

Main findings and opinions of the National Audit Office

Derivative contracts concluded by Finavia Corporation between 2009 and 2011

The audit focused on the financing arrangements of Finavia Corporation and its predecessor, the Finnish Civil Aviation Administration, particularly on the appropriateness of the use of derivative instruments and the appropriateness of the company's internal control and state ownership steering.

The performance audit conducted in 2012¹ revealed that Finavia has used derivative contracts the appropriateness of which has not been entirely clear. Even though the use of derivative contracts is not as such inappropriate, they may theoretically involve the risk of unlimited financial losses.

Based on the report findings, the National Audit Office decided to conduct a separate performance audit on the subject. The main findings of this audit are presented below.

The financial statements did not provide adequate information on use of derivatives

The audit of the 2011 financial statements revealed that the company was not fully aware of the content of the derivative contracts that it had concluded. Information on interest rate derivatives is only provided in the notes to the financial statements from 2010 onwards. There was no reference to interest rate derivatives in the notes to the 2009 financial statements. However, it is stated in the 2009 Board of Directors' report that at the end of 2009, the group's hedge ratio was 39 per cent. From this, an outsider is able to conclude that the state enterprise has made use of derivatives. The deferral of interest has been entered into the 2009 income statement. According to the audit findings, details of derivatives with a nominal value of about 160 million euros should have been presented in the 2009 financial statements.

¹ *'A good governance model in special assignment companies and their ownership steering', audit report 7/2013*

Thus, there is a discrepancy between the information contained in the 2009 Board of Director's report and the notes to the financial statements for the same year. The 2009 auditor's report specifically states that the information presented in the Board of Directors' report is consistent with the financial statements.

The 2010 financial statements give the value of the underlying instrument of the derivative contracts and state that the purpose of the interest rate swaps is to hedge the group against interest rate risk in accordance with the financing policy set out by the Board. According to a report prepared in Finavia during the audit, in 2010 the company concluded structured non-hedging derivative contracts that are not in accordance with the guidelines of 30 May 2001. Details of derivative liabilities with a nominal value of about 30 million euros are missing from the notes to the 2010 financial statements.

We are not aware that the right of Finavia as a state enterprise to conclude derivative contracts would have been specifically discussed in Finavia or as part of its audit reporting procedure.

Under the act on converting the Finnish Civil Aviation Administration into a limited company (877/2009), the secondary liability of the Finnish government for its loans and commitments remains in effect and the assumption is that the Finnish government also has secondary liability for the derivative liabilities not included in the financial statements of the state enterprise.

In the view of the National Audit Office, the 2009 financial statements of the state enterprise do not present true and fair information on the use of the derivatives.

The National Audit Office is of the opinion that the owners and the management of a company must use the audits and internal control to ascertain that the operations of the company are in accordance with the guidelines and objectives set out by the management and the owners. Using the audits, the owners must also be able to ascertain that the company provides true and fair information on its financial position in accordance with the auditing reporting standards.

Shortcomings in the financing risk management and reporting procedures and contract management and monitoring systems

Reporting on the company's financing risks has not been in accordance with the guidelines of 30 May 2001. The nature of the derivative contracts concluded by Finavia is not clear from the company's risk management and risk reporting procedures and the practices governing them. The

company's management was unaware of the nature of the derivative contracts.

The 2011 audit revealed that the company had derivative contracts that were not in accordance with what could be assumed on the basis of the company's business operations, debt structure and internal guidelines. The hedging of the positions to be hedged had not been carried out in accordance with the guidelines of 30 May 2001.

The way in which the derivatives were used was not entirely appropriate or in accordance with internal guidelines and the company's management was not fully aware of the use of the derivatives

The state enterprise and Finavia Corporation concluded structured derivative contracts between 2009 and 2011. Not all derivative contracts contained provisions allowing the state enterprise or Finavia to ensure that the hedging arrangements are effective and appropriate or that they are in accordance with internal guidelines or that appropriate measures had been taken to ascertain the effectiveness of the hedging arrangements.

Some of the structured derivative contracts are of such nature that they cannot be considered to be in accordance with the guidelines in force at the time or to provide an appropriate hedging instrument when consideration is given to the company's business operations, loan portfolio and internal guidelines.

Finavia entered a valuation loss of about 9 million euros from non-hedging derivative contracts in its interim report for January - September 2013.

In the opinion of the National Audit Office, the financing policy of the company's Board would not have allowed a reduction in interest rate costs by means of speculative derivatives. The National Audit Office is of the view that under the detailed guidelines of 30 May 2001, the company could only have been able to use derivatives for hedging positions that they were intended to hedge. Not all derivative contracts have been used for hedging the positions that they were intended to hedge, as set out in the guidelines.

