

CURRENT CONDITIONS AND METHODOLOGICAL APPROACHES IN THE AUDIT OF OPERATIONS WITH DERIVATIVES

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Abstract: Nowadays in the Republic of Belarus the derivatives market is still evolving and its volume is not suitable for the needs of the innovative economy, however, economic conditions stimulate the organizations to use the available ways to reduce the risks caused by market factors to an acceptable level. In this regard, the audit of transactions with derivatives can be considered as an important and promising direction of research. Because the positive audit opinion with other necessary documents can have a significant meaning in the decision-making of the main users of accounting (financial) statements of the organization.

The purpose of the study is to research the current state of the audit of the transactions with derivatives and to develop the methodological approach to the audit of this type of operations. The article considers the current methodological approaches to the audit of operations with derivatives. Here are presented the purpose, objectives and information support of the audit of these operations. Justified the model of the proposed object-based approach of segmenting the accounting data and the accounting reporting in the process of auditing transactions with derivatives in the organizations in the Republic of Belarus, which will allow to estimate the impact of derivatives on the financial statements of the audited entity fully and reliably, would help to express the reliable opinion in the audit report.

Key words: auditing, transactions with derivatives, risks, accounting (financial) statements, audit report, object-based approach

Introduction

The audit of operations with derivatives is a promising direction of research because the complexity inherent in some financial instruments may cause significant risks. The auditing organization has to plan and perform the audit in order to reduce auditing risk to an acceptably low level. In this regard, in the procedure of familiarization with the activities of the audited entity and its environment the auditing company should establish the presence or absence of transactions with derivatives, their specific types and influence on the reporting of the audited entity. In the auditor's working documents should be reflected all the actions and insights connected to these objects, which were investigated during the auditing process. As a result, the positive audit opinion with other necessary documents can have significant meaning for making decisions by both internal and external users of accounting (financial) statements of the audited organization.

The basis of legal regulation of auditing activity in the Republic of Belarus is the Law "On auditing activities", which defines legal bases of implementation of auditor activities on the territory of the Republic of Belarus, it regulates relations arising in the process of implementing such activities [1, p. 1]. However, in the Republic of Belarus, the derivatives market is still evolving and its volume is not suitable for the needs of the innovative economy, and there are no methodological approaches to the auditing process connected with transactions with derivatives, and as a result it is not possible to assess the impact on the reporting of the audited entity of such operations. In this regard, the aim of this study is to develop an approach to segmentation the accounting data during the audit of transactions with derivatives in the organizations of the Republic of Belarus.

The main part

It should be noticed that the nature, classification, functions of derivative financial instruments are analyzed in the works of foreign scientists: A. N. Burenin, B. I. Alekhina, I. A. Basov, T. B. Berdnikova, V. A. Galanova, L. F. Ibragimova, A. B. Feldman, and others.

The basics of the modern theory of financial derivatives can be found in the works of foreign economists: J. M. Keynes, J. Hicks, N. Kaldor, F. Black, D. Gross, W. F. Sharpe, M. Scholes, J. Cox, M. Rubinstein. In the study of the nature and strategies of the usage of derivatives for hedging they focus on the necessity of control over operations with derivatives in the organization that uses these financial instruments.

The process of auditing operations with derivatives is investigated in the works of such authors from the CIS-countries: A. A. Kharisova, A. E. Suglobova, A. A. Soprovich, S. V. Ponomareva, but as noted by S. V. Bank "... the methodology of auditing for derivatives in the economic literature is not presented" [2, p. 27]. Also the auditing process is considered by the following western authors: Thomas R. Weirich, Thomas C. Pearson, Natalie Tatiana Churyk [3], Steven Collings [4].

As noted by M. Dima and L. Grigoras "the Auditor works in the interests of the interested users..." and therefore helps them "...by the expression, based on the obtained evidence, professional opinion on the conformity of the financial statements in all significant aspects for the established requirements" [5, p. 5].

National rules of auditing activity – established by the Ministry of Finance of the Republic of Belarus normative legal acts, which establish the procedure of auditing, and also regulate other issues stipulated by the Law "On auditing" [1, p. 18].

The groups (thematic sections), on which are separated National rules of auditor activity, are approximately similar to those in the International standards on auditing. It is important to emphasize that some of the rules include additional standards and regulations that are relevant for legislation of the Republic of Belarus. On the basis of International auditing standards in Belarus has been developed and implemented 38 National rules of auditing activity, which contain requirements and guidelines for the audit.

