Agenda Item 4-C

The Project to Revise ISA 540: The Challenges Arising From the Adoption of Expected Credit Losses and the Way Forward For the Project

This publication has been prepared by the ISA 540 Working Group of the International Auditing and Assurance Standards Board (IAASB). It does not constitute an authoritative pronouncement, nor does it amend or override the International Standards on Auditing (ISAs). Further, this publication is not intended to be exhaustive. Reading this publication is not a substitute for reading the ISAs, the text of which alone is authoritative.

Section I: Introduction

1. Financial reporting frameworks are evolving and the Working Group recognizes that the ISAs and other IAASB pronouncements need to evolve as well. Increasingly, accounting estimates and fair value measurements are more prevalent and more critical to a user's understanding of the financial position and financial performance of an entity.

2. This publication provides an overview of the IAASB's recently approved project[1] to revise ISA 540.[2] It is intended to inform the IAASB's stakeholders of the forthcoming activities in this area and the implications of those activities. It includes:
    - Section II: The Project to Revise ISA 540
    - Section III: New Accounting Standards
    - Section IV: Special Considerations for Audits of Loan Loss Provisions Under an Expected Credit Loss (ECL) Model
    - Section V: Way Forward and Consultation Opportunities

3. One development is a particular area of focus for this publication: the release of new accounting standards governing accounting for ECL which significantly change how many entities will account for a significant amount of their activities. In some industries, particular those that involve heavy usage of financial instruments such as banking and insurance, the upcoming adoption of IFRS 9[3] and the forthcoming finalization of [FASB TITLE] will be a significant challenge for auditors, preparers, regulators, and users. All stakeholders are encouraged to prepare for the adoption and implementation of these new standards.

4. Therefore, of particular importance is Section IV of this paper which explains the Working Group's discussions regarding how the issues identified by the Working Group may interact with the ISAs and other IAASB pronouncements. This section may be particularly relevant for audits of banks, insurers, and other entities with a significant amount of financial instruments subject to expected credit losses.

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[1] [Link to Project Proposal]

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

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

Section II: Overview of the IAASB's Project to Revise ISA 540

5. The ISA Implementation Monitoring project, specific requests from banking[4] and insurance regulators[5] and outreach activities by the ISA 540 Working Group,[6] have identified issues with respect to auditing accounting estimates, in particular in relation to audits of financial institutions. Also, inspection finding reports[7] from audit regulatory bodies highlighted consistent issues with respect to the audit of accounting estimates, including in relation to audits of financial institutions. There are areas where there have been calls for clearer or additional requirements or guidance to enable auditors to appropriately deal with increasingly complex accounting estimates and related disclosures, including obtaining sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements as a whole.

6. It is therefore in the public interest that the IAASB contributes to enhancing the credibility of audit procedures performed over accounting estimates included within the financial statements and, therefore, approved a project to revise ISA 540. In light of the issues identified it is important for the IAASB to clarify and strengthen the auditor's work effort with respect to accounting estimates so that users of the auditor's report can continue to have confidence in audited financial statements.

7. The IAASB intends to debate the issues and concerns that have been noted and consider what revisions will be necessary to ISA 540 to promote audit quality in the varied and complex scenarios that arise today, and that are likely to continue to evolve in the future. In particular, the IAASB will consider how specific requirements in ISA 540 could be further enhanced or clarified, to drive auditors to perform appropriate procedures on specific types of accounting estimates, taking into consideration the processes in place at the entity in developing them, and reinforcing the application of professional judgment and professional skepticism.

8. The IAASB will also consider what guidance is needed for auditors to understand the various contexts in which ISA 540 can be applied – ranging from the most simple accounting estimates, to those that arise in complex business environments, such as, financial institutions or extractive industries. Further, auditors will benefit from guidance that addresses how to deal with challenges that may be encountered in practice, in particular in relation to:

    - Accounting estimates with high estimation uncertainty;
    - Accounting estimates developed using complex business processes;
    - Accounting estimates that need the involvement of management's or auditor's experts; and
    - How those challenges may be overcome through various approaches to the audit.

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4 http://www.iaasb.org/system/files/meetings/files/20150316-IAASB-Agenda_Item_5-B-BCBS%20Letter.pdf

5 [To post on website]

6 The IAASB's Work Plan includes a project to address special audit considerations relevant to financial institutions and therefore a working group was formed in 2015 to commence the activities contemplated by the Work Plan. This working group has since been reformulated as the ISA 540 Working Group

7 https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR%20Global%20Survey%20Media%20Coverage/IFIAR-2014-Survey-of-Inspection-Findings.pdf

9. The IAASB's Project Proposal is available on the IAASB's website. The Project Proposal notes that the IAASB's current plan is to issue an exposure draft of a revised ISA 540 in 2016 and a final pronouncement in 2017 or shortly thereafter. Further publications may be issued to keep stakeholders informed of the progress of the project.

