Financial Institutions – Issues and Working Group Recommendations

Background

1. The Financial Institutions Working Group (WG) has developed this paper to provide the CAG with an update on the WG's activities and the proposed way forward on the Financial Institutions project.

2. In view of the IAASB's comments at its June 2015 meeting, the WG has continued to develop the gap analysis of the audit issues raised by IFRS 9,[1][2] in particular with respect to the new expected loss model, and whether and how they are addressed in ISA 540[3] and sections of other relevant standards. This analysis has been informed by the outreach activities performed by the WG, including input from financial institution auditors (including one who has already conducted an audit of a bank that early adopted IFRS 9) and regulators.

3. This paper is intended to provide the IAASB CAG with information about:
   - Section A — Issues identified based on the gap analysis
   - Section B — Way forward to address the IFRS 9 challenges

A. Issues Identified Based on the Gap Analysis

Introduction

4. The WG's work to date has validated the initial assessment that IFRS 9 is likely to pose particular challenges for the auditors of financial institutions. The remainder of this section discusses the particular issues that the WG believes represent the most significant challenges to audits of financial institutions.[4]

5. In making the assessment of where gaps exist, the WG has focused on identifying those areas which have the most relevance to financial institutions in accordance with the mandate of the WG as laid out in the 2015-2016 Work Plan.[5] When this Work Plan was approved, the intention was that the WG would first concentrate on the special audit considerations of financial institutions, then consider whether any of these audit considerations would have broader applicability to other entities. However, the WG did not disregard the issues arising from IFRS 9 that are relevant to other entities that were noted while reviewing the gap analysis, and relevant comments about these issues are included below.

6. Overall, some of the outreach, particularly to experienced bank auditors, has indicated that ISA 540 may need some updating and refreshing to recognize the greater prevalence and importance of accounting estimates in the financial statements of financial institutions. Of particular concern was

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[1] The WG recognizes that the ISAs are framework neutral. The WG notes that the US Financial Accounting Standards Board expects to issue its standard on financial instrument impairment in Q4 2015.

[2] International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

[3] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

[4] The term "financial institutions" has been used for ease of reference. See paragraph 64 for further discussion of the issues regarding the definition of "financial institutions."

[5] http://www.ifac.org/system/files/publications/files/IAASB-Work-Plan-2015-2016.pdf

that ISA 540 may be seen as suggesting that accounting estimates are prepared in a bespoke fashion every year, rather than as part of a tightly controlled and high volume system with many inputs and "models" embedded within.

7. For information, **Agenda Item D.2** contains a paragraph by paragraph gap analysis of ISA 540 against identified issues relating to IFRS 9, together with links to the WG's assessment of each significant issue as described below. The significant issues from that analysis have been included below, but the more detailed analysis is provided to explain the process used by the WG.

Issues Related to Risk Assessments and Responses to Assessed Risks

Issue 1 – Performance of Sufficient Risk Assessment Procedures, Including Understanding and Further Consideration of the Appropriateness of Methodologies Used by Management

8. The risk assessment and consideration of the appropriateness of methodologies used to calculate the accounting estimates required for financial institutions under IFRS 9 will be important for the auditor. For many financial institutions, these accounting estimates occur in a high volume and extremely complex environment and are the result of extensive systems containing many processes and controls.

9. In the WG's outreach, questions were raised whether the auditing standards provide the auditor with sufficient guidance on how to address accounting estimates that are created in such a system, as opposed to "one-off" calculations that may be more prevalent in some other accounting estimates. In particular, it was noted by one auditor that ISA 540 has only limited material addressing the control environment around accounting estimates – which is not reflective of the audit process required for financial institution audits. It was also noted by a regulator that IFRS 9 will require management to make many judgments, not least regarding the use of data that is outside the traditional areas of financial reporting (see issue 10 below) and, therefore, there are real concerns about the critical need to understand these systems, the control environment, and the related audit risk. IFRS 9 also requires an understanding of the entity's business model for managing financial assets, as this is central to how they are classified and measured.

