

# Auditing IFRS 9

## Considerations for audit committees of systemically important banks

**Audit committees of banks are expected to play an oversight role as banks adopt IFRS 9. Expectations of them, and of auditors, are high.**

## A quick guide to the GPPC's July 2017 paper

The adoption date of IFRS 9 *Financial Instruments* is drawing near – and critical accounting judgements will soon need to be finalised. The requirement to estimate expected credit losses (ECLs) is perhaps the single most significant change in banks' financial reporting. It is critical that capital markets have confidence in banks' estimates – and audit committees and auditors have a crucial role to play in ensuring those estimates can be relied upon.

### **Audit committees need to assess and monitor the effectiveness of auditors**

This will include:

- considering the appropriateness of the planned audit approach including:
  - proposed responses to areas of significant risk; and
  - changes to the proposed approach during the course of the audit;
- evaluating the findings of the auditor in the context of their understanding of the bank's processes, systems and controls.

### **Guidance to help audit committees evaluate the effectiveness of auditors**

The Global Public Policy Committee – which comprises representatives from BDO, Deloitte, EY, GrantThornton, KPMG and PwC – has published a joint paper<sup>1</sup> that seeks to help audit committees evaluate the effectiveness of their auditors' response to ECLs.

The paper discusses:

- fundamental concepts for auditing ECL estimates;
- what banks will base their judgements on when estimating ECLs and compiling disclosures; and
- key questions for audit committees to use to focus their discussions with auditors.

This quick guide outlines the background to (and key themes in) the paper.

1. [The Auditor's Response to the Risks of Material Misstatement Posed by Estimates of Expected Credit Losses under IFRS 9.](#)

# The GPPC's July 2017 paper

**The guidance will help audit committees focus their discussions with auditors about whether estimates of ECLs and related audit work are robust and reasonable.**

**Application is complex for both preparers and those charged with governance; it will be demanding for auditors too.**

## What is it?

The paper is designed to assist audit committees in their oversight of auditors with regard to audit work on IFRS 9 ECLs. It is addressed primarily to the audit committees of systemically important banks (SIBs), but the principles are relevant to other banks and financial institutions in a proportionate way. The paper focuses on SIBs' lending activities, being their core activity, as opposed to investing in securities.

This paper also takes account of the concepts and guidance proposed in International Standards on Auditing (ISA) 540 *Auditing Accounting Estimates* (revised) and illustrates ways that may be appropriate to apply them to the audit of ECLs.

## Why has it been produced?

IFRS 9 is one of the most momentous accounting changes for many