The purpose of the audit of financial statements is to express an audit opinion on the reliability of this reporting. If we turn directly to the operations with derivative financial instruments (derivatives), the purpose of the audit of such operations in the organizations of the Republic of Belarus would be more specific: to express an audit opinion on the reliability of the reporting on operations with derivatives. The proposed aim of the audit of operations with derivatives is presented in figure 1.

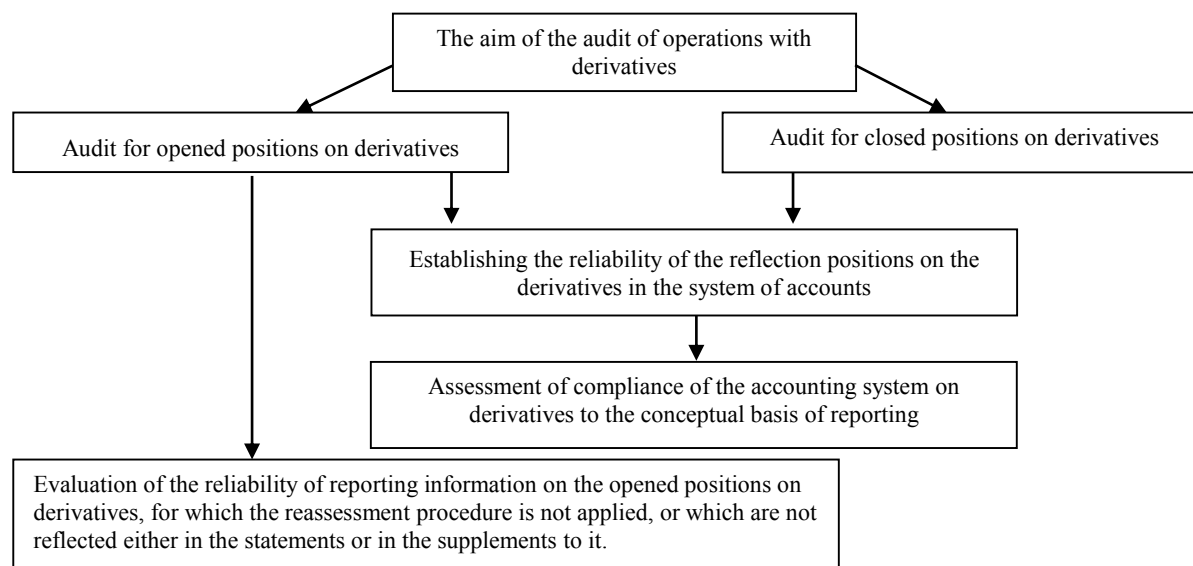


Fig. 1. The purpose of the audit of derivative transactions in the organizations of the Republic of Belarus

Source: own elaboration

For example, Bank C. V. notes that the purpose of the audit of derivative financial instruments is to determine, how the statements of company management on these instruments, reflected in the compiled financial statements, in all significant aspects conform to the applicable conceptual framework for financial reporting. Along with that, the aim of the audit is not to provide assurances

that the management of risks associated with derivatives and monitoring system for these risks are appropriate [2, p. 251].

According to the Law "On auditing activity" audit of accounting (financial) statements – is the audit service on the independent estimation of the accounting (financial) statements of the audited entity, including those prepared in accordance with International financial reporting standards and their Explanations, or the law of other countries, in order to express the audit opinion on its reliability. The reliability of accounting (financial) statements – a degree of accuracy of the data presented in the accounting (financial) statements, which allows users to make reliable conclusions about the financial position, financial performance and changes in financial position of audited organizations and to make reasonable economic decisions based on these insights [1, p. 2]. In this regard, "... in order to reduce the risks of significant misrepresentation of the financial statements, the audit organization should carry out the audit methodology, whereby it is possible to obtain sufficient evidence to establish the reliability of the data ..." [6, p. 39].

It is important to emphasize that the audit of transactions with derivatives requires to consider a number of features that are inherent in these instruments. In particular in the International practice of auditing 1012 "Auditing derivative financial instruments" (which provides a practical guide to planning and performing audit procedures to confirm assertions, on the basis of which the financial statements are prepared, in respect to derivative financial instruments) are allocated specific properties that increase the risks, namely [7, p 7]:

- minimal or no outflows/inflows of funds, which appears only with the onset of the period of execution of the transaction;
- there is no minimum balance and the other fixed amount paid or received;
- potential risks or rewards can far exceed the end up current expenditures;
- the value of the assets or liabilities of the entity may exceed the amount of the recognized in the financial statements derivative instrument, especially for entities that should not reflect derivatives at fair market value in the financial statements.