10. Further, in its annual survey of inspection findings, the International Forum of Independent Audit Regulators (IFIAR) noted that, for fair value measurements, an area of frequent deficiency is the failure to perform sufficient risk assessment procedures, including understanding and further consideration of the appropriateness of methodologies used by management to determine fair value.

Possible Way Forward

11. Paragraph 8 of ISA 540 contains a requirement regarding the risk assessment and the methodologies used. It is pitched at a high level given the broad range of accounting estimates to which it applies. The WG believes that more detailed requirements and guidance[6] about risk assessment procedures for more complex estimates and engagements (e.g., financial institutions audits) may be warranted. One possible path to more rigorous risk assessments for financial institution audits may be to provide guidance on how to disaggregate the estimate into sub-models and understand and assess which of the sub-models (and inputs and assumptions therein) have a significant influence on the overall

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[6] The term "guidance" is used in this document to refer to new application material in ISA 540 or other forms of guidance, such as an International Auditing Practice Note (IAPN). See paragraph 61 for further discussion of the way forward..

accounting estimate. Guidance may also be helpful on the need for auditors of financial institutions to gain an understanding of the financial institution's business model for managing financial assets.

Issue 2 – Identification of Significant Risks

12. Paragraph 10 of ISA 540 requires the auditor to evaluate the degree of estimation uncertainty associated with an accounting estimate, while paragraph 11 requires the auditor to determine whether any accounting estimate with high estimation uncertainty gives rise to significant risks. Paragraphs A47–A51 of ISA 540 provide further guidance on the identification of estimates that give rise to significant risk.

13. The outreach conducted to date has led the WG to question whether certain accounting estimates required by IFRS 9 for financial institutions (particularly the Expected Credit Loss (ECL) provision) should always be considered significant risks.[7] The ECL provision calculation requires management to make several key judgments about inputs to the modelling, whether significant credit deterioration has occurred, assumptions, segmentation of the loan portfolio into pools, and judgments about individual large exposures. Accordingly, the ECL provision is likely to always have high estimation uncertainty in all but the simplest loan portfolios.

14. The link between the degree of estimation uncertainty and whether an accounting estimate is a significant risk has been raised both in the ISA Implementation Monitoring project and in the WG's outreach. For example, one suggestion offered was that there should be a rebuttable presumption that all accounting estimates that have high estimation uncertainty are significant risks. The WG's own outreach has pointed to the degree of judgment management has to exercise in making the ECL, which means that it will almost always be an area of significant audit and regulatory attention when IFRS 9 is implemented.

Possible Way Forward

15. The WG believes that this issue should be progressed via an amendment to ISA 540, which would create a rebuttable presumption that, for financial institutions, accounting estimates with high estimation uncertainty are significant risks. This would need to be accompanied by guidance material to provide additional examples of accounting estimates that are likely to have high estimation uncertainty (including from IFRS 9) and be linked to a documentation requirement when the presumption is rebutted. Input from the IAASB and further analysis on this possible response is needed before progressing to a draft amendment to ISA 540, including whether this amendment should apply to all entities.

Issues Related to Audit Evidence

Issue 3 – Should the Auditor Always Develop an Independent Model to Evaluate Management's Estimate?

16. For financial institutions, the models used to calculate the ECL include many inputs, assumptions, and parameters, and will be complex for all but the simplest loan portfolios. This raises the question of which procedures the auditor should perform as a response to the assessed risk of material misstatement. Paragraph 13 of ISA 540 provides the auditor with the option to undertake one or more

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[7] A brief summary of the IFRS 9 requirements for ECL has been included in the Appendix 1.

responses but leaves the option which responses should be taken up to the auditor's professional judgment. During the WG's outreach, some have suggested that the auditor should always develop their own model to evaluate management's point estimate. Others are of the view that it is more important for the auditor to challenge management's estimate instead of developing an independent model.

17. The requirement in paragraph 13 of ISA 540 leaves open the option which procedures the auditor performs to evaluate management's estimates. In the application material there is a steer that, for non-routine estimates or estimates that have unobservable inputs, the auditor should develop a point estimate or a range to evaluate management's point estimate. Depending on the auditor's interpretation of the standards and the difficulty in developing the financial institutions' ECL model, the auditor could either test how management made the accounting estimate or develop a point estimate or a range.