Development Process and Project Timetable

10. The project will be conducted in accordance with International Federation of Accountants' Standards-Setting Public Interest Activity Committees' Due Process and Working Procedures.[8] The preliminary timetable is provided below, although specific project milestones and outputs may change as the project develops.

Timing	**Action**
March 2016 – September 2016	Obtain CAG input on the issues and proposals, including a draft exposure draft of revised ISA 540 (including possible revisions or conforming amendments to other ISAs)
	IAASB deliberation of issues, proposals and draft versions of the exposure draft
	Consideration of any relevant feedback from the IAASB's December 2015 Invitation to Comment, *Enhancing Audit Quality in the Public Interest–A Focus on Quality Control, Group Audits and Professional Skepticism,* and related IAASB outreach activities
	Dialogue with stakeholders on key issues and proposals
December 2016	IAASB approval of exposure draft, with a 120-day comment period
2017	Obtain CAG input on consideration of the responses to the exposure draft and proposed changes to ISA 540 (Revised) as a result of those responses
	IAASB deliberation of responses to the exposure draft and resulting proposed changes to ISA 540 (Revised)
Q4 2017	IAASB approval of ISA 540 (Revised)

Section III: New Accounting Standards

11. The implementation by entities of new accounting standards may create new challenges for auditors. This section summarizes some recently released accounting standards that some stakeholders have noted may have a significant impact on audits of financial statements globally. Of the new standards

8 https://www.ifac.org/system/files/uploads/PIAC-Due_Process_and_Working_Procedures.pdf

listed below, the Working Group notes that the requirements around ECL are likely to raise particular issues for auditors in the near term.

Expected Credit Losses

12. As a result of the financial crisis, concerns were raised about whether the use of an incurred loss model for loan loss provisioning had contributed to the crisis by failing to anticipate the losses that could be expected in a loan portfolio. The incurred loss model required an event to take place or a circumstance to become evident before a loan impairment can be accounted for, meaning that the loan loss provision likely lags economic reality.

13. In response, some accounting standard-setters, including the International Accounting Standards Board and Financial Accounting Standards Board (FASB), are shifting to an ECL model. An ECL model anticipates the losses that are expected over a given period (initially either 12 months or the lifetime of the loan, depending on the credit quality of the loan and the applicable financial reporting framework).

14. Many financial instruments will be subject to ECL. However, some entities (typically those who are not in the business of extending loans to external parties) are able to avail themselves of practical expediencies which may serve to simplify the accounting requirements. Therefore, the most significant impact is likely to be for banks and similar financial institutions that are in the business of providing finance.

15. The Working Group believes that auditors will need to be actively involved in the adoption and implementation of the ECL approach as it is likely to have a significant impact on the audit of financial statements for entitities with many financial instruments subject to ECL. Of particular concern is that entities are likely to be identifying and sourcing data from outside the traditional accounting systems and building the necessary models in 2016/7 in anticipation of the implementation of the ECL requirements in 2018.

[Sidebar – Overview of the features of IFRS 9 and FASB ECL/CECL that cause audit challenges]

- Reasonable and supportable info, including forward looking info
- Probability weightings

16. Section IV below provides an overview of the challenges idenfied by the ISA 540 Working Group, discusses the Working Group's deliberations, and briefly summarizes the direction the ISA 540 project may take.

Other New Accounting Standards

17. Other new accounting standards have been released that may be relevant to the revision of ISA 540. The Working Group will monitor developments regarding these standards and will address any issues raised as the project progresses.

18. For example, new accounting standards addressing revenue recognition have been released[9] And these standards apply a principles-based approach to revenue recognition and, in some cases, may result in a greater use of accounting estimates. For example, the process of identifying performance obligations and measuring satisfaction of those performance obligations may result in the need for estimations that introduce estimation uncertainty into revenue recognition.

19. While not yet issued, new accounting standards addressing insurance contracts are likely to be released in the near future. These standards may raise new audit issues, and auditors, regulators and others may be in need of additional requirements or guidance to respond to those issues.

Section IV: Special Considerations for Audits of Loan Loss Provisions Under an Expected Credit Loss Model

The ISA 540 Working Group

20. The ISA 540 Working Group was formed by the IAASB in early 2015 and includes members from diverse backgrounds representing key stakeholder groups. Originally formed to investigate special audit considerations relative to financial institutions, it now also has primary responsibility for making recommendations to the IAASB regarding the revision of ISA 540. The ISA 540 Working Group has conducted outreach to stakeholders including global and national regulators, auditors, preparers, and users. This outreach, and discussions within the Working Group itself, have informed the development of this section.

Relevant IAASB Standards

21. This section includes references to IAASB pronouncements, many of which are relevant when an entity adopts an ECL model. The main ISA addressing the issues is ISA 540, which deals with the audit of accounting estimates, including fair value measurements, and related disclosures. International Auditing Practice Notes (IAPN) 1000[10] provides background information about financial instruments and a discussion of audit considerations relating to financial instruments. While IAPN 1000 does not address loan loss provisioning, ECL included, some elements of the IAPN are nevertheless helpful when considering the audit issues raised by ECL in some environments. This section is focussed on ECL issues, and does not address other aspects of IFRS 9, [FASB standard] or other accounting standards.

