section 332

# ***Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***<sup>1</sup>

(Supersedes SAS No. 81.)

Source: SAS No. 92.

See section 9332 for interpretations of this section.

Effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application is permitted.

### **Applicability**

.01 This section provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities<sup>2</sup> that are made in an entity's financial statements.<sup>3</sup> Those assertions<sup>4</sup> are classified according to three broad categories that are discussed in section 326, *Audit Evidence*, paragraphs .14–.19, as follows:

- a. Assertions about classes of transactions and events for the period under audit:
  - i. *Occurrence*. Transactions and events that have been recorded have occurred and pertain to the entity.
  - ii. *Completeness*. All transactions and events that should have been recorded have been recorded.
  - iii. *Accuracy*. Amounts and other data relating to recorded transactions and events have been recorded appropriately.
  - iv. *Cutoff*. Transactions and events have been recorded in the correct accounting period.
  - v. *Classification*. Transactions and events have been recorded in the proper accounts.
- b. Assertions about account balances at the period end:
  - i. *Existence*. Assets, liabilities, and equity interests exist.
  - ii. *Rights and obligations*. The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

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<sup>1</sup> The AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing this section.

<sup>2</sup> Throughout the remainder of this section, the word *security* or *securities* refers to an entity's investment in a security or securities.

<sup>3</sup> The guidance provided in this section applies to audits of financial statements prepared in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. Such other bases of accounting are described in section 623, *Special Reports*, paragraph .04. References in this section to generally accepted accounting principles are intended to also refer to other comprehensive bases of accounting when the reference is relevant to the basis of accounting used.

<sup>4</sup> Throughout the remainder of this section, the word *assertion* refers to an assertion made in an entity's financial statements.

- iii. *Completeness.* All assets, liabilities, and equity interests that should have been recorded have been recorded.
- iv. *Valuation and allocation.* Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- c. Assertions about presentation and disclosure:
  - i. *Occurrence and rights and obligations.* Disclosed events and transactions have occurred and pertain to the entity.
  - ii. *Completeness.* All disclosures that should have been included in the financial statements have been included.
  - iii. *Classification and understandability.* Financial information is appropriately presented and described and disclosures are clearly expressed.
  - iv. *Accuracy and valuation.* Financial and other information are disclosed fairly and at appropriate amounts.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 106.]

## Derivative Instruments and Hedging Activities Included in the Scope of this Section

.02 The guidance in this section applies to derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), of all entities. This section uses the definition of a derivative instrument that is in Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 815, Derivatives and Hedging*. FASB ASC 815 addresses the accounting for derivatives that are either freestanding or embedded in contracts or agreements. For purposes of applying the guidance in this section, a derivative instrument is a financial instrument or other contract with all three of the characteristics listed in FASB ASC 815-10-15-83, which are the following.

- a. *Underlying, notional amount, payment provision.* The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
  - (1) One or more underlyings
  - (2) One or more notional amounts or payment provisions or both
- b. *Initial net investment.* The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. *Net settlement.* The contract can be settled net by any of the following means:
  - (1) Its terms implicitly or explicitly require or permit net settlement.
  - (2) It can readily be settled net by a means outside the contract.
  - (3) It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.03 An entity may enter into a derivative<sup>5</sup> for investment purposes or to designate it as a hedge of exposure to changes in fair value (referred to as a *fair value hedge*), exposure to variability in cash flows (referred to as a *cash flow hedge*), or foreign currency exposure. The guidance in this section applies to hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB ASC 815 permits hedge accounting. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

## Securities Included in the Scope of this Section

.04 The guidance in this section applies to all securities. There are two types of securities—debt securities and equity securities. This section uses the definitions of *debt security* and *equity security* that are in the FASB ASC glossary. This section applies to debt and equity securities without regard to whether they are subject to the accounting requirements of FASB ASC 320, *Investments—Debt and Equity Securities*. For example, it applies to assertions about securities accounted for under the equity method following the requirements of FASB ASC 323, *Investments—Equity Method and Joint Ventures*. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

## The Need for Special Skill or Knowledge to Plan and Perform Auditing Procedures

.05 The auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. Examples of such auditing procedures and the special skill or knowledge required include—

- Obtaining an understanding of an entity's information system for derivatives and securities, including services provided by a service organization, which may require that the auditor have special skill or knowledge with respect to computer applications when significant information about derivatives and securities is transmitted, processed, maintained, or accessed electronically.
- Identifying controls placed in operation by a service organization that provides services to an entity that are part of the entity's information system for derivatives and securities, which may require that the auditor have an understanding of the operating characteristics of entities in a certain industry.
- Understanding the application of generally accepted accounting principles for assertions about derivatives, which might require that the auditor have special knowledge because of the complexity of those principles. In addition, a derivative may have complex features that require the auditor to have special knowledge to evaluate the measurement and disclosure of the derivative in conformity with generally accepted accounting principles. For example, features embedded in contracts or agreements may require separate accounting as a derivative, and complex pricing structures may increase the complexity of the assumptions used in estimating the fair value of a derivative.

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<sup>5</sup> To simplify the use of terminology, the remainder of this section often uses the term *derivative* to refer to both the derivative and the purpose for which the entity uses it.

- Understanding the determination of the fair values of derivatives and securities, including the appropriateness of various types of valuation models and the reasonableness of key factors and assumptions, which may require knowledge of valuation concepts.
- Assessing inherent risk and control risk for assertions about derivatives used in hedging activities, which may require an understanding of general risk management concepts and typical asset/liability management strategies.

