

### ISA 540 / Financial Institutions – Issues and Working Group Recommendations

#### Minutes – September IAASB Meeting

Mr. Sharko and Mr. Pickeur introduced the topic and explained the outreach conducted with regulators, practitioners, and investors since the June 2015 IAASB meeting. They also explained the Financial Institution Working Group's (FIWG) proposed actions as outlined in the agenda material, as well as an alternative approach that was raised by Consultative Advisory Group's (CAG) Representatives and Observers at their recent meeting. The alternative approach involved issuing a "project update" in the fourth quarter of 2015 or first quarter of 2016 to explain the IAASB's activities in the area as well as commencing a holistic revision of ISA 540<sup>1</sup> immediately, rather than pursuing targeted changes to ISA 540 in the short term to address the implications of IFRS 9.<sup>2</sup>

The IAASB agreed that it would be preferable to commence a more holistic revision of ISA 540 as a matter of priority and progress towards an exposure draft in 2016, rather than undertake a two-step approach or develop an International Auditing Practice Note (IAPN) specific to IFRS 9 for financial institutions now. In this regard, the IAASB noted that most, if not all, of the issues raised by the FIWG would be equally relevant to audits of accounting estimates more generally and for all entities to which IFRS 9 applies. The IAASB noted that concerns expressed about the IAASB's ability to issue, on a timely basis, targeted amendments of ISA 540 specific to the audit of loan loss provisions were valid.

The IAASB also noted that it will be necessary for the Board to raise awareness of the challenges that both preparers and auditors may face with respect to the implementation of IFRS 9 for financial institutions and explain how ISA 540 and other ISAs apply. Accordingly, the IAASB agreed to consider publication of a "project update" in the near term, which would enable the IAASB to alert auditors and other interested parties to the IAASB's work in this area and its consideration of the public interest issues, highlight how the extant ISAs and IAPNs address the audit issues in relation to an expected credit loss (ECL) model for financial institutions, and signal the IAASB's plans with respect to the issues that are likely to be addressed in the revision of ISA 540.

The IAASB further noted that supplemental activities may be necessary to address specific considerations in the audit of financial institutions, beyond those that will be addressed in the revision of ISA 540. It was noted that this would be considered at a later date, after the revision of ISA 540 has progressed. Such activities may include an IAPN addressing the relationship between auditors and banking supervisors, or other specific guidance in relation to financial institutions or ECL models.

#### IMPLICATIONS FOR THE INVITATION TO COMMENT

The Board also discussed the implications of this changed approach to the Invitation To Comment (ITC) and agreed:

- To consider including the issues identified by the FIWG related to the use of experts in the ITC, as some of the issues are broader than accounting estimates only. For example, the level of

<sup>1</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>2</sup> International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

understanding needed by the engagement partner to evaluate the adequacy of the work of an auditor's experts affects other active IAASB projects, with similar issues as to how component auditors or other auditors may be used on an engagement.

- To highlight the linkage to the topic of professional skepticism, including the possibility of revisiting the use of language that reinforces a "corroboration" mentality in ISA 540.
- That other issues identified in Agenda Item 7-C for possible inclusion in the ITC should not be in the ITC to avoid delaying the holistic revision of ISA 540.

#### GAP ANALYSIS

The IAASB discussed the FIWG's gap analysis included as Agenda Item 7-B, the purpose of which was to identify which issues related to IFRS 9 are already addressed in the extant ISAs and identify where further attention may be needed.

Aside from the view that the issues raised would be equally relevant to audits of accounting estimates more generally and for all entities to which IFRS 9 applies, the IAASB, in general, agreed with the issues identified and the possible way forward. However, the Board asked the FIWG to:

- Consider whether the link between the degree of estimation uncertainty and whether an accounting estimate is a significant risk should be considered through the ISA 315 (Revised)<sup>3</sup> project, as that project will take a broader look at the concept of significant risk and how such risks are identified. It was also noted that assisting auditors in developing an appropriate response to a significant risk is likely more important than making every accounting estimate with a high estimation uncertainty a significant risk via a rebuttable presumption.
- Consider how ISA 540 could further encourage auditors to be skeptical and challenge management's assumptions when assessing management's models. The FIWG was encouraged to identify different procedures beyond those described in requirement 13 of ISA 540 to test management's accounting estimate, including, for example, the auditor putting different assumptions through management's model.
- Highlight the importance of an effective dialogue between the auditor and the banking supervisor, both in the project update, as well as potential revisions to ISA 540 or a separate IAPN on the topic.
- Focus on unintentional and intentional management bias when evaluating the reasonableness of management's accounting estimate.
- Consider linkages with the changes to the ISAs made as part of the IAASB's Disclosure project, as issues relating to data from information systems that have traditionally not been part of financial reporting process were addressed in this project.
- Highlight the role that audit data analytics can play in testing the integrity of data. For example, audit data analytics may be used to assess outliers in large populations, such as loan portfolios. The IAASB encouraged the FIWG and the Data Analytics Working group to work together on this matter.