Section IV-A: Challenges with Data and Assumptions

The Issue

Data from outside the traditional accounting systems

22. Use of an ECL model requires an entity to bring together data from systems that may be developed by different functions of the entity, including systems that are not part of the general or subsidiary ledgers, such as risk management systems. Data from outside of the entity may also be needed, covering matters such as economic forecasts and loss statistics from credit bureaus or government

[9] See, for example, IFRS 15, *Revenue from Contracts with Customers* (effective from 1 January 2018) and FASB Topic 606 (Accounting Standards Update 2014-09, Revenue from Contracts with Customers).

[10] IAPN 1000, Special Considerations in Auditing Financial Instruments

agencies. For example, certain entities may have a simple loan portfolio and use simpler processes and procedures – such as using data from a third-party credit rating agency to assist in determining whether significant credit deterioration has taken place. For other entities, including larger financial institutions, the control environment is likely to be more complex and involve different departments of the entity.

23. These systems, and the data obtained from outside the entity, may be the responsibility of departments that have not been historically subject to audit procedures and, therefore, may not have the necessary controls in place or there may be a lack of documentation regarding such controls. As the ECL model may draw in data, including historical data, from these systems, it will be a challenge to determine how to address such systems and data in the audit.

24. Depending on the ECL model, some data sources may have a greater effect on the output of the model than others. For example, an ECL model for a portfolio of residential mortgages may be particularly sensitive to changes in prepayment rates or to unemployment rates in the geographical region concerned.

Forward-looking data

25. Entities and, as a consequence, auditors may find the extent of the need for forward-looking data to be a particular challenge when implementing ECL models due to the significance of forward-looking data to the calculation of the ECL, and the degree to which forward-looking data from outside the entity is involved. The key difference with other accounting standards that require forward-looking information is that ECL models may make greater use certain forward-looking information that is not directly related to the entity such as forward-looking macro-economic information related to external events. The required use of forward-looking data under accounting standards may raise considerations regarding:

    - How many and which scenarios should be taken into account;
    - The probability for each scenario;
    - Where to obtain the information;
    - How forward-looking data can be aggregated;
    - How to match the forward-looking data with the maturity of the financial instruments subject to ECL;
    - How to factor in inputs from various sources and how to aggregate data, when necessary; and
    - Their impact on audit quality.

Extracts from Related IAASB Pronouncements and Working Group Discussions

26. Paragraph 8(c) of ISA 540 requires the auditor to obtain an understanding of how management makes the accounting estimates, and an understanding of the data on which they are based. Paragraph 8(c)(ii) of ISA 540 requires the auditor to obtain an understanding of the relevant controls around the accounting estimate. IAPN 1000 notes that controls are needed to ensure that data is completely and accurately picked up from external sources and from the entity's records and is not tampered with before or during the entity's use of such data.

27. The Working Group's discussion of this issue noted that, for most financial institutions, the complexity and interactions between the systems that will feed into the ECL models, the need for controls over the data, and the high volume of financial instruments subject to ECL may lead to specific challenges to the audit that need to be addressed in the planning phase. These challenges may include:

    (a) Controls and governance over data: Addressing controls over, and governance of, data is important at an early phase of the audit. See the section headed "Governance and Controls over Models and Data" below for more information about controls in a highly complex environment.

    (b) Focussing on key data sources: There may be a large number of discrete data sources relevant to credit quality, some of which may be correlated with each other. By obtaining an understanding of the data on which the estimate is based, the auditor may be able to target the data that is most important to the ECL model's output and to concentrate audit procedures on those data sources.

    (c) Consideration of alternative data sources: The Working Group notes that it may be helpful for the auditor to inquire of management about possible alternative data sources, and why the particular data source(s) were chosen.

    (d) Determining the level of work effort: The Working Group's discussions noted professional judgment is key to determining the nature and extent of audit procedures to apply to data sources.

    (e) System interactions: Data may move between systems within the entity which may bring into question the integrity of the data.

    (f) Data from outside of the entity: Data obtained from outside of the entity may bring particular challenges to the audit. Some data may be obtained from sources such as central banks or regulatory authorities, while other data may come from private sources. For some third-party data, it may be difficult to determine how the data was prepared and what were the controls and governance over that data.

28. The Working Group also noted that the following considerations may aide the auditor in considering management's use of data, including forward looking data:

    (a) Whether the entity has written criteria for considering the impact of forward-looking and macroeconomic data: Such criteria, formally documented and overseen by the appropriate levels of management and those charged with governance, may provide the auditor with evidence of management's rationale for selecting one data source over another, as well as for changing data sources.