**.06** The auditor may plan to seek the assistance of employees of the auditor's firm, or others outside the firm, with the necessary skill or knowledge. Section 311, *Planning and Supervision*, provides guidance on the use of individuals who serve as members of the audit team and assist the auditor in planning and performing auditing procedures. The auditor also may plan to use the work of a specialist. Section 336, *Using the Work of a Specialist*, provides guidance on the use of the work of specialists as audit evidence. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

## Audit Risk and Materiality

**.07** Section 312, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor's consideration of audit risk and materiality when planning and performing an audit of financial statements in accordance with generally accepted auditing standards. It requires the auditor to design procedures to obtain reasonable assurance of detecting misstatements of assertions about derivatives and securities that, when aggregated with misstatements of other assertions, could cause the financial statements taken as a whole to be materially misstated. When designing such procedures, the auditor should consider the inherent risk and control risk for these assertions. The auditor may also consider the work performed by the entity's internal auditors in designing procedures. Guidance on considering the work performed by internal auditors is found in section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

## Inherent Risk Assessment

**.08** The inherent risk for an assertion about a derivative or security is its susceptibility to a material misstatement, assuming there are no related controls. Examples of considerations that might affect the auditor's assessment of inherent risk for assertions about a derivative or security include the following.

- *Management's objectives.* Accounting requirements based on management's objectives may increase the inherent risk for certain assertions. For example, in response to management's objective of minimizing the risk of loss from changes in market conditions, the entity may enter into derivatives as hedges. The use of hedges is subject to the risk that market conditions will change in a manner other than expected when the hedge was implemented so that the hedge is no longer effective. That increases the inherent risk for certain assertions about the derivatives because in such circumstances continued application of hedge accounting would not be in conformity with generally accepted accounting principles.
- *The complexity of the features of the derivative or security.* The complexity of the features of the derivative or security may increase the complexity of measurement and disclosure considerations required by

generally accepted accounting principles. For example, interest payments on a structured note may be based on two or more factors, such as one or more interest rates and the market price of certain equity securities. A formula may dictate the interaction of the factors, such as a prescribed interest rate less a multiple of another rate. The number and interaction of the factors may increase the inherent risk for assertions about the fair value of the note.

- *Whether the transaction that gave rise to the derivative or security involved the exchange of cash.* Derivatives that do not involve an initial exchange of cash are subject to an increased risk that they will not be identified for valuation and disclosure considerations. For example, a foreign exchange forward contract that is not recorded at its inception because the entity does not pay cash to enter into the contract is subject to an increased risk that it will not be identified for subsequent adjustment to fair value. Similarly, a stock warrant for a traded security that is donated to an entity is subject to an increased risk that it will not be identified for initial or continuing measurement at fair value.
- *The entity's experience with the derivative or security.* An entity's inexperience with a derivative or security increases the inherent risk for assertions about it. For example, under a new arrangement, an entity may pay a small deposit to enter into a futures contract for foreign currency to pay for purchases from an overseas supplier. The entity's inexperience with such derivatives may lead it to incorrectly account for the deposit, such as treating it as inventory cost, thereby increasing the risk that the contract will not be identified for subsequent adjustment to fair value.
- *Whether a derivative is freestanding or an embedded feature of an agreement.* Embedded derivatives are less likely to be identified by management, which increases the inherent risk for certain assertions. For example, an option to convert the principal outstanding under a loan agreement into equity securities is less likely to be identified for valuation and disclosure considerations if it is a clause in a loan agreement than if it is a freestanding agreement. Similarly, a structured note may include a provision for payments related to changes in a stock index or commodities prices that requires separate accounting.
- *Whether external factors affect the assertion.* Assertions about derivatives and securities may be affected by a variety of risks related to external factors, such as—
  - *Credit risk*, which exposes the entity to the risk of loss as a result of the issuer of a debt security or the counterparty to a derivative failing to meet its obligation.
  - *Market risk*, which exposes the entity to the risk of loss from adverse changes in market factors that affect the fair value of a derivative or security, such as interest rates, foreign exchange rates, and market indexes for equity securities.
  - *Basis risk*, which exposes the entity to the risk of loss from ineffective hedging activities. Basis risk is the difference between the fair value (or cash flows) of the hedged item and the fair value (or cash flows) of the hedging derivative. The entity is subject to the risk that fair values (or cash flows) will change so that the hedge will no longer be effective.

- *Legal risk*, which exposes the entity to the risk of loss from a legal or regulatory action that invalidates or otherwise precludes performance by one or both parties to the derivative or security.

Following are examples of how changes in external factors can affect assertions about derivatives and securities.

- The increase in credit risk associated with amounts due under debt securities issued by entities that operate in declining industries increases the inherent risk for valuation assertions about those securities.
  - Significant changes in and the volatility of general interest rates increase the inherent risk for the valuation of derivatives whose value is significantly affected by interest rates.
  - Significant changes in default rates and prepayments increase the inherent risk for the valuation of retained interests in a securitization.
  - The fair value of a foreign currency forward contract will be affected by changes in the exchange rate, and the fair value of a put option for an available-for-sale security will be affected by changes in the fair value of the underlying security.
- *The evolving nature of derivatives and the applicable generally accepted accounting principles.* As new forms of derivatives are developed, interpretive accounting guidance for them may not be issued until after the derivatives are broadly used in the marketplace. In addition, generally accepted accounting principles for derivatives may be subject to frequent interpretation by various standard-setting bodies. Evolving interpretive guidance and its applicability increase the inherent risk for valuation and other assertions about existing forms of derivatives.
  - *Significant reliance on outside parties.* An entity that relies on external expertise may be unable to appropriately challenge the specialist's methodology or assumptions. This may occur, for example, when a valuation specialist values a derivative.
  - *Generally accepted accounting principles may require developing assumptions about future conditions.* As the number and subjectivity of those assumptions increase, the inherent risk of material misstatement increases for certain assertions. For example, the inherent risk for valuation assertions based on assumptions about debt securities whose value fluctuates with changes in prepayments (for example, interest-only strips) increases as the expected holding period lengthens. Similarly, the inherent risk for assertions about cash flow hedges fluctuates with the subjectivity of the assumptions about probability, timing, and amounts of future cash flows.