According to these features it is possible to highlight the specific objectives of the audit of derivatives:

- examination and assessment the importance of transactions with derivatives to the audited entity in the planning phase of the audit;
- identification of the opened positions on derivatives and verification of reporting information on them, as well as the estimation the potential impact of the opened positions on derivatives on financial statements;
- verification of accounting information on the closed positions on derivatives;
- assessment of the influence of transactions with derivatives on the financial statements of the audited entity.

In the Republic of Belarus not all of the International Auditing Practice Statements (IAPS) are reflected in national standards. For example, IAPS 1010 "The consideration of environmental matters in the audit of financial statements" has been reworked in the appropriate national statement, which is called National rules of auditor activities "The consideration of ecological questions in the audit of the accounting (financial) statements". While the provisions of IAPS 1012 "Auditing derivative financial instruments" and the International Auditing Practice Note (IAPN) 1000 "Special Considerations in Auditing Financial Instruments" were omitted in the development of National rules of auditor activities. As rightly pointed out by P. Y. Papkovskaya "International approaches should be harmoniously combined with the peculiarities of domestic system" [8, p. 5].

Currently, due to the absence in the Republic of Belarus a clear regulatory for accounting transactions with derivatives, organizations have to develop and consolidate in accounting policy the appropriate methodology on their own. In relation to accounting policies National rules of auditor activities state the following: "the audit organization should obtain information on the accounting policy of the entity, namely on the following aspects" [9, p. 13]:

- proper selection and application of accounting policy;
- the adequacy of the accounting for complex or unusual transactions;

- the correct application of accounting policy for the reflection of economic operations in relation to which there is uncertainty or ambiguity because of unclear regulatory requirements or their absence;

- disclosure of significant information in accounting (financial) statements, including facts about which the audit organization had gotten information at that moment.

It can be said that National rules of auditor activities cover issues related to the audit of operations with derivatives. In addition to the list of the issues that should be examined obligatorily while the mandatory audit of financial statements is performed, the auditor should get familiarized with the activities of the entity in a number of aspects. Among the issues that the audit organization considers in the process of familiarization with the activities of the entity and its environment there are such issues as "usage of derivative financial instruments" and "accounting for unusual or complex transactions" [10, app. 1]. But, there is no any specification related to the audit of operations with derivatives, which could facilitate establishment of a reliable assessment of these transactions.

In our opinion, the objects of the audit of operations with derivatives will be the objects of accounting, namely the particular contracts, which are based on underlying assets. The composition of the auditing objects is shown in figure 2.

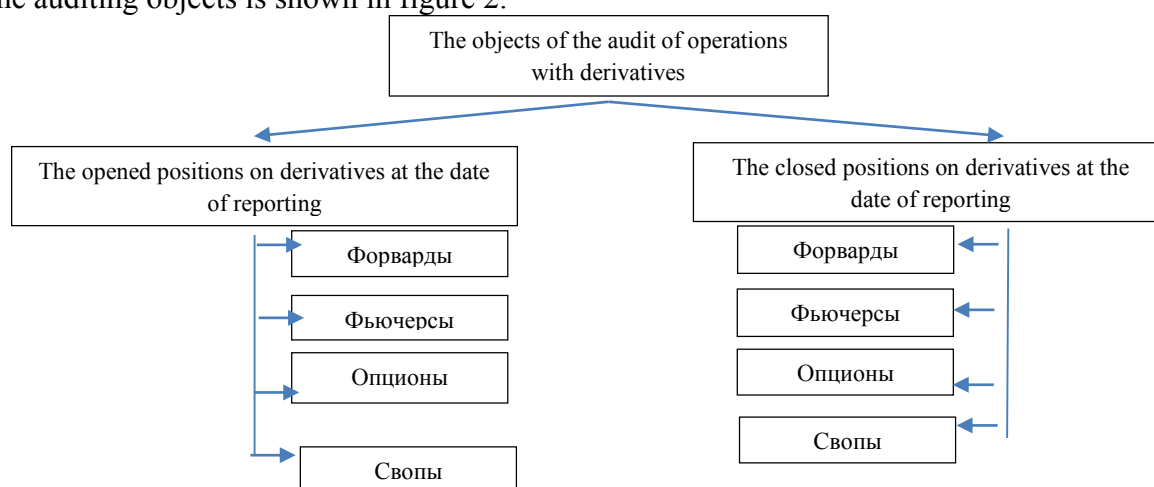


Fig. 2. The proposed objects of the audit of operations with derivatives

Source: own elaboration

The next important aspect of the audit of transactions with derivatives is informational support. Figure 3 presents the proposed scheme of informational support of audit of operations with derivatives.