    (b) Process to develop the appropriate scenarios used in the estimation of the ECL: When developing scenarios, management and those charged with governance will make decisions about what scenarios are likely to take place in the future. For example, an overvalued housing market may be subject to a correction at some point in the future or a high unemployment rate may be likely to improve. In some cases, the entity may use scenarios defined by the vendor of a service or model while in other cases the entity may generate its own scenarios. The auditor's procedures may include consideration of the process management used to select the scenarios, subject to the requirements of the applicable financial reporting framework.

(c) Use of market indicators of credit quality: Market indicators of credit quality, including traded instruments such as credit default swaps, provide evidence of changes in credit quality for some larger borrowers. Documented processes for how market indicators of credit quality will be incorporated into the entity's ECL models may aide the auditor in understanding management's incorporation of such data into the model.

(d) Consistent use of similar data and assumptions: Within the entity, there are processes and reporting obligations that are concerned with forecasting similar economic phenomena, e.g. internal forecasting, regulatory reporting, and impairment calculations for other assets. The Working Group's discussions focussed on the interactions between these processes and reporting obligations, and noted that auditors may be able to consider whether these processes and reports use data and assumptions consistently – for example, if the entity's internal forecasting indicate that the Gross Domestic Product in a certain jurisdiction is likely to increase by 2% over the next year, the ECL model may use the same assumption, or management may be able to explain why a different assumption was used. The Working Group also noted that benchmarking acros the industry may be useful in some circumstances.

(e) Comparing data and assumptions with external sources: The Working Group noted that, if the auditor has access to a central economic forecasting unit (as may be publicly available from a central bank or government treasury), the auditor may be able to benchmark the entity's data and assumptions with external sources. In the context of financial institutions, the Working Group noted that meetings with the financial institution's supervisor may provide an opportunity, subject to law, regulation and relevant ethical requirements, for the auditor and the supervisor to share information about the reasonableness of management's data and assumptions.

(f) Discussions with supervisors provide insight: Supervisors of financial institutions often meet with the auditor and may be able to share their views on data, including forward-looking data, and assumptions as relevant to the jurisdiction.

(g) Transition to ECL: As noted above, the transition to ECL is likely to involve audit procedures being performed on systems that are outside the traditional accounting systems. The Working Group notes that discussion with management, those charged with governance, and supervisors (when applicable) early in the implementation process may assist the auditor in planning their audit procedures.

Possible Future Direction in the ISA 540 Project

The Working Group noted that the importance of systems and data, including forward looking data, from outside the traditional accounting systems (including the general and subsidiary ledgers) will be a challenge for the implementation of an ECL model – but is also an issue for other accounting estimates. The ISA 540 project may look at including additional requirements or application material to more directly address issues around data given its importance in the modelling of accounting estimates including, for example, some fair value accounting estimates. Consideration will also be given as to the work effort on models and data obtained from third parties.

Section IV-B: Identification of Significant Risks Related to an ECL Model

The Issue

29. The ECL model calculation requires management to make several key judgments about inputs to the model, assumptions, segmentation of the portfolio into pools, judgments about individual exposures, and, under some financial reporting frameworks, may include whether significant credit deterioration has occurred. Accordingly, the ECL provision is likely to have high estimation uncertainty in all but the simplest loan portfolios and may, therefore, give rise to one or more significant risks. ECL provisions may also be complex, and have a high degree of subjectivity, both of which are indicators of the existence of one or more significant risks.[11]

Extracts from Related IAASB Pronouncements and Working Group Discussions

30. From the Working Group's discussions, it was noted that professional judgment was key to identifying significant risks related to ECL and that it was important that the audit effort is focused on the risks that give rise to the greatest risk of material misstatement. The following circumstances were seen by the Working Group as possible indications of the existence of one or more significant risks:

- High estimation uncertainty related to the ECL provision;[12]
- A large portfolio of financial instruments subject to ECL relative to the size of the entity;
- The existence of complex financial instruments subject to ECL; or
- The outcome of the ECL model has a significant effect on regulatory ratios or profitability, or may be subject to management bias.

The Working Group's discussion also covered factors specific to the portfolio may indicate that ECL does not give rise to a significant risk, such as a low value of financial instruments subject to ECL relative to the size of the entity or a small number of loans to customers with high credit quality.

[11] ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 27

[12] Where the auditor determines that the high estimation uncertainty related to the loan loss provision gives rise to a significant risk, ISA 540 requires the auditor to perform substantive procedures and evaluate the adequacy of the disclosure of their estimation uncertainty. See ISA 540, paragraphs 11, 15 and 20.

Possible Future Direction in the ISA 540 Project

The Working Group notes that ISA 540 already draws a link between accounting estimates with high estimation uncertainty and the existence of one or more significant risks. The Working Group will investigate whether and how to draw a stronger link between certain accounting estimates, including those with high estimation uncertainty, and the existence of a significant risk. One way of achieving this may be to propose that a rebuttable presumption be created.