## Control Risk Assessment

### *Obtaining an Understanding of Internal Control to Plan the Audit*

.09 Section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to obtain an understanding of internal control that will enable the auditor to—

- a. Identify the risk of material misstatement at the assertion level.
- b. Assess the risk of material misstatement at the assertion level.

- c. Evaluate the design of internal controls and determine whether they are implemented.

[Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94. Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

**.10** Controls should be related to management's objectives for financial reporting, operations, and compliance.<sup>6</sup> For example, to achieve its objectives, management of an entity with extensive derivatives transactions may implement controls that call for—

- a. Monitoring by a control staff that is fully independent of derivatives activities.
- b. Derivatives personnel to obtain, prior to exceeding limits, at least oral approval from members of senior management who are independent of derivatives activities.
- c. Senior management to properly address limit excesses and divergences from approved derivatives strategies.
- d. The accurate transmittal of derivatives positions to the risk measurement systems.
- e. The performance of appropriate reconciliations to ensure data integrity across the full range of derivatives, including any new or existing derivatives that may be monitored apart from the main processing networks.
- f. Derivatives traders, risk managers, and senior management to define constraints on derivatives activities and justify identified excesses.
- g. Senior management, an independent group, or an individual that management designates to perform a regular review of the identified controls and financial results of the derivatives activities to determine whether controls are being effectively implemented and the entity's business objectives and strategies are being achieved.
- h. A review of limits in the context of changes in strategy, risk tolerance of the entity, and market conditions.

**.11** The extent of the understanding of internal control over derivatives and securities obtained by the auditor depends on how much information the auditor needs to identify and assess the risk of material misstatement at the assertion level. The understanding obtained may include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements. It may encompass controls placed in operation by the entity and by service organizations whose services are part of the entity's information system. Section 314 paragraph .81 defines the information system as the procedures, whether automated or manual, and records established by an entity to initiate, authorize, record, process, and report entity transactions and

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<sup>6</sup> The AICPA issued an Audit Guide concurrent with this section entitled *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (the Guide). Chapter 5 of the Guide, "Control Risk Assessment," provides sample control objectives for derivatives, hedging activities, and securities which may be useful to auditors in assessing control risk for relevant assertions. Additionally, in 1996, The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued *Internal Control Issues in Derivatives Usage: An Information Tool for Considering the COSO Internal Control—Integrated Framework in Derivatives Applications*. Although the document precedes Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*, its guidance may be useful to entities in developing controls over derivatives transactions and to auditors in assessing control risk for assertions about those transactions. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

to maintain accountability for the related assets, liabilities, and equity. Following the guidance in section 324, *Service Organizations*, a service organization's services are part of an entity's information system for derivatives and securities if they affect any of the following:

- a. How the entity's derivatives and securities transactions are initiated.
- b. The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the entity's derivatives and securities transactions
- c. The accounting processing involved from the initiation of those transactions to their inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information
- d. The process the entity uses to report information about derivatives and securities transactions in its financial statements, including significant accounting estimates and disclosures

[Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94. Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statements on Auditing Standards No. 106, and No. 109.]

**.12** Examples of a service organization's services that would be part of an entity's information system include—

- The initiation of the purchase or sale of equity securities by a service organization acting as investment adviser or manager.
- Services that are ancillary to holding<sup>7</sup> an entity's securities such as—
  - Collecting dividend and interest income and distributing that income to the entity.
  - Receiving notification of corporate actions.
  - Receiving notification of security purchase and sale transactions.
  - Receiving payments from purchasers and disbursing proceeds to sellers for security purchase and sale transactions.
  - Maintaining records of securities transactions for the entity.
- A pricing service providing fair values of derivatives and securities through paper documents or electronic downloads that the entity uses to value its derivatives and securities for financial statement reporting.

**.13** Examples of a service organization's services that would not be part of an entity's information system are the following:

- The execution by a securities broker of trades that are initiated by either the entity or its investment adviser
- The holding of an entity's securities

**.14** An auditor who needs information about the nature of a service organization's services that are part of an entity's information system for derivatives and securities transactions, or its controls over those services, to plan the audit may be able to gather the information from a variety of sources, such as the following:

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<sup>7</sup> In this section, maintaining custody of securities, either in physical or electronic form, is referred to as *holding* securities, and performing ancillary services is referred to as *servicing* securities.

- User manuals
- System overviews
- Technical manuals
- The contract between the entity and the service organization
- Reports by auditors,<sup>8</sup> internal auditors, or regulatory authorities on the information system and other controls placed in operation by a service organization
- Inquiry or observation of personnel at the entity or at the service organization

In addition, if the services and the service organization's controls over those services are highly standardized, information about the service organization's services, or its controls over those services, obtained through the auditor's prior experience with the service organization may be helpful in planning the audit.