Possible Way Forward

18. The WG believes that guidance is needed to provide additional context for this requirement as it pertains to financial institutions, as it could be read that each of these estimates are one-off events, rather than a system-based regular process with governance and controls over the process. At the present time, and drawing upon the outreach conducted to date, the WG does not believe that mandating that auditors prepare an "independent model" is either necessary or practical. However, the WG believes that useful guidance could be drafted to include steps that may go some way towards driving improved audit quality in this area – for example:
    - Asking management to push alternative assumptions or data inputs into their model; and
    - Disaggregating management's model into smaller models, and evaluating those "sub-models" separately or developing models of aspects of those "sub-models".

Issue 4 – Models: Governance over Models and Systems, Including Selecting Appropriate Data Sources and Having Appropriate Controls over the Data, Models and Systems

19. Due to the size of the loan portfolios at all but the smallest financial institutions, the ECL calculation is likely to be based on complex modelling. These models create audit challenges as there needs to be appropriate internal controls over the models and systems for the calculation of the ECL.

20. The WG's outreach shows that, while model governance (including internal control) has been an audit issue for some time, the application of IFRS 9 is likely to create new challenges in this area. This issue was also noted in the development of IAPN 1000[8] (see, for example, paragraphs 20–23 and 47–49), however IAPN 1000 specifically excludes loan loss provisioning from its scope.[9] It was also noted by some participants in the banking expert working group organized by the Global Public Policy Committee that the related requirements, while not incorrect, are pitched at a high level and do not guide the auditor through the process of addressing the most common ways management is likely to make ECL provisions in financial institutions.

[8] IAPN 1000, *Special Audit Considerations in Auditing Financial Instruments*

[9] IAPN 1000, paragraph 6

Possible Way Forward

21. ISA 540 contains several related requirements, including paragraph 8 that includes the following:

> *"…the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates…*
>
> *(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: (Ref: Para. A22–A23)*
>
> *(i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24–A26)*
>
> *(ii) Relevant controls; (Ref: Para. A27–A28)…"*

Another relevant requirement, for significant risks only, is paragraph 15 which states *"…the auditor shall evaluate….how management has considered alternative assumptions or outcomes, and why it has rejected them…".*

22. The WG believes that the requirements and guidance material should be strengthened and made more detailed for financial institutions to appropriately reflect the sophisticated governance and control environment that is likely to be encountered. Input from the IAASB and further analysis on this possible response is needed before progressing to a draft amendment to ISA 540, including whether this amendment should apply to all entities that use complex models.

Issue 5 – Consistent Use of a Model and Data across a Market and Jurisdiction

23. Financial institutions create their own models and use their own assumptions to calculate the ECL. Some regulators may expect that management and auditors in a given market and jurisdiction will use assumptions consistently as inputs for their ECL model as they are all in the same market and jurisdiction, while practitioners highlight that confidentiality obligations could limit the information available to do so.

24. Paragraph 12(b) of ISA 540 requires that the auditor assess that the method of measurement is appropriate and has been applied consistently, and whether changes in the estimates or in the method for making them are appropriate in the circumstances. The WG notes that this provision could help auditors approach models and data consistently across a market and jurisdiction.

Possible Way Forward

25. The WG is of the view that additional guidance might be useful to highlight the importance and benefits of the two-way dialogue between the external auditor and the financial institution's regulatory supervisor during the risk assessment and while performing the audit procedures. The regulator could inform the auditor about the use of models and data in the relevant market and jurisdiction, while the auditor could share its insights from the audit with the regulator.

Issue 6 – Assessing the Reasonableness of Management's Assumptions

26. As the estimation uncertainty for loan loss provisions will likely be higher under IFRS 9 than under IAS 39[10] because of the ECL model, the range of reasonable outcomes may likewise increase, and therefore there is a greater risk that management's point estimate and the auditor's point estimate will be different.