Section IV-C: Audit Procedures on Models: Understanding and Assessing Models and Controls Thereon

The Issue

31. The risk assessment and consideration of the appropriateness of management's method of estimating the ECL will be important for the audit of entities with a material portfolio of financial instruments subject to ECL. For many entities, particularly financial institutions, these accounting estimates occur in a complex data environment, are the result of extensive systems containing many processes and controls, and may involve bespoke models.

32. While some entities may choose to use a third-party model for their ECL models, many entities, particularly larger financial institutions, will develop their own models. These models may be subject to significant management judgment and are complex, and the auditor may need access to specific skills in order to perform the audit (see section IV-E below). An overall ECL model for a large bank may contain models for each significant portfolio and jurisdiction, each with their own assumptions about future economic conditions in the respective portfolio and jurisdiction and their own data sources. Models can be used both to value the ECL but also to develop assumptions as inputs to another model.

As the introduction of an ECL model is seen by many stakeholders to be a landmark event in loan asset accounting, some regulatory bodies have issued their own guidance regarding its implementation, including considerations for models.

[Links to BCBS, Fed Model Risk Management guidance, other docs?]

Extracts from Related IAASB Pronouncements and Working Group Discussions

Extract from ISA 540

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA 315 (Revised), 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: (Ref: Para. A12)

……

(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)

………

33. The Working Group spent much of its time discussing different audit challenges raised by models. The following sections summarize the Working Group's discussions on models:

- Model development and validation; and
- Assessing management's model.

Model development and validation

34. ISA 540 requires the auditor to obtain an understanding of the model, if any, used in making an accounting estimate[13]. To aid auditors in understanding complex models, paragraph 49 of IAPN 1000 explains matters that an entity may address when establishing or validating a model, whether management's own model or a third party model. While this is written in the context of fair value accounting estimates, many of the matters are equally relevant to financial instruments subject to ECL. The Working Group's discussions of the application of paragraph 49 of IAPN 1000 to financial instruments subject to ECL focussed on the following matters that may vary depending on the circumstances:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
    - The methodology's theoretical soundness and mathematical integrity, including the appropriateness of parameters and sensitivities.
    - The consistency and completeness of the model's inputs with market practices, and whether the appropriate inputs are available for use in the model.
    - Back testing of the model using existing historical data.
- There are appropriate change control policies, procedures and security controls over the model.
- Whether the model has controls to mitigate the risk of historical bias in the data, such as when the historical data does not include events that would have an impact on the ECL, even if the probability of the event is remote.
- The model is periodically calibrated, reviewed and tested for validity by a separate and objective function, possibly including back testing.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required data, results of any validation analysis performed and any adjustments made to the output of the model.
- When management has used a third party model, whether the assumptions used in that model are reasonable in light of the facts and circumstances of the entity;

[13] ISA 540, paragraph 8(c)(i)

35. The Working Group notes that performance of risk assessment procedures and related activities at the model development and validation stage will aid auditors in focussing on those areas of the models of ECL at a portfolio or jurisdiction level that have the most significant impact on the model's output. Guidance issued by regulators may be useful to the auditor in understanding the entity's environment and may assist in performing these risk assessments.

Responding to the assessed risks of material misstatement

Extract from ISA 540

13. In responding to the assessed risks of material misstatement, as required by ISA 330,[14] the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59–A61)

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62–A67)

(b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Para. A68–A70)

(i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71–A76)

(ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77–A83)

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84–A86)

(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87–A91)

(i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)

(ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93–A95)

36. Paragraph 13 of ISA 540 requires the auditor to apply one or more procedures from a list of four procedures. However, given that the nature of the models used to calculate the ECL include many inputs, assumptions, and parameters, and will be complex for all but the simplest loan portfolios, the Working Group's discussions focused on the challenges of obtaining sufficient appropriate audit

[14] ISA 330, *The Auditor's Responses to Assessed Risks*

evidence over the ECL calculation by performing only one of the procedures listed in paragraph 13 of ISA 540.

37. For example, given that information on subsequent events regarding credit products is unlikely to be consistently available on a timely basis, events occurring up to the date of the auditor's report may not provide sufficient appropriate audit evidence regarding the accounting estimate. The Working Group noted, however, that it may be helpful in considering whether management's system for estimating credit losses is functioning as designed.

38. Further, the Working Group noted that auditors may have difficulties in developing a point estimate or range of the overall complex ECL calculation. This is because the requirements for systems and data feeds may be difficult or impractical for the auditor to replicate. However, the Working Group noted that the auditor may be able to use management's model to test alternative data or assumptions, or develop their own model over part of the ECL calculation. The Working Group also notes that reperforming or recalculating parts of management's model may also provide audit evidence.

39. As a way of approaching management's model with an independent mind, another approach discussed by the Working Group is for the auditor to use their knowledge of the market to develop their own assumptions (or engage an expert to do so) prior to evaluating management's assumptions. This may not be possible or practicable for all assumptions, but may be helpful for certain assumptions such as discount rates, inflation rates, and consumer credit loss rates.