### Assessing Control Risk

**.15** After obtaining the understanding of internal control over derivatives and securities transactions, the auditor should assess control risk for the related assertions. Guidance on that assessment is found in section 314. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

**.16** If the auditor plans to assess control risk below the maximum for one or more assertions about derivatives and securities, the auditor should identify specific controls relevant to the assertions that are likely to prevent or detect material misstatements and that have been placed in operation by either the entity or the service organization, and gather audit evidence about their operating effectiveness. Audit evidence about the operating effectiveness of a service organization's controls may be gathered through tests performed by the auditor or by an auditor engaged by either the auditor or the service organization—

- a. As part of an engagement in which a service auditor reports on the controls placed in operation by the service organization and the operating effectiveness of those controls, as described in section 324.
- b. An agreed-upon procedures engagement.<sup>9</sup>
- c. To work under the direction of the auditor of the entity's financial statements.

Confirmations of balances or transactions from a service organization do not provide audit evidence about its controls. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.17** The auditor should consider the size of the entity, the entity's organizational structure, the nature of its operations, the types, frequency, and complexity of its derivatives and securities transactions, and its controls over those transactions in designing auditing procedures for assertions about derivatives and securities. For example, if the entity has a variety of derivatives

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<sup>8</sup> Section 324 provides guidance on auditors' reports on controls placed in operation by a service organization and the operating effectiveness of those controls.

<sup>9</sup> AT section 201, *Agreed-Upon Procedures Engagements*, provides guidance on applying agreed-upon procedures to controls. [Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

and securities that are reported at fair value estimated using valuation models, the auditor may be able to reduce the substantive procedures for valuation assertions by gathering audit evidence about the controls over the design and use of the models (including the significant assumptions) and evaluating their operating effectiveness. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.18** In some circumstances, it may not be practicable or possible for the auditor to reduce audit risk to an acceptable level without identifying controls placed in operation by the entity or a service organization and gathering audit evidence about the operating effectiveness of those controls. For example, if the entity has a large number of derivatives or securities transactions, the auditor likely would be unable to reduce audit risk to an acceptable level for assertions about the occurrence of earnings on those securities, including gains and losses from sales, without identifying controls over the authorization, recording, custody, and segregation of duties for those transactions and gathering audit evidence about their operating effectiveness.<sup>10</sup> [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

## Designing Substantive Procedures Based on Risk Assessments

**.19** The auditor should use the assessed levels of inherent risk and control risk for assertions about derivatives and securities to determine the nature, timing, and extent of the substantive procedures to be performed to detect material misstatements of the financial statement assertions. Some substantive procedures address more than one assertion about a derivative or security. Whether one or a combination of substantive procedures should be used to address an assertion depends on the auditor's assessment of the inherent and control risk associated with it as well as the auditor's judgment about a procedure's effectiveness. Paragraphs .21 through .58 provide examples of substantive procedures that address assertions about derivatives and securities. In addition, the auditor should consider whether the results of other audit procedures conflict with management's assertions about derivatives and securities. The auditor should consider the impact of any such identified matters on management's assertions about derivatives and securities. Additionally, the auditor should consider the impact of such matters on the sufficiency of the audit evidence evaluated by the auditor in support of the assertions. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.20** The provision by a service organization of services that are part of an entity's information system may affect the nature, timing, and extent of the auditor's substantive procedures for assertions about derivatives and securities in a variety of ways. Following are examples of such services and how they may affect the nature, timing, and extent of the auditor's substantive procedures.

- Supporting documentation, such as derivative contracts and securities purchases and sales advices, may be located at the service organization's facilities. As a result, either the auditor of the entity's financial statements, an auditor working under the direction of that auditor, or

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<sup>10</sup> See footnote 6.

an auditor engaged by the service organization may need to visit the facilities to inspect the documentation.

- Data processors, investment advisers, holders of securities, record-keepers, and other service organizations may electronically transmit, process, maintain, or access significant information about an entity's securities. In such situations, it may not be practicable or possible for the auditor to reduce audit risk to an acceptable level without identifying controls placed in operation by the service organization or the entity and gathering audit evidence about the operating effectiveness of those controls.
- Service organizations may initiate securities transactions for an entity and hold and service the securities. In determining the level of detection risk for substantive tests, the auditor should consider whether there is a segregation of duties and other controls for the services provided. Examples include—
  - When one service organization initiates transactions as an investment adviser and another service organization holds and services those securities, the auditor may corroborate the information provided by the two organizations. For example, the auditor may confirm holdings with the holder of the securities and apply other substantive tests to transactions reported by the entity based on information provided by the investment adviser. Depending on the facts and circumstances, the auditor also may confirm transactions or holdings with the investment adviser and review the reconciliation of differences. Paragraph .24 provides additional guidance on the auditor's considerations.
  - If one service organization initiates transactions as an investment adviser and also holds and services the securities, all of the information available to the auditor is based on the service organization's information. The auditor may be unable to sufficiently limit audit risk without obtaining audit evidence about the operating effectiveness of one or more of the service organization's controls. An example of such controls is establishing independent departments that provide the investment advisory services and the holding and servicing of securities, then reconciling the information about the securities that is provided by each department.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

## Financial Statement Assertions

### *Existence or Occurrence*

.21 Existence assertions address whether the derivatives and securities reported in the financial statements through recognition or disclosure exist at the date of the statement of financial position. Occurrence assertions address whether derivatives and securities transactions reported in the financial statements, as a part of earnings, other comprehensive income, or cash flows or through disclosure, occurred. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for existence or occurrence assertions about derivatives and securities include—

- Confirmation with the issuer of the security.
- Confirmation with the holder of the security, including securities in electronic form, or with the counterparty to the derivative.<sup>11</sup>
- Confirmation of settled transactions with the broker-dealer or counterparty.
- Confirmation of unsettled transactions with the broker-dealer or counterparty.
- Physical inspection of the security or derivative contract.
- Reading executed partnership or similar agreements.
- Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form, for the following:
  - Amounts reported
  - Evidence that would preclude the sales treatment of a transfer
  - Unrecorded repurchase agreements
- Inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period.
- Performing analytical procedures.<sup>12</sup> For example, the absence of a material difference from an expectation that interest income will be a fixed percentage of a debt security based on the effective interest rate determined when the entity purchased the security provides evidence about existence of the security.