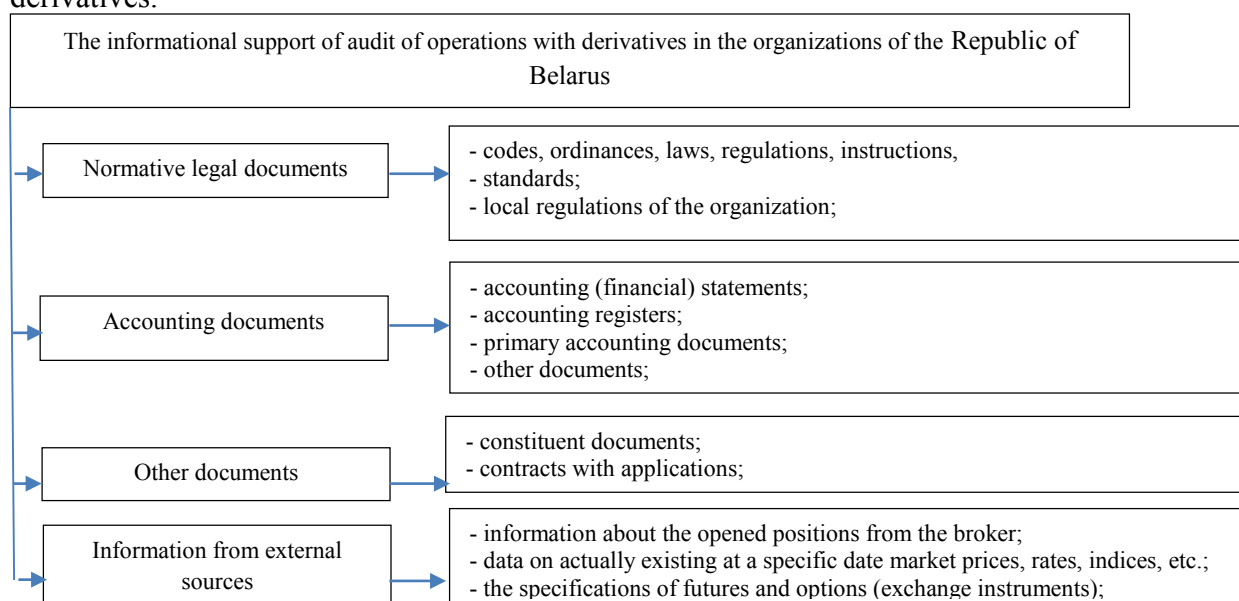


Fig. 3. The proposed informational support of audit of operations with derivatives

Source: own elaboration

It is important to note that "... the formation of a technique of audit in the organizations is influenced by the approaches for the segmentation of accounting information, which determine the procedural steps of verification. In the literature there are presented two approaches: object-based and cyclic approach. These approaches are considered in the works of the following scientists: N.V. Parushina and S.P. Suvorova, A.V. Gusarova; R.N. Sungatullina and E.A. Klimova, I.N. Bogataya, A.D. Sheremet and V.P. Suits" [11, p. 65]. It is important to emphasize that N.V. Parushina and S.P. Suvorova come to the conclusion that for the auditors in their practice it is reasonable to combine these approaches in audit procedures. Gusarova L.V. stresses out that in the international practice of auditing the cycle approach prevails; it is believed that this approach is most optimal, as it allows highlighting the most significant cycles from the total mass of business transactions. I.N. Bogataya draws attention to the fact that it is possible to allocate process-object approach to planning and conducting an audit. It contains both elements of cyclic and object-based approach. A.D. Sheremet and V.P. Suits come to the conclusion that in the practice of auditing should be founded the optimal combination of that two approaches [11, p. 65].

In object-based approach the allocated segments of the audit coincide with the objects of accounting [12, p. 120]. In our opinion, for the audit of transactions with derivatives it is necessary to use object-based approach to segmentation of accounting information. To assess whether this assumption is true, it is necessary to examine the interpretation of object-based approach (table 1).