Possible Future Direction in the ISA 540 Project

The project to revise ISA 540 will consider whether paragraph 13 of ISA 540 should contain more options, including specifically referencing the possible option of performing procedures on individual elements of a large, complex model as a way of accumulating audit evidence. The Working Group notes that a combination of the procedures listed in paragraph 13 is likely to be necessary for some accounting estimates involving signficant risks, and will investigate whether and how to include this in the ISA. There may also be an opportunity to incorporate material from IAPN 1000 regarding audit procedures on models.

*Section IV-D: Governance and Controls over Models and Dat*a

The Issue

40. The extent of an entity's use of financial instruments and the degree of complexity of the instruments, including loan portfolios, can result in differing levels of sophistication of the entity's internal control environment. For example, certain entities may have a simple loan portfolio and use simpler processes and procedures such as, for certain applicable financial reporting frameworks, using data from a third-party credit rating agency as a check on management's assessment of whether significant credit deterioration has taken place. For other entities, including large financial institutions, the control environment is likely to be more complex and involve different departments of the entity.

41. For ECL models, there is often governance and controls over both the model itself and the data that feeds into the model.

Extracts from Related IAASB Pronouncements and Working Group Discussions

42. While IAPN 1000 does not apply to loan loss provisioning,[15] aspects of the discussion on controls over fair value models may be applicable, amended as appropriate, for ECL models. IAPN 1000 notes that "Management and, where appropriate, those charged with governance are also responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework."

43. The Working Group discussed the factors of an effective internal control over ECL. The discussion focussed on the auditor's assessment of the entity's risk management process, including the challenges posed for preparers of different sizes and whose operations have varying degrees of complexity. It was noted that:

    - Governance and controls over models becomes more challenging when the entity has a bespoke model;
    - Data and assumptions obtained from third parties may be subject to controls to ensure their suitability for the entity's circumstances;
    - ECL models will require data from departments that are not part of the traditional accounting system. In this circumstance, the nature and extent of controls over information drawn from the general and subsidiary ledgers may not be present in those other departments, or may only be newly implemented;
    - Some financial reporting frameworks require a different accounting treatment for financial instruments that have experienced significant credit deterioration. Data to determine whether significant credit deterioration has taken place, and controls around that determination, may be a particular challenge; and
    - There is a need for appropriate levels of challenge and skepticism within the entity including, for example, robust discussions between risk management, lending, and finance departments in relation to assumptions and forward looking information;

44. The Appendix to IAPN 1000 provides examples of controls that may exist in an entity that deals in a high volume of financial instrument transactions. While written in the context of complex financial instruments recorded at fair value, many of the controls described are also relevant for loan portfolios.

45. For large financial institutions, the Working Group noted the complexity and interactions between such systems, the controls likely to be in place, and that the high volume of financial instruments subject to ECL may lead to specific challenges to the audit. In this circumstance, the Working Group noted that an expectation that controls are operating effectively may be more common, and therefore controls testing may be an effective means of obtaining audit evidence. The Working Group noted that, due to the reliance financial institutions place on automated processes to manage the data flows, and the related internal control, substantive tests alone may not provide sufficient appropriate audit evidence.[16]

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[15] IAPN 1000, paragraph 6

[16] ISA 330, paragraph 18 states "The auditor is required by ISA 330 to design and perform substantive procedures for each material class of transactions, account balance and disclosure."

Possible Future Direction in the ISA 540 Project

The project to revise ISA 540 will consider whether there should be a greater or more explicit focus on governance and controls over how management made the accounting estimate. The Working Group notes that material from IAPN 1000 may be useful in this regard.

Section IV-E: Management's and Auditor's Experts

The Issue

46. Audits involving ECL are likely to be more judgmental and complex than many other audits. This is because management's process to calculate the ECL may involve sophisticated, extensive, and bespoke processes. Accordingly, such audits often involve extensive use, in different ways, of experts around valuations, credit risk, modelling and other areas of expertise by both management and the auditor and this may give rise to particular challenges.

Extracts from Related IAASB Pronouncements and Working Group Discussions

47. The engagement partner is required to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement.[5] Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement.[6]

48. The Working Group's discussions focussed on the importance of the auditor having access to the right skills and expertise, including access to internal and external experts as needed, as well as being able to adequately supervise or evaluate their work. The Working Group noted the need for such experts may depend on how sophisticated, extensive, and bespoke management's process is for preparing the ECL. The Working Group also noted that an inability to access the requisite skills and experience would be detrimental to audit quality, and may prevent the auditor from accepting the engagement.