### Completeness

.22 Completeness assertions address whether all of the entity's derivatives and securities are reported in the financial statements through recognition or disclosure. They also address whether all derivatives and securities transactions are reported in the financial statements as a part of earnings, other comprehensive income, or cash flows or through disclosure. The extent of substantive procedures for completeness may properly vary in relation to the assessed level of control risk. In addition, the auditor should consider that since derivatives may not involve an initial exchange of tangible consideration, it may be difficult to limit audit risk for assertions about the completeness of derivatives to an acceptable level with an assessed level of control risk at the maximum. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for completeness assertions about derivatives and securities are—

- Requesting the counterparty to a derivative or the holder of a security to provide information about it, such as whether there are any side agreements or agreements to repurchase securities sold.

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<sup>11</sup> Section 330, provides guidance to auditors in using confirmations as substantive tests of financial statement assertions. Confirmations may be used as a substantive test of various financial statement assertions about derivatives and securities. For example, a confirmation may be designed to—

- Obtain information about valuation assertions or assumptions underlying valuations.
- Determine whether there are any side agreements that affect assertions about the entity's rights and obligations associated with a transaction, such as an agreement to repurchase securities sold or an agreement to pledge securities as collateral for a loan.
- Determine whether the holder of the entity's securities agrees to deliver the securities reported or their value when required by the entity.

<sup>12</sup> Section 329, provides guidance to auditors in using analytical procedures as substantive tests.

- Requesting counterparties or holders who are frequently used, but with whom the accounting records indicate there are presently no derivatives or securities, to state whether they are counterparties to derivatives with the entity or holders of its securities.<sup>13</sup>
- Inspecting financial instruments and other agreements to identify embedded derivatives.
- Inspecting documentation in paper or electronic form for activity subsequent to the end of the reporting period.
- Performing analytical procedures. For example, a difference from an expectation that interest expense is a fixed percentage of a note based on the interest provisions of the underlying agreement may indicate the existence of an interest rate swap agreement.
- Comparing previous and current account detail to identify assets that have been removed from the accounts and testing those items further to determine that the criteria for sales treatment have been met.
- Reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees.

**.23** One of the characteristics of derivatives is that they may involve only a commitment to perform under a contract and not an initial exchange of tangible consideration. Therefore, auditors designing tests related to the completeness assertion should not focus exclusively on evidence relating to cash receipts and disbursements. When testing for completeness, auditors should consider making inquiries, inspecting agreements, and reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees. Auditors should also consider making inquiries about aspects of operating activities that might present risks hedged using derivatives. For example, if the entity conducts business with foreign entities, the auditor should inquire about any arrangements the entity has made for purchasing foreign currency. Similarly, if an entity is in an industry in which commodity contracts are common, the auditor should inquire about any commodity contracts with fixed prices that run for unusual durations or involve unusually large quantities. The auditor also should consider inquiring as to whether the entity has converted interest-bearing debt from fixed to variable, or vice versa, using derivatives.

**.24** Derivatives may not involve an initial exchange of tangible consideration, as discussed in paragraphs .22 and .23. If one or more service organizations provide services that are part of the entity's information system for derivatives, the auditor may be unable to sufficiently limit audit risk for assertions about the completeness of derivatives without obtaining audit evidence about the operating effectiveness of controls at one or more of the service organizations. Since the auditor's concern is that derivatives that do not require an initial exchange of tangible consideration may not have been recorded, testing reconciliations of information provided by two or more of the service organizations as discussed in paragraph .20 of this section may not sufficiently limit audit risk for assertions about the completeness of derivatives. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

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<sup>13</sup> Section 317 paragraph .17 discusses the blank form of positive confirmation in which the auditor does not state the amount or other information but instead asks the respondent to provide information.

### ***Rights and Obligations***

**.25** Assertions about rights and obligations address whether the entity has the rights and obligations associated with derivatives and securities, including pledging arrangements, reported in the financial statements. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for assertions about rights and obligations associated with derivatives and securities are—

- Confirming significant terms with the counterparty to a derivative or the holder of a security, including the absence of any side agreements.
- Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form.
- Considering whether the findings of other auditing procedures, such as reviewing minutes of meetings of the board of directors and reading contracts and other agreements, provide evidence about rights and obligations, such as pledging of securities as collateral or selling securities with a commitment to repurchase them.

### ***Valuation***

**.26** Assertions about the valuation of derivatives and securities address whether the amounts reported in the financial statements through measurement or disclosure were determined in conformity with generally accepted accounting principles. Tests of valuation assertions should be designed according to the valuation method used for the measurement or disclosure. Generally accepted accounting principles may require that a derivative or security be valued based on cost, the investee's financial results, or fair value. They also may require disclosures about the value of a derivative or security and specify that impairment losses should be recognized in earnings prior to their realization. Also, generally accepted accounting principles for securities may vary depending on the type of security, the nature of the transaction, management's objectives related to the security, and the type of entity. Procedures for evaluating management's consideration of the need to recognize impairment losses are discussed in paragraphs .47 and .48 of this section.