---

<sup>3</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

- Explain the importance of disclosures when acceptable ranges are multiple times materiality, even though the accounting estimate might be in the middle of the range.

#### EDUCATIONAL SESSION

As part of its efforts to increase its awareness about issues relevant to financial institutions, the IAASB received a presentation from an outside presenter on IFRS 9. The presentation focused on the ECL model, including the measurement criteria for the loan loss provision, and its implications for financial institutions and other entities.

#### WAY FORWARD

The IAASB will consider a standard-setting project proposal to revise ISA 540 and the project update at its December 2015 meeting. The FIWG will continue to liaise with key stakeholders including banking and insurance supervisors and regulators, auditors, and accounting standard-setters.

#### **Objectives of the IAASB Discussion**

The objectives of the IAASB discussion at its December 2015 meeting are:

- (a) Inform the Board on the Working Group's activities since the September 2015 IAASB meeting;
- (b) Approve a project proposal on revisions to ISA 540;
- (c) Obtain input on a publication to update stakeholders on the project's progress, including the audit issues identified arising from IFRS 9,<sup>4</sup> particularly regarding ECLs, and preliminary views of the Working Group on what related action the Board may consider in the revision of ISA 540.

## **Background**

1. The Working Group has developed this paper to provide the IAASB with an update on the Working Group's activities since the September meeting and to get the Board's input on the project proposal and the publication to update stakeholders on the project's progress.
2. In view of the IAASB's comments at its September 2015 meeting, the Working Group has developed a project proposal for the revision of ISA 540 and a publication to update stakeholders on the project's progress, including the audit issues identified arising from IFRS 9 and preliminary views of the Working Group on what related action the Board may consider in the revision of ISA 540. The publication to update stakeholders on the project's progress has been informed by the outreach activities performed by the Working Group, including input from practitioners and regulators.
3. This paper is intended to provide the IAASB with information about:
  - Project Proposal (see Section A below and Agenda Item 4-B)
  - Project Publication to Update Stakeholders on the Project's Progress (see Section B below and Agenda Item 4-C)

---

<sup>4</sup> International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

## A. Project Proposal

4. The project proposal has been reviewed by both the Steering Committee and the Working Group, and will be discussed with the IAASB's CAG at a teleconference on December 2<sup>rd</sup>. In summary, the project objectives outlined in the project proposal are to:
  - (a) Propose revisions to ISA 540, establishing more robust requirements and appropriately detailed guidance to foster audit quality by driving auditors to perform appropriate procedures in relation to accounting estimates and related disclosures. It is anticipated that these revisions would also seek to emphasize the importance of the appropriate application of professional skepticism.
  - (b) Determine whether non-authoritative guidance and support tools, such as IAPNs, Staff publications, project updates or other materials, should be developed in the future to address special audit considerations relevant to financial institutions to supplement the revisions to ISA 540.
5. The scope of this project includes the development of new or revised requirements and expanded application material in ISA 540 in order to respond to the issues and concerns raised by responses to the ISA Implementation Monitoring project, the Work Plan for 2015–2016, outreach conducted by the Working Group, and the discussions in the CAG and the IAASB. In addition, inspection finding reports from audit regulatory bodies have consistently highlighted issues with respect to accounting estimates, including in relation to audits of financial institutions.
6. The IAASB will seek to make the application of the principles-based requirements in ISA 540 clearer, in particular in light of developments in accounting standards, the increasing complexity and need for management judgment in developing accounting estimates, and challenges that are encountered in practice in relation to accounting estimates with high estimation uncertainty.
7. Throughout the revision of ISA 540, consideration will be given whether supplemental activities may be necessary in the future to address specific considerations in the audit of financial institutions, beyond those that will be addressed in the revision of ISA 540. The effect of these proposals on small- and medium-sized practices will also be taken into account.

### Matter for IAASB Consideration

1. The IAASB is asked to approve the project proposal as is shown in **Agenda Item 4-B**.

## B. Project Publication to Update Stakeholders on the Project's Progress

### Overview

8. At the September 2015 IAASB meeting, the IAASB asked the Working Group to prepare a “project update” to alert auditors and other interested parties to the IAASB's work in this area and its consideration of the public interest issues, highlight how the extant ISAs and IAPNs address the audit issues in relation to an ECL model for financial institutions, and signal the IAASB's plans with respect to the issues that are likely to be addressed in the revision of ISA 540.
9. A draft project publication has been prepared by the Working Group and is included as **Agenda Item 4-C**.