27. If the auditor decides to develop a point estimate or range to evaluate management's point estimate, paragraph 13(d)(i) of ISA 540 requires the auditor to obtain an understanding of management's assumptions used to determine the accounting estimate sufficient to establish that the auditor's point estimate (or range) takes into account relevant variables. The auditor's understanding is also used to evaluate any significant differences from management's estimate. The standard also provides the auditor with guidance for resolving differences between the auditor's point estimate and that of management (see paragraph A92 of ISA 540). In its discussions, the WG has considered whether the language used in the ISA reflects a "corroboration" mentality.

Possible Way Forward

28. The WG sees merit in including reference to the language used in the ISA in the planned December 2015 Invitation to Comment (ITC) to obtain respondents' views on whether the language reflects a "corroboration" mentality – an issue noted in the IAASB's work on professional skepticism. The terms "appropriate" and "reasonable" in paragraph 13 of ISA 540 are of particular interest to the WG, as are the options available under paragraph 13 to respond to the assessed risk of material misstatement. Dealing with large differences between auditor and management point estimates is not a uniquely financial institution issue, and the WG believes that it would benefit from public input on the implications of the language used in the ISA before considering whether more requirements or guidance are needed.

Issue 7 – Sufficiently Evaluate Management's Estimate

29. As the amount of judgment involved in determining the lifetime ECL is significant and is likely higher than under the current incurred loss model, there is a greater risk for intentional or unintentional management bias and, therefore, it becomes more important for the auditor to evaluate management's judgments and assessments in setting the estimates related to the ECL.

30. Insufficient evaluating and testing of management's judgments and assessments has been one of the most significant findings that regulators have had the last couple of years based on IFIAR's Survey of Inspection Findings. As part of its outreach, the WG has heard a similar message, such as the importance of the auditor looking for consistent use of assumptions across the organization – for example, the gross domestic product growth estimates or default rates in a jurisdiction should feed into the entity's budgets, planning, external economic advice (if any), risk management practices, and accounting estimates. It was also suggested that auditors should look for signs of an appropriate level of tension and debate between the entity's risk management, valuation, finance, and trading functions when setting the assumptions.

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[10] International Accounting Standard (IAS) 39, *Financial Instruments: Disclosure and Presentation*

Possible Way Forward

31. The WG is of the view that ISA 540 contains several requirements and application material to address the risk of management bias. In light of the forthcoming work on the topic of professional skepticism, the WG believes that targeted guidance material (such as the need for consistent use of assumptions across the organization as indicated in the preceding paragraph) would be an appropriate response to this issue.

Issue 8 – Work to Be Performed 0ver Different Scenarios Prepared by Management

32. In the case of accounting estimates arising from IFRS 9, management may need to evaluate alternative assumptions and the outcomes of the accounting estimate through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis based on various scenarios. For financial institutions, the differences between the different outcomes of the scenarios considered in the ECL provision could be greater than materiality, possibly by multiples of performance materiality.

33. ISA 540 provides application material covering the following aspects of sensitivity analysis:

    - Guidance how to assess if the assumptions used by management are reasonable (paragraphs A77–A83);
    - Suggestions how management could consider alternative assumptions or outcomes in the case of accounting estimates that give rise to significant risks (paragraphs A103 – A106); and
    - Guidance how the auditor should narrow a range when they developed a point estimate or a range (paragraphs A93–A95)

34. During outreach and in the WG's discussions, questions have been asked as to how the auditor should approach the scenarios that management analyzes and how the auditor evaluates whether the significant assumptions used by management are "reasonable."

Possible Way Forward

35. The WG proposes to draft guidance material addressing sensitivity analysis in more detail than is currently offered in ISA 540, which may draw upon relevant paragraphs of IAPN 1000.[11] While the guidance in extant ISA 540 may be sufficient for other entities, the greater complexity and importance of sensitivity analysis for financial institutions means there may be scope for further guidance. The WG has also noted that there may be scope to expand on what "reasonable" means in the context of paragraphs 13(b)(ii) and 15(b) of ISA 540.