**.27** *Valuation Based on Cost.* Procedures to obtain evidence about the cost of securities may include inspection of documentation of the purchase price, confirmation with the issuer or holder, and testing discount or premium amortization, either by recomputation or analytical procedures. The auditor should evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its cost that is other than temporary.

**.28** *Valuation Based on an Investee's Financial Results.* For valuations based on an investee's financial results, including but not limited to the equity method of accounting, the auditor should obtain sufficient appropriate audit evidence in support of the investee's financial results. The auditor should read available financial statements of the investee and the accompanying audit report, if any. Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose,<sup>14</sup> to the investor's auditor

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<sup>14</sup> In determining whether the report of another auditor is satisfactory for this purpose, the auditor may consider performing procedures such as making inquiries as to the professional reputation and standing of the other auditor, visiting the other auditor and discussing the audit procedures followed and the results thereof, and reviewing the audit program and/or working papers of the other auditor.

may constitute appropriate audit evidence. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.29** If in the auditor's judgment additional audit evidence is needed, the auditor should perform procedures to gather such evidence. For example, the auditor may conclude that additional audit evidence is needed because of significant differences in fiscal year-ends, significant differences in accounting principles, changes in ownership, changes in conditions affecting the use of the equity method, or the materiality of the investment to the investor's financial position or results of operations. Examples of procedures the auditor may perform are reviewing information in the investor's files that relates to the investee such as investee minutes and budgets and cash flows information about the investee and making inquiries of investor management about the investee's financial results. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.30** If the investee's financial statements are not audited, or if the investee auditor's report is not satisfactory to the investor's auditor for this purpose, the investor's auditor should apply, or should request that the investor arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor.

**.31** If the carrying amount of the security reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, the auditor should obtain sufficient evidence in support of these amounts. Paragraphs .35 through .46 of this section provide guidance on audit evidence that may be used to corroborate assertions about the fair value of derivatives and securities, and paragraphs .47 and .48 provide guidance on procedures for evaluating management's consideration of the need to recognize impairment losses.

**.32** There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph should be added to the auditor's report because of the change in reporting period.<sup>15</sup>

**.33** The auditor should evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its carrying amount that is other than temporary. In addition, with respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the investor auditor's report, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor to identify subsequent events and transactions that are material to the investor's financial statements. Such events or transactions of the type contemplated in section 560, *Subsequent Events*, paragraphs .05–.06), should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information.

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<sup>15</sup> See section 508, *Reports on Audited Financial Statements*, paragraphs .16–.18.

For the purpose of recording the investor's share of the investee's results of operations, recognition should be given to events or transactions of the type contemplated in section 560 paragraph .03.

**.34** Evidence relating to material transactions between the entity and the investee should be obtained to evaluate (a) the propriety of the elimination of unrealized profits and losses on transactions between the entity and the investee that is required when the equity method of accounting is used to account for an investment under generally accepted accounting principles and (b) the adequacy of disclosures about material related party transactions.

**.35** *Valuation Based on Fair Value.* The auditor should obtain evidence supporting management's assertions about the fair value of derivatives and securities measured or disclosed at fair value. The method for determining fair value may be specified by generally accepted accounting principles and may vary depending on the industry in which the entity operates or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums, and commissions and other costs that would be incurred to dispose of the derivative or security. The auditor should determine whether generally accepted accounting principles specify the method to be used to determine the fair value of the entity's derivatives and securities and evaluate whether the determination of fair value is consistent with the specified valuation method. Paragraphs .35–.46 of this section provide guidance on audit evidence that may be used to support assertions about fair value; that guidance should be considered in the context of specific accounting requirements. If the determination of fair value requires the use of estimates, the auditor should consider the guidance in section 342, *Auditing Accounting Estimates*. In addition, section 312 paragraph .56 provides guidance on considering a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107.]

**.36** Quoted market prices for derivatives and securities listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, the National Association of Securities Dealers Automated Quotations System (NASDAQ), or pricing services based on sources such as those. Quoted market prices obtained from those sources are generally considered to provide sufficient evidence of the fair value of the derivatives and securities.

**.37** For certain other derivatives and securities, quoted market prices may be obtained from broker-dealers who are market makers in them or through the National Quotation Bureau. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by the National Quotation Bureau may not be based on recent trades and may only be an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative or security.

**.38** If quoted market prices are not available for the derivative or security, estimates of fair value frequently can be obtained from broker-dealers or other third-party sources based on proprietary valuation models or from the entity based on internally or externally developed valuation models (for example, the Black-Scholes option pricing model). The auditor should understand the method used by the broker-dealer or other third-party source in developing the estimate, for example, whether a pricing model or a cash flow projection was used. The auditor may also determine that it is necessary to obtain estimates from more

than one pricing source. For example, this may be appropriate if either of the following occurs.

- The pricing source has a relationship with an entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product.
- The valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.

**.39** For fair-value estimates obtained from broker-dealers and other third-party sources, the auditor should consider the applicability of the guidance in section 336 or section 324. The auditor's decision about whether such guidance is applicable and which guidance is applicable will depend on the circumstances. The guidance in section 336 may be applicable if the third-party source derives the fair value of the derivative or security by using modeling or similar techniques. If the entity uses a pricing service to obtain prices of securities and derivatives, the guidance in section 324 may be appropriate.