49. The Working Group's discussions focussed on the challenges around accessing the following skills for an audit involving financial instruments subject to ECL:

    (a) Understanding of the legal and regulatory environment including, if appropriate, laws and regulations specific to financial institutions such as capital requirements;

    (b) Modelling of ECL;

    (c) Governance and controls over models and data, including data obtained from outside the traditional accounting system or outside the entity;

    (d) Credit risk analysis, using credit risk data obtained in-house or from third-parties; or

    (e) Interactions between systems controlled by different parts of the business (i.e. trading, risk management, finance).

Possible Future Direction in the ISA 540 Project

The Working Group acknowledges the importance of the involvement of auditor's experts in auditing certain complex accounting estimates. Accordingly, the ISA 540 project will consider whether ISA 540 addresses the use of auditor's experts appropriately and whether amendments to ISA 620 may be necessary to more clearly address the need for the auditor to consider whether and when an auditor's expert should be involved. The IAASB will closely follow the PCAOB's projects on auditing estimates and fair value measurements[17] and the use of the work of specialists,[18] and consider if there are opportunities for the IAASB to benefit from the PCAOB's work on this project.

Section IV-F: Addressing the Estimation Uncertainty Implicit In ECL Models

The Issue

50. As noted above, it may be possible for the auditor to generate a point estimate or a range by, for example, varying the assumptions in management's model and comparing the output with that obtained using management's assumptions or by using an expert. Given the complexity and uncertainty implicit in an ECL model, and the significant level of judgment that is involved in determining the ECL, it is possible that the auditor's range, or the difference between management's estimate and the auditor's point estimate, may be multiples of performance materiality. This may be because:
    - The level of judgment required could be greater than for other accounting estimates. For example, the assessment of whether a given financial instrument subject to ECL has experienced significant credit deterioration may be highly judgmental in some cases;
    - The number and sensitivity of assumptions may be greater than for other accounting estimates;
    - The length of the forecasted period may be longer than for other accounting estimates; and
    - There may be less reliable data from external sources available and the accounting estimate may be based on more unobservable inputs. For example, the financial reporting framework may require that all reasonable and supportable information that is available without undue cost or effort be considered when determining whether credit risk has increased significantly since initial recognition.[19]

51. For financial institutions, such large ranges can result from only minor differences in assumptions due to the size of the exposures and the sensitivity of the output to changes in the assumptions. It is possible that well-credentialed and experienced experts may disagree with respect to the appropriate assumptions for a given circumstance.

[17] On August 19, 2015 the PCAOB issued for public comment a staff consultation paper that seeks input on certain issues related to auditing accounting estimates and fair value measurements.

[18] On May 28, 2015 the PCAOB issued for public comment a staff consultation paper that seeks input on potential changes to the PCAOB's standards for the auditor's use of the work of specialists, specifically the objectivity and oversight of specialists and the use of their work in audits. The IAASB response to the PCAOB's staff consultation paper is available at: http://www.ifac.org/news-events/2015-08/iaasb-comments-pcaob-staff-consultation-paper-auditor-s-use-work-specialists.

[19] IFRS 9, paragraph B5.5.15

Extracts from Related IAASB Pronouncements and Working Group Discussions

The challenges posed by ranges wider than materiality

52. Paragraph A94 of ISA 540 states:

> Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102–A115.

53. Paragraph A95 of ISA 540 notes that the range may be narrowed by

- Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and
- Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

54. The Working Group notes that an inability to narrow the range below performance materiality may be an indication that the estimation uncertainty associated with the ECL model is such that it gives rise to one or more significant risks (see Section IV-B above).

55. The Working Group's discussion on how auditor's might deal with such wide ranges noted that audit procedures are unable to reduce estimation uncertainty that is a result of the application of an accounting treatment mandated by an applicable financial reporting framework. When the estimation uncertainty associated with ECL gives rise to a significant risk, the Working Group noted that focusing on the disclosures about the estimation uncertainty of the ECL model in the financial statements is required by paragraph 20 of ISA 540. The Working Group also noted that the matter may be discussed with those charged with governance or a financial institution's supervisor.

> Extract from EDTF document [EDTF Principles and Recommendations for Enhancing the Risk Disclosures of Banks]

56. In addition to disclosures, the Working Group notes that revised Auditor Reporting standards requires auditors of listed entities to communicate key audit matters in the auditor's report. Section IV-H below discusses how this may be useful when dealing with ranges that are multiples of materiality.

Reasonableness of assumptions

57. Both paragraphs 13(b)(ii) (for when the auditor chooses to test how management made the accounting estimate and the data on which it is based) and 15(b) (for significant risks) of ISA 540 require the auditor to evaluate whether the significant assumptions used by management are reasonable. Paragraph A78 of ISA 540 notes:

Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.