Issue 9 – Experts

36. The audit of the ECL could require specialized skills or knowledge for one or more aspects of the accounting estimate. The auditor should therefore consider whether an internal or external auditor's expert should be engaged to assist in obtaining sufficient appropriate audit evidence. With respect to the ECL model under IFRS 9, outreach identified the following issues related to the use of experts:

    - Increased likelihood that an expert will be needed, particularly credit risk experts;

[11] See, for example, paragraphs 109, 124, and 128 of IAPN 1000.

- Difficulties in evaluating different views between experts, given the potential for different judgments producing large differences in estimates;
- Possible lack of availability of experts in certain geographical locations and for specialized areas; and
- Increased level of work effort and skills needed by the auditor to understand and evaluate the adequacy of the expert's work for the purposes of the audit of financial statements.

Possible Way Forward

37. The WG notes that this issue is likely not limited to financial institutions or even accounting estimates. Accordingly, the WG believes that coordination with the Quality Control Working Group is important given the importance of the assignment of engagement team members as addressed in ISA 220.[12] The WG also notes that guidance material addressing some of the issues identified in paragraph 36 of this paper could assist auditors, with conforming amendments to ISA 620[13] as appropriate. The WG also believes that inclusion of this issue in the forthcoming ITC would assist in informing the IAASB's future deliberations.

Issue 10 – Limited Availability of Sufficient and Appropriate Data to Assess the Inputs into the ECL Model

38. As noted above, the information included in the ECL model will partly come from systems that have traditionally not been part of financial reporting process. For example, the ECL's comprehensive credit risk information must incorporate not only past-due information but also all relevant credit information, including credit ratings and forward-looking macro-economic information. If the governance over these systems is not appropriate, it could create challenges in obtaining sufficient appropriate audit evidence to assess the inputs into the ECL model. Also, in certain jurisdictions there could be a limited number of independent third-party data sources to verify the client's inputs into the ECL.

Possible Way Forward

39. The WG is of the view that more focus on data inputs would be useful, including with respect to systems not traditionally part of the financial reporting process. This could be achieved, for example, by providing guidance on the importance of data inputs to the estimation process and different audit approaches to inputs. This issue is also linked to issue 3 above as it is affected by any focus that the IAASB may choose to take on system-based regular estimation processes with governance and controls over the process

Issue 11 – Estimates under the ECL Model Will Be Based on More Forward-Looking Information

40. The use of forward-looking data to measure assets and liabilities existed before the release of IFRS 9. Under the current set of IFRSs, forward-looking information is used, among other scenarios, to calculate future generated cash flows in an impairment analysis. The key difference with other IFRSs that require forward-looking information is that IFRS 9 uses certain forward-looking information that

[12] ISA 220, *Quality Control for an Audit of Financial Statements*

[13] ISA 620, *Using the Work of an Auditor's Expert*

is not directly related to the entity; for example, forward-looking macro-economic information. The required forward-looking economic information under IFRS 9 raises questions such as:

- How many conditions should be taken into account?
- What probability should be given to each condition?
- From where can the information be derived?

41. As management is required to calculate the lifetime ECL if the credit risk on a financial instrument has increased significantly since initial recognition, the term of the forecasts will likely be longer and contain more estimation uncertainty than many other estimates under the current set of IFRSs.

Possible Way Forward

42. ISA 540 contains only limited material on the audit issues pertaining to forward-looking information. The WG believes that guidance material would assist auditors in addressing common issues in this area, whether for financial institutions or other entities. For example, the guidance material could address that publicly available data (e.g., from other banks or the central bank) could be used to evaluate the reasonableness of macro-economic data.

Issue 12 – Work to Be Performed on Outliers

43. For audits of very large financial institutions, audit procedures performed on whole populations such as loan portfolios (that may be comprised of a large number of small balances) may result in many "outliers" being detected by the auditor.

44. During the WG's outreach, questions were asked as to what the auditor's work effort should be on outliers. As noted earlier as an overall comment, the concern expressed was that the ISAs did not reflect a high-volume transaction environment where there may be many outliers due to the size of the data set.