**.40** If the derivative or security is valued by the entity using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management.<sup>16</sup> Examples of valuation models include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

The auditor should obtain evidence supporting management's assertions about fair value determined using a model by performing procedures such as—

- Assessing the reasonableness and appropriateness of the model. The auditor should determine whether the valuation model is appropriate for the derivative or security to which it is applied and whether the assumptions used are reasonable and appropriately supported. Estimates of expected future cash flows, for example, to determine the fair value of debt securities should be based on reasonable and supportable assumptions. The evaluation of the appropriateness of valuation models and each of the assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect value, and actual and expected market conditions, particularly in relation to similar derivatives and securities that are traded. Accordingly, the auditor may consider it necessary to involve a specialist in assessing the model.
- Calculating the value, for example using a model developed by the auditor or by a specialist engaged by the auditor, to develop an independent expectation to corroborate the reasonableness of the value calculated by the entity.
- Comparing the fair value with subsequent or recent transactions.

However, a valuation model should not be used to determine fair value when generally accepted accounting principles require that the fair value of a security be determined using quoted market prices.

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<sup>16</sup> Independence Standards Board Interpretation 99-1, *FAS 133 Assistance*, provides guidance to auditors of public companies on services an auditor may provide management to assist with the application of FASB ASC 815 that would and would not impair the auditor's independence. Ethics Interpretation 101-3, *Performance of Nonattest Services* [ET section 101.05], provides general guidance to auditors of all entities on the effect of nonattest services on the auditor's independence. [Footnote revised, September 2003, to reflect conforming changes necessary due to the revision of Ethics Interpretation No. 101-3. Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

**.41** Evaluating audit evidence for assertions about derivatives and securities may require the auditor to use considerable judgment. That may be because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying circumstances. Valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or on assumptions about conditions expected to exist over a long period; for example, default rates or prepayment rates. Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.42** Considerable judgment may also be required in evaluating audit evidence for assertions based on features of the derivative or security and applicable accounting principles, including underlying criteria such as for hedge accounting, that are extremely complex. For example, determining the fair value of a structured note may require consideration of a variety of features of the note that react differently to changes in economic conditions. In addition, one or more other derivatives may be designated to hedge changes in cash flows under the note. Evaluating audit evidence to support the fair value of the note, the determination of whether the hedge is highly effective, and the allocation of changes in fair value to earnings and other comprehensive income may require considerable judgment. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.43** In situations requiring considerable judgment, the auditor should consider the guidance in—

- a. Section 342 on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates.
- b. Section 336 on the use of the work of a specialist in performing substantive procedures.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.44** Negotiable securities, real estate, chattels, or other property is often assigned as collateral for debt securities. If the collateral is an important factor in evaluating the fair value and collectibility of the security, the auditor should obtain evidence regarding the existence, fair value, and transferability of such collateral as well as the investor's rights to the collateral.

**.45** Generally accepted accounting principles may specify how to account for unrealized appreciation and depreciation in the fair value of the entity's derivatives and securities. For example, generally accepted accounting principles require the entity to report a change in the unrealized appreciation or depreciation in the fair value of—

- A derivative that is designated as a fair value hedge in earnings, with disclosure of the ineffective portion of the hedge.
- A derivative that is designated as a cash flow hedge in two components, with the ineffective portion reported in earnings and the effective portion reported in other comprehensive income.
- A derivative that was previously designated as a hedge but is no longer highly effective, or a derivative that is not designated as a hedge, in earnings.
- An available-for-sale security in other comprehensive income.

Generally accepted accounting principles may also require the entity to reclassify amounts from accumulated other comprehensive income to earnings. For example, such reclassifications may be required because a hedged transaction is determined to no longer be probable of occurring, a hedged forecasted transaction affects earnings for the period, or a decline in fair value is determined to be other than temporary.

**.46** The auditor should evaluate management's conclusion about the need to recognize in earnings an impairment loss for a decline in fair value that is other than temporary as discussed in paragraphs .47 and .48 of this section. The auditor should also gather audit evidence to support the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized in earnings or other comprehensive income or that is disclosed because of the ineffectiveness of a hedge. That requires an understanding of the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.47 *Impairment Losses.*** Regardless of the valuation method used, generally accepted accounting principles might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors.

- Fair value is significantly below cost and—
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - The decline has existed for an extended period of time.
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

**.48** The auditor should evaluate (a) whether management has considered relevant information in determining whether factors such as those listed in paragraph .47 exist and (b) management's conclusions about the need to recognize an impairment loss. That evaluation requires the auditor to obtain evidence about such factors that tend to corroborate or conflict with management's conclusions. When the entity has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the entity has appropriately followed generally accepted accounting principles.

### **Presentation and Disclosure**

.49 Assertions about presentation and disclosure address whether the classification, description, and disclosure of derivatives and securities in the entity's financial statements are in conformity with generally accepted accounting principles. The auditor should evaluate whether the presentation and disclosure of derivatives and securities are in conformity with generally accepted accounting principles.

[Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93. Revised, October 2009, to reflect conforming changes necessary due to the withdrawal of SAS No. 69.]

.50 For some derivatives and securities, generally accepted accounting principles may prescribe presentation and disclosure requirements. For example—

- Whether changes in the fair value of derivatives used to hedge risks are required to be reported as a component of earnings or other comprehensive income depends on whether they are intended to hedge the risk of changes in the fair value of assets and liabilities or changes in expected future cash flows and on the degree of effectiveness of the hedge.
- Certain securities are required to be classified into categories according to management's intent and ability, such as held-to-maturity.
- Specific information is required to be disclosed about derivatives and securities.

.51 In evaluating the adequacy of presentation and disclosure, the auditor should consider the form, arrangement, and content of the financial statements and their notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts reported. The auditor should compare the presentation and disclosure with the requirements of generally accepted accounting principles. However, the auditor should also follow the guidance in section 431, *Adequacy of Disclosure in Financial Statements*, in evaluating the adequacy of disclosure that is not specifically required by generally accepted accounting principles.