Table 1. Interpretations of the object-based approach

Author	Definition
Bukata O.R.	If we consider the account balance as a separate segment – it is object-based approach. In this approach, the selectable segments of the audit actually coincide with the objects of accounting, so the economic operations are tested from the point of view of separate obtaining evidence related to specific accounts. It requires at the end of the audit to analyze the relationship between verified accounts, which is quite expensive from the point of view of auditing costs [13, p.12].
Kochinev U.	When the object-based approach is applied, accounting documentation is distributed (segmented) between auditors according to the Chart of accounts: each segment consists of one or more accounts. In this case there is a duplication: for example, the auditor checks the account turnover at the account 10 (materials), and the auditor who checks the account turnover at the account 60 (settlements with suppliers and contractors) will do the same job when checking the debit turnover of the account 10, with the offsetting credit turnover at the account 60 [14, p. 243].
Parushina N.V. Suvorova S.P.	The object-based approach involves the allocation the segments of the strategic audit coinciding with the objects of accounting. While business operations are tested from the point of view of separate obtaining evidence related to specific accounts. This variant of the organization of the audit cannot be considered rational, since the same financial-economic operations can be checked by different members of the group of auditors repeatedly with the point of view of different segments of the audit [12, p. 122].
Varlamova E.N.	Object-based approach is a method in auditing, based on the segmentation of accounting information by allocating individual elements of the accounting corresponding to the individual sections of accounting or articles of the accounting (financial) statements. This approach assumes that the audit of each business transaction is conducted by gathering evidence, confirming compliance with the criteria of individual accounts without identifying the relationship between them [15, p. 107].
Podolsky V.I.	Object-based approach is most prevalent in domestic practice of auditing. In this approach the selected segments of the audit actually coincide with the objects of accounting and economic operations are tested from the point of view of obtaining audit evidence in respect of individual accounts. When object-based approach is applied, the control sections are allocated in accordance with the structure of the object of accounting to be examined – assets, liabilities, income, expenses, and components of capital. The undoubted advantage of object-based approach – simplicity and clarity for the members of the working group. Also it is easy enough to establish the verification program, there is no danger to ignore those accounting objects that are not directly reflected in the statements [16, p. 356].

Source: own elaboration on the basis [12, 13, 14, 15, 16]

The proposed model of the object-based approach of segmenting the accounting data and the accounting reporting in the process of auditing transactions with derivatives is presented in figure 4.