Possible Way Forward

45. The WG notes that the IAASB's initiative relating to data analytics may have some bearing on this issue. The WG believes there may be merit in addressing this issue in guidance material specific to financial institutions as a preliminary step. However, further study is needed before making a firm recommendation to the Board.

Issue 13 – Acceptable Ranges, Including a Range That is Multiple Times Materiality

46. As noted above, under IFRS 9 there may be greater estimation uncertainty for some accounting estimates as:

- The length of the forecasted period will be longer;
- There might be less reliable data from external sources available; and
- The accounting estimate is based on more unobservable inputs.

47. The ECL model for large, complex financial institutions could have an estimation uncertainty that is multiple times materiality. Paragraph A49 of ISA 540 notes that, in some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made – although

it also acknowledges that the applicable financial reporting framework may require recognition of, and disclosures about, the accounting estimate. One of the options available to the auditor is to develop a point estimate or range (see paragraph 13(d) of ISA 540).

48. From the outreach conducted so far, one of the questions has been how to deal with the practical implications of very large ranges developed by the auditor (or the auditor's expert) to evaluate management's point estimate. For financial institutions, such large ranges can result from only minor differences in assumptions. ISA 540 provides some guidance on the topic (see paragraph A94) and links the issue to the determination of whether an accounting estimate is a significant risk, but does not provide further guidance.

Possible Way Forward

49. The WG notes that there is already guidance material in ISA 540 on this topic as indicated above. Accordingly, the WG believes that redrafting/restructuring some of the application material might help by bringing all common points into a common area of the ISA, rather than being spread out across the application material as is currently the case. As discussed in Issue 2, such a wide range (if unable to be narrowed by the auditor) is likely indicative that the accounting estimate has high estimation uncertainty and therefore the additional evaluations required by paragraph 15 of ISA 540 are needed. In addition, guidance material could be added to highlight the importance of disclosures in such cases.

50. Further, the Basis for Conclusions on the Disclosures project (see paragraph 54 of this paper) noted that a more holistic review of ISA 320[14] could be considered as part of the IAASB's *Work Plan for 2017–2018*. Any such review could also include addressing the challenges posed by ranges greater than materiality.

51. The WG could also consider whether there is scope for guidance on how to respond if management's point estimate is within the range, but sits at or close to the boundaries of the range. The guidance could also clarify that a point estimate outside the auditor's range represents a misstatement, as some stakeholders have noted this is not always clear.

Issues Related to Disclosures

Issue 14 – Disclosures: Materiality

52. For many financial institutions, IFRS 9 will result in heightened expectations regarding disclosures, given that the high estimation uncertainty associated with some of the required accounting estimates and the disclosures around the estimation uncertainty will be important to provide users of the financial statements with sufficient and relevant information to make judgments.

53. During the WG's outreach activities, several parties have mentioned the importance of disclosures and particularly the application of materiality to the audit of those disclosures.

54. In July 2015, the IAASB released revisions to the ISAs to address disclosures in the audit of financial statements.[15] The changes include new introductory and application material emphasizing that

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[14] ISA 320, *Materiality in Planning and Performing an Audit*

[15] https://www.ifac.org/publications-resources/addressing-disclosures-audit-financial-statements

materiality needs to be considered for qualitative disclosures, including a specific example relevant to financial institutions.[16] The new guidance also notes, in paragraph A10 of ISA 320, that a sensitivity analysis for fair value accounting estimates with high estimation uncertainty is one of the factors that may indicate that misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Possible Way Forward

55. Given that the recent revisions to the ISAs to address disclosures in the audit of financial statements, the WG does not propose to make additional changes at this time. Any guidance that may be released specific to financial institutions should, however, address the topic of disclosures in that context.

Other Matters

56. The WG also considered whether there are other audit issues as a result of the issuance of IFRS 9. The WG noted that the other key change from IAS 39 is the classification of debt instruments into amortized cost, fair value through other comprehensive income or fair value through profit or loss via a business model test. Another topic that has been raised during the outreach is the audit issues regarding circumstances when a debt instrument suffers significant credit deterioration as this requires the estimate to go from forecasting 12 months expected losses to lifetime expected losses. The WG has not yet concluded on whether audit guidance may be needed on these topics and further outreach is needed.