## **Additional Considerations About Hedging Activities**

.52 To account for a derivative as a hedge, generally accepted accounting principles require management at the inception of the hedge to designate the derivative as a hedge and contemporaneously formally document<sup>17</sup> the hedging relationship, the entity's risk management objective and strategy for undertaking the hedge, and the method of assessing the effectiveness of the hedge. In addition, to qualify for hedge accounting, generally accepted accounting principles require that management have an expectation, both at the inception of the hedge and on an ongoing basis, that the hedging relationship will be highly effective in achieving the hedging strategy.<sup>18</sup>

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<sup>17</sup> FASB ASC 815 requires formal documentation of prescribed aspects of hedging relationships at the inception of the hedge. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

<sup>18</sup> FASB ASC 815 requires management to periodically reassess the effectiveness of hedging relationships whenever financial statements or earnings are reported, and at least every three months. It also requires that all assessments of effectiveness be consistent with the risk management strategy documented for the particular hedging relationship. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

**.53** The auditor should gather audit evidence to determine whether management complied with the hedge accounting requirements of generally accepted accounting principles, including designation and documentation requirements. In addition, the auditor should gather audit evidence to support management's expectation at the inception of the hedge that the hedging relationship will be highly effective and its periodic assessment of the ongoing effectiveness of the hedging relationship as required by generally accepted accounting principles. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.54** When the entity designates a derivative as a fair value hedge, generally accepted accounting principles require that the entity adjust the carrying amount of the hedged item for the change in the hedged item's fair value that is attributable to the hedged risk. The auditor should gather audit evidence supporting the recorded change in the hedged item's fair value that is attributable to the hedged risk. Additionally, the auditor should gather audit evidence to determine whether management has properly applied generally accepted accounting principles to the hedged item. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.55** For a cash flow hedge of a forecasted transaction, generally accepted accounting principles require management to determine that the forecasted transaction is probable of occurring. Those principles require that the likelihood that the transaction will take place not be based solely on management's intent. Instead, the transaction's probability should be supported by observable facts and the attendant circumstances, such as the following:

- The frequency of similar past transactions
- The financial and operational ability of the entity to carry out the transaction
- The extent of loss that could result if the transaction does not occur
- The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose

The auditor should evaluate management's determination of whether a forecasted transaction is probable.

## Assertions About Securities Based on Management's Intent and Ability

**.56** Generally accepted accounting principles require that management's intent and ability be considered in valuing certain securities; for example, whether—

- Debt securities are classified as held-to-maturity and reported at their cost depends on management's intent and ability to hold them to their maturity.
- Equity securities are reported using the equity method depends on management's ability to significantly influence the investee.
- Equity securities are classified as trading or available-for-sale depends on management's intent and objectives in investing in the securities.

**.57** In evaluating management's intent and ability, the auditor should—

- a. Obtain an understanding of the process used by management to classify securities as trading, available-for-sale, or held-to-maturity.

- b. For an investment accounted for using the equity method, inquire of management as to whether the entity has the ability to exercise significant influence over the operating and financial policies of the investee and evaluate the attendant circumstances that serve as a basis for management's conclusions.
- c. If the entity accounts for the investment contrary to the presumption established by generally accepted accounting principles for use of the equity method, obtain sufficient appropriate audit evidence about whether that presumption has been overcome and whether appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with that presumption.
- d. Consider whether management's activities corroborate or conflict with its stated intent. For example, the auditor should evaluate an assertion that management intends to hold debt securities to their maturity by examining evidence such as documentation of management's strategies and sales and other historical activities with respect to those securities and similar securities.
- e. Determine whether generally accepted accounting principles require management to document its intentions and specify the content and timeliness of that documentation.<sup>19</sup> The auditor should inspect the documentation and obtain audit evidence about its timeliness. Unlike the formal documentation required for hedging activities, audit evidence supporting the classification of debt and equity securities may be more informal.
- f. Determine whether management's activities, contractual agreements, or the entity's financial condition provide evidence of its ability. Examples follow.
  - (1) The entity's financial position, working capital needs, operating results, debt agreements, guarantees, alternate sources of liquidity, and other relevant contractual obligations, as well as laws and regulations, may provide evidence about an entity's ability to hold debt securities to their maturity.
  - (2) Management's cash flow projections may suggest that it does not have the ability to hold debt securities to their maturity.
  - (3) Management's inability to obtain information from an investee may suggest that it does not have the ability to significantly influence the investee.
  - (4) If the entity asserts that it maintains effective control over securities transferred under a repurchase agreement, the contractual agreement may be such that the entity actually surrendered control over the securities and therefore should account for the transfer as a sale instead of a secured borrowing.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

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<sup>19</sup> FASB ASC 320-10-25-1 requires an investor to document the classification of debt and equity securities into one of three categories—held-to-maturity, available-for-sale, or trading—at their acquisition. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

## Management Representations

.58 Section 333, *Management Representations*, provides guidance to auditors in obtaining written representations from management. The auditor ordinarily should obtain written representations from management confirming aspects of management's intent and ability that affect assertions about derivatives and securities, such as its intent and ability to hold a debt security until its maturity or to enter into a forecasted transaction for which hedge accounting is applied. In addition, the auditor should consider obtaining written representations from management confirming other aspects of derivatives and securities transactions that affect assertions about them.<sup>20</sup>

## Effective Date

.59 This section is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application is permitted.

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<sup>20</sup> Section 333 paragraph .17 provides illustrative representations about derivatives and securities transactions.