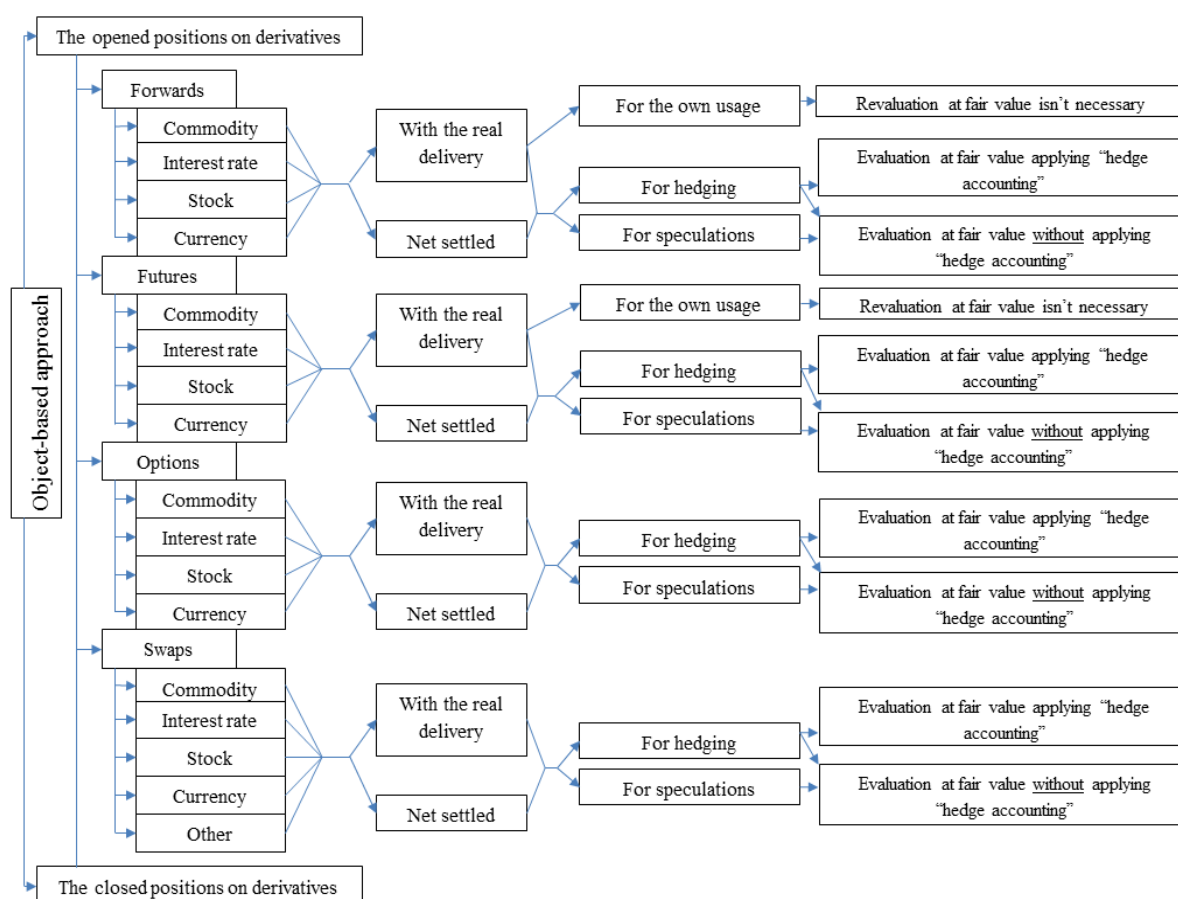


Fig. 4. The proposed model of the object-based approach of segmenting the accounting data and the accounting reporting in the process of auditing transactions with derivatives

Source: own elaboration

The feasibility of applying the object-based approach is supported by A.D. Sheremet and V.P. Suits, noting that the validation of the typical numerous operations should be carried out by cycles of economic operations, while the single significant operations should be checked objectively [17, c. 346].

It is difficult to find the cases when transactions with derivatives can be called numerous and typical, because they depend on the movement of unpredictable market factors, so the choice of object-based approach for segmentation the accounting data and accounting statements is reasonable. As, "... based on substantive knowledge of the object of study..." [18, p. 29] will be implemented consistent set of controls, forming the audit methodology, through which it is possible to obtain sufficient evidence. It is important to note that for the executed contracts will be required ordinary evaluation of the reliability of reporting information, while for the derivatives, which will be executed after the balance sheet date, will be required additional examination how the opened positions are reflected in the financial statements.

Moreover, as noted by A.A. Arens, J. K. Loebbecke "... in some cases, after the audit of the financial statements it becomes apparent that some information contained in these statements, is wrong (is a significant error that may mislead the user)..." [19, p. 501]. And since the open positions on derivatives sometimes may be not revalued at the reporting date and as a result the reporting will be profitable while in reality, due to adverse movements in market variables (prices, index rates, exchange rates, etc.) these positions will be the sources of future losses, in this case the significant misrepresentation will take place in fact. Then "... the auditor is obliged to take additional measures to ensure that users are aware of the identified erroneous data. Rather often the auditor is faced with the situation where the financial statements have been presented in such a way that a substantial error has arisen because of the submission the audit report without reservations..." [19, p. 501]. As a result,

" ... it is desirable in such cases for the auditor to request the client to review the financial statements immediately and to explain the reason for revision..." [19, p. 501]. In order to avoid such situations we propose a distinction between opened and closed positions on derivatives.

Also it should be noted that the proposed model considers the requirements of the valuation the derivatives at fair value and their revaluation at the reporting date, hedge accounting, and contracts with features of derivatives (own-use contracts).

In our opinion, the proposed model of the object-based approach of segmenting the accounting data and the accounting reporting in the process of auditing transactions with derivatives based on the auditing objects, with the further detail by type of the asset, method of execution and the purpose of entering, will enable to cover all the significant aspects of transactions with derivatives. We consider two additional criteria in the audit of operations with derivatives are opened and closed positions, which is important for establishing executed and open contracts.

Conclusion

The results of the study justify the conclusion that the established approach to the audit of transactions with derivatives with two additional criteria, the tasks, which take into account the specific characteristics of derivatives, the scheme of information support and the model of the object-based approach of segmenting the accounting data and the accounting reporting in the process of auditing, will contribute to improve the quality of work of the auditor, accurate assessment of the impact of the operations with derivatives on the reporting of the audited entity and expression the professional opinion of the auditor in the audit report.

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