57. In 2013, changes to hedge accounting were released by the International Accounting Standards Board as an earlier phase of the IFRS 9 project. While the outreach to date has been focused mostly on the more recent changes to IFRS 9, there has been no indication from the present outreach that the 2013 changes to hedge accounting are likely to cause particular audit issues in practice. The WG will specifically include the topic of hedge accounting in future outreach activities.

Matters for IAASB CAG Consideration

1. Do Representatives agree with the WG's proposed actions to address the issues noted in the gap analysis?
2. Are there other IFRS 9 issues that should be addressed by the WG?

B. Way Forward to Address IFRS 9 Challenges

Proposed Approach

58. Given the complexity of the issues and the timing challenges, the WG proposes several courses of action.

59. Part of the challenge facing the WG is the timing of IFRS 9's implementation. IFRS 9 is applicable for annual periods beginning on or after 1 January 2018 but systems changes at financial institutions are needed well before that. A number of banks have adopted IFRS 9 already.

[16] See paragraph A1 of ISA 320.

60. In addition, the issues related to ISA 540 that will be addressed in the ITC (as outlined in **Agenda Item D.3**) will need to be taken into account and amendments made to ISA 540, as appropriate.

61. In summary, the WG proposes the following:

    (a) Q4 2015/Q1 2016 – A project update to explain the IAASB's interest in the area, and to highlight the IAASB's intended activities in the area;

    (b) 2016 – Following the approval of a standard-setting project proposal by the IAASB, development of an Exposure Draft (ED) of targeted changes to ISA 540 to: (a) draw a stronger link between high estimation uncertainty and the existence of a significant risk; (b) consider whether the requirements and guidance related to significant risks reflect the current accounting estimate environment; and (c) amend the application material to better guide the auditor's thought process in high-volume environments. The IAASB will need to decide if these targeted changes should be limited to financial institutions or be applicable to audits of all entities. The WG also proposes to draft a IAPN to accompany these changes in order to assist auditors in addressing the challenges caused by the application of IFRS 9 to financial institutions. A list of the intended topics for the IAPN is included in Appendix 2.

    (c) 2017 and onwards – Broader revision of ISA 540 to include the matters covered in the ITC, as well as other issues such as those raised in the ISA Implementation Monitoring findings and the treatment of third-party pricing sources (which was noted by the IAASB in finalizing IAPN 1000).

62. The WG believes that the ED with the targeted changes (in (b) above) would need to become effective at the same time as IFRS 9 – that is, 1 January 2018. This means that the effective date for this ED would be before the resolution of the other revisions to ISA 540.

63. The WG believes that this approach balances (a) the need for timely action on IFRS 9 in light of the outreach conducted to date with (b) the need for more research before commencing a wider project to revise ISA 540. The WG recognizes that making two sets of amendments to ISA 540 may be seen as suboptimal by some. However, none of the issues will be easily addressed and a two-phase approach will allow each set of issues to be given due consideration and focus, without being overwhelmed by the scope of the issues at hand. The WG notes that this phased approach has been used before by other standard-setters, notably on the accounting side.

64. In relation to the question of whether the ED with the targeted changes should apply only to financial institutions or to all entities, the WG believes that development of the draft changes is necessary before coming to a recommendation on the matter. The WG notes that a Board member has previously questioned the appropriateness of the IAASB issuing industry-specific material, and noted that guidance on auditing particular activities, regardless of the industry of the entity, may be more appropriate. The WG notes that this issue, as well as the definition of a financial institution, requires further study and will present an informed discussion on the issue at meetings of the Board and CAG in the future.

65. The WG noted the request that it continues to progress the IAPN on the relationship between financial institution supervisors and auditors. In mid-2016, European prudential regulators intend to finalize their guidance on the auditor/supervisor dialogue and the WG also understands that the World Bank is publishing a document in the forthcoming months as well. In light of these developments, the WG

believes that its time is better invested in monitoring these developments before further progressing the proposed IAPN.