### **Purpose of the Project Publication**

10. The project publication is intended to:
  - Highlight the IAASB's activity in the area and the public interest issues to be addressed in the revision of ISA 540. This includes a brief summary of new accounting standards that are likely to give rise to audit issues around accounting estimates;
  - Specifically, raise awareness of the challenges likely to be encountered by auditors and preparers with respect to ECL models as identified by the Working Group;
  - Highlight how the extant ISAs and other material addresses the audit issues in relation to ECL models for financial institutions and other entities;
  - Summarize the Working Group's discussions of the challenges regarding the audit of ECL models; and
  - Signal the possible direction that the project to revise ISA 540 may take with regards to these challenges.
11. Outreach with both practitioners (via a group of expert bank auditors assembled by the Banking Working Group of the Global Public Policy Committee<sup>5</sup>) and regulators has indicated that there is an urgent need for the project publication in light of the adoption of ECL models in 2018. Of particular concern is the need for auditors to begin preparations as early as possible, as many of the necessary systems changes for financial institutions will take place in 2016. Accordingly, it is the view of the Working Group that this publication should be issued in the near term to allow auditors, regulators, preparers, and other stakeholders an opportunity to hear about the IAASB's work in this area.

### **Style of the Project Publication**

12. In drafting the project publication, the Working Group explored a few options regarding the tone and look of the publication with respect to the material addressing ECL models. One option considered was a drafting style close to that of an IAPN, with initial guidance on each issue, and use of the present tense to convey the messages, such as "the auditor may need to consider the following factors...". In discussions within the Working Group and the group of expert bank auditors, it was noted that this approach was challenging, given the stage of the project, as the language was seen to be too strong and definitive, and that this approach may stifle innovation by giving the impression that the IAASB has already come to a view on how best to respond to the audit issues identified.
13. Accordingly, the Working Group concluded that there was merit in a more factual approach that clearly describes both the Working Group's discussions to date on the issues identified with respect to ECL and the direction that the project may take – that is, areas or options that the Working Group will explore and bring to the IAASB for discussion as part of the revision of ISA 540.
14. The Working Group notes that the project publication is not authoritative but rather is useful as a summary of what the Working Group has found as a result of extensive outreach, input from the IAASB, input from stakeholders of various backgrounds, and the Working Group's own discussions. In this sense, it provides an overview of both the issues likely to be encountered by auditors as they

---

<sup>5</sup> The Global Public Policy Committee C comprises the six largest international accounting networks: BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG and PwC.

approach ECL models for the first time, as well as a summary of the current thinking on how best to respond to these issues.

15. The Working Group will discuss the project publication with both regulators and the expert bank auditor group prior to issuance to gain any final input on the document.<sup>6</sup> The Working Group also notes that, as the project unfolds, there may be merit in issuing a further publication to inform stakeholders of the evolving thinking.

#### **Title**

16. As part of the outreach conducted by the Working Group, various parties noted that the title of the publication, which was provisionally titled as a “Project Update,” appeared to indicate that the publication was focused on procedural matters, rather than a substantive discussion of the issues relating to ECL and the Working Group’s discussion of how they might be addressed. Accordingly, the Working Group has proposed a new, more descriptive title for the project publication (“*The Project to Revise ISA 540: The Challenges Arising From the Adoption of Expected Credit Losses and the Way Forward For the Project*”), and invites comments thereon.

#### **Content of the project update/publication**

17. The content of Section IV of **Agenda Item 4-C** is based on the 14 issues as described in the IAASB’s September 2015 agenda material.<sup>7</sup> This section loosely follows the structure of the ISAs by beginning with overall considerations and then working through risk assessment, responses to risks, audit evidence considerations and finishing with reporting considerations.
18. At the Working Group meeting and the meeting with the expert bank auditors, there was discussion about how the various audit issues identified as a result of the Working Group’s outreach could be approached from the angles of risk assessment, responses to risk, or audit evidence considerations. For example, the material on modelling could be repeated in any or all of the above, depending on the angle that is taken. The Working Group considered whether these issues should be repeated under each section, but noted that this would involve considerable repetition and may give the impression that the publication is an IAPN on the audit considerations of ECL – an approach which the IAASB rejected at its September 2015 meeting. Accordingly, the content of the publication has been structured based on the Working Group’s assessment of the most logical order without repetition of the issues.
19. The Working Group notes that representatives of both IASB<sup>8</sup> and FASB<sup>9</sup> will be asked for their comments on material describing the requirements of the applicable financial reporting frameworks.

---

<sup>6</sup> Other stakeholder groups, for example small- and medium sized practitioners and national standard setters, may be consulted with respect to this or future project updates.

<sup>7</sup> [www.iaasb.org/system/files/meetings/files/20150921-IAASB\\_Agenda\\_Item\\_7A-Financial\\_Institutions\\_Issues-Final.pdf](http://www.iaasb.org/system/files/meetings/files/20150921-IAASB_Agenda_Item_7A-Financial_Institutions_Issues-Final.pdf)

<sup>8</sup> International Accounting Standards Board

<sup>9</sup> Financial Accounting Standards Board

### **Way Forward**

20. Subject to the IAASB's comments, the Working Group will revise the project publication in light of the IAASB's comments, together with comments that may be received from selected groups to which the Working Group will reach out.

#### **Matter for IAASB Consideration**

2. What views does the IAASB have on the proposed project publication as shown in **Agenda Item 4-C?**