Based on the internal reporting in the state enterprise and Finavia Corporation, the management did not have an overall picture of the derivatives used. The deferral of interest had been entered in the income statement but the manner in which the financing risks were reported did not provide the management with an overview of the risks or nature of the derivative contracts. Based on internal reporting and monitoring, it was not possible

to make any prior or post assessment of the effectiveness of derivative contracts as hedging instruments.

When the company management became aware that there was lack of clarity in matters concerning the derivatives it took the initiative and introduced appropriate measures

After the situation concerning the derivatives had been revealed in the audit of the 2011 financial statements, the operative management and Board of the Finavia Corporation did not wait for NAO's performance audit to take measures that they considered appropriate.

According to a report submitted by Finavia, it did not have a separate system for reporting on interest rate derivatives. Finavia did not have a centralised contract register and between 2007 and 2011 not all derivative contracts were registered.

In the opinion of the National Audit Office, the 'Financing policy of the Finavia Group', the company's most recent document on the subject, which was approved by Finavia's Board on 4 March 2013, meets the minimum criteria for an appropriate risk management policy. It identifies currency, interest rate, credit and liquidity risks, sets out minimum and maximum levels for each risk type, identifies the company's task and lays out the powers.

The guidelines issued by the Government do not clearly set out to what extent state enterprises may use derivative contracts without the explicit authorisation of the Parliament

It is not entirely clear whether state enterprises are allowed to acquire interest rate derivatives without the authorisation of the Parliament in all situations. It is not entirely clear from the documents that when receiving a parliamentary authorisation to raise loans, the Finnish Civil Aviation Administration was also allowed to use interest rate derivatives. Moreover, it is specifically laid down in the parliamentary resolution on amending the Government's borrowing authority (739/2009) that the Parliament (only) authorises the Government or, within the limits laid out by it, the Ministry of Finance or the State Treasury to conclude interest rate and currency swaps and other derivative contracts necessary for managing the risks connected with government debt servicing.

Under section 5(1) and section 8(1)(3) of the State Enterprise Act (1185/2002), a state enterprise requires parliamentary authorisation for raising loans, which is granted in connection with the consideration of the state budget.

A situation in which the Finnish Civil Aviation Administration or any other state enterprise uses (or has used) such derivatives without an explicit authorisation can be considered problematic because non-hedging derivative commitments may involve risks that, when realised, may be likened to an increase in the debt liabilities of the state enterprise in question.

According to the risk management policy for state enterprises issued by the State Treasury in 2003, state enterprises are responsible for their risks and making decisions on them, while under the State Enterprise Act their financing and insurance arrangements became market-based operations.

In the view of the National Audit Office, the above document may be useful for a state enterprise when it prepares its general risk management policy but not when it manages its financing and investment risks. It is not specifically stated in the guidelines whether state enterprises may use derivative contracts as an instrument for managing financing risks.

Recommendations of the National Audit Office

1. State enterprises and state-owned companies should have a risk management policy and risk management guidelines approved by the Board.

The risk management policy should guide the operations of state enterprises, state-owned companies and especially special assignment companies, which are wholly owned by the state, so that the status of the companies as a state-owned companies is considered. In the opinion of the National Audit Office, this means that state enterprises and state-owned companies should not aim for profits by increasing their financing risks.

The risk management policy should guide their operations so that the financing operations serve their main task/special assignment.

2. In addition to the concrete and detailed instructions and division of responsibility set out in the document on the Finavia Group's financing policy of 14 March 2013, Finavia and other state-owned companies should in the long-term and in a systematic manner promote the expertise and awareness aims listed in the document:
 - increasing awareness and understanding of financing risks in the group;
 - maintaining effective communications and best practices in financing matters;

- maintaining and developing reporting (reporting to the Board and operational reporting).
3. The company's management has already started assessing previous activities and taken corrective measures and is assessing the role of derivative contracts in the company's risk management. However, in addition to this, the Ministry of Transport and Communications, which is responsible for ownership steering in Finavia, should also assess whether the company's management and auditors are carrying out their duties with the necessary care.
 4. Considering the risks arising from derivative contracts, it is advisable that when a state enterprise is granted an authorisation to raise loans it is also specifically given the right to conclude derivative contracts for hedging purposes if this is the purpose of the authorisation. The Government guidelines for state enterprises should also, as part of the management of financing risks, set out adequately detailed procedures for dealing with such risks.