Other Approaches Considered

66. The WG considered, but rejected, the option of immediately undertaking a fuller revision of ISA 540. The most important consideration in this regard was that any changes to the ISA would likely come well after the introduction of IFRS 9 and therefore would fail to meet the need for guidance thereon. The WG also noted that the public consultation via the issuance of the ITC allows the IAASB to be better informed before issuing an ED on the more holistic changes to ISA 540 arising from the ISA Implementation Monitoring Project. A redrafted ISA 540 is also unlikely to be a suitable vehicle for the targeted, financial institution-specific guidance that the WG believes will be necessary.

67. The WG also considered whether an IAPN would be sufficient on its own to address the audit challenges of IFRS 9, but concluded that an IAPN would not be suitable. An IAPN must be based on the extant ISA and some of the audit issues are caused by the requirements of ISA 540 which may be seen as not addressing the audit issues arising from the ECL model sufficiently. Accordingly, drafting an IAPN within the existing ISA 540 might prove more difficult than drafting amendments to ISA 540 concurrently with drafting the IAPN.

Matters for IAASB CAG Consideration

3. Do Representatives agree with the proposal that the WG develop:
    (a) A project update to draw attention to the issues around IFRS 9 and the IAASB's planned work;
    (b) Targeted changes to ISA 540 and an IAPN addressing special audit considerations in auditing financial institutions, including consideration of whether these targeted changes should apply to all entities; and
    (c) A revised ISA 540 to address other issues, including the ISA Implementation Monitoring findings and the responses from the Discussion Paper?
4. What views do Representatives have on the possible topics for inclusion in the ITC (see **Agenda Item D.3**)?

Appendix 1

Summary of IFRS 9 Requirements for Expected Credit Loss Provisions

1. IFRS 9 introduces a new impairment model that recognizes an impairment based on 12 month ECL and lifetime ECL depending on the credit quality since initial recognition. The calculation of the lifetime ECL is forward-looking and therefore substantially different from IAS 39. Under IFRS 9, management has to calculate lifetime ECL for all loans that have a more than insignificant deterioration in credit quality (underperforming credit) and loans that have objective evidence of impairment (non-performing credit).

2. Lifetime ECL could be recognized on a collective basis through a model that considers comprehensive credit risk information. This model must incorporate not only past-due information but also all relevant credit information, including forward-looking macro-economic information, in order to approximate the result of recognizing lifetime ECL. The information to be included in the model will partly come from systems that have traditionally not been part of financial reporting processes.

Appendix 2

Intended Topics for an IAPN

1. After taking into account the gap analysis, the WG has reached the preliminary conclusion that targeted amendments to ISA 540 and an associated IAPN would assist auditors in addressing the challenges caused by the application of IFRS 9 to financial institutions. This guidance material could also be helpful to audits of other entities with similar issues. This IAPN could address the following matters:

    - Guidance on auditing in high-volume financial instrument environments, drawing upon existing material in IAPN 1000 and adapted as appropriate.
    - More detailed guidance on risk assessment considerations for financial institutions.
    - The auditor's approach to complex models and systems, including the importance of sensitivity and scenario analysis to determine which aspects of the model (whether inputs, assumptions, or sub-models) have the greatest effect on the accounting estimate. The material could also provide guidance on model governance and controls and the auditor's approach to data inputs, including comparison with third party data sources.
    - Guidance material that notes that ECL provisions are almost always going to have high estimation uncertainty and may be significant risks.
    - The importance of the two-way dialogue between auditors and financial institutions regulators, including regarding forward-looking macro-economic data and industry benchmarking.
    - The consistent use of assumptions across the organization and the relationship between the risk management, valuation, and training functions of the entity.
    - The involvement of auditor's experts.
    - Material on the possible approaches to outliers (taking into account how this concept is approached in the ISAs).
    - Circumstances when management's point estimate is within the auditor's range, but is close to a boundary and when management's point estimate is outside the auditor's range.