58. In the context of ECL models, the Working Group's discussions about how the auditor may be able to evaluate the reasonableness of assumptions used by management focused on the following matters:

- Whether the auditor's dialogue with financial institution supervisors, and associated benchmarking inside and outside the entity, provides indications that the assumptions are not inconsistent with the supervisor's or the auditor's understanding of the circumstances. The Working Group noted that the supervisors may have different objectives (for example, stability and capital adequacy objectives) that may explain differences in views;
- Whether the auditor's retrospective review of management judgments and assumptions related to prior period significant accounting estimates provides indication of a possible bias on the part of management.[20]

Possible Future Direction in the ISA 540 Project

The Working Group notes that additional specificity around the auditor's work effort when dealing with ranges that are greater than materiality may be warranted in light of the issues around ECL and other highly judgmental estimates. This may include more comprehensively addressing disclosures and reporting implications. The Working Group also notes that paragraph A78 could be expanded to include additional considerations about how the auditor can evaluate the reasonableness of the assumptions used by management.

Section IV-G: Management Bias

The Issue

59. In the context of an entity's use of an ECL model, there are many judgments and decisions that may be subject to management bias, whether intentional or unintentional. Indicators of management bias may include:

(a) Changes in model methodologies, data, or assumptions that are unreasonable; and

(b) Management decisions that have the effect of moving the ECL estimate within the auditor's range estimate from year to year, for example from a more conservative ECL estimate to a less conservative estimate, when this move is not supported by a valid business reason.

[20] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

Extracts from Related IAASB Pronouncements and Working Group Discussions

60. Paragraph 21 of ISA 540 states that "the auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias." As noted in paragraph A9 of ISA 540, for continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

61. ISA 240 contains requirements and application and other explanatory material regarding the auditor's responsibilities relating to fraud in an audit of financial statements. The Working Group notes that the auditor is required to review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.[21]

62. Difficult financial market conditions may give rise to increased incentives for management or employees to engage in fraudulent financial reporting: to protect personal bonuses, to hide employee or management fraud or error, to avoid breaching regulatory, liquidity or borrowing limits or to avoid reporting losses. For example, in a favorable economic climate there may be incentives for management to build up an excessive provision to draw upon in challenging economic times.

63. In the context of ECL, the Working Group notes that the following cicumstances may be examples of management bias, whether intentional or unintentional:

    (a) Override of controls over data, assumptions, and processes;

    (b) Selecting data sources to present a biased view of the ECL. As noted in paragraph 34, historical data may not include events or scenarios that would be required to be addressed in the forecasts meaning the data is biased;

    (c) Choosing scenarios, and assigning probabilities to those scenarios (when required by the applicable financial reporting framework), that are not in compliance with the applicable financial reporting framework;

    (d) Changing from one data source or assumption to another data source or assumption;

    (e) When management overlays are overstated or understated.

64. The Working Group notes that there may be controls and governance arrangements that are able to reduce the risk of management bias. For example, appropriate levels of challenge and skepticism between different functions within the entity (such as risk management, lending, and finance departments) may reduce the risk of management bias in some cases. The Working Group also notes that auditors may discuss the risk of management bias with those charged with governance and financial institutions' supervisors, particularly when considering the implementation of new systems or controls relevant to the ECL model.

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[21] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32

> **Possible Future Direction in the ISA 540 Project**
>
> *The Working Group believes that there may be merit in investigating whether ISA 540 can better describe the role of professional skepticism when reviewing management's judgments and decisions.*

Section IV-H: Implications for Reporting

The Issue

65. For listed entities, ISA 701[22] requires the communication of key audit matters in the auditor's report. In the context of an audit of a listed entity when ECL gives rise to one or more significant risks, the auditor's evaluation of the ECL may be a key audit matter.

Extracts from Related IAASB Pronouncements and Working Group Discussions

66. The Working Group's discussions focussed on how the new Auditor's Report, including the disclosure of key audit matters, gives the auditor greater scope to communicate directly with users about matters relating to the ECL. The Working Group noted that the following information may be helpful to users:

    - A qualitative or quantitative description of the level or degree of estimation uncertainty of the ECL;
    - A description of what matters were most significant to the auditor with regards to the ECL;
    - How the audit addressed the ECL, including the choice of procedures made under paragraph 13 of ISA 540, or how experts were used;
    - If the auditor's range was greater than materiality, what additional audit procedures were performed to address this; and
    - How the auditor addressed the risk of management bias.

> **Possible Future Direction in the ISA 540 Project**
>
> The Working Group's discussions in this area have noted the opportunities that KAM provide to communicate with users about how the auditor approached the ECL model. The Working Group will consider whether and how to incorporate relevant guidance into ISA 540.

Section V: Way Forward and Consultation Opportunities

67. The IAASB is interested in stakeholders' views and perspectives on its activities. At the moment, there are several areas on which the IAASB is consulting:

    - [Included here will be the Invitation to Comment with a high level summary of topic areas and a list of outreach events, as well as a look forward to a Consultation Paper on Data Analytics]

68. In addition to these activities, IAASB leadership and the ISA 540 WG will continue a program of targeted outreach to key regulatory bodies, firms, and other stakeholders throughout the course of the project.

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[22] ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

69. As the ISA 540 project progresses, the Working Group may issue further publications to update stakeholders on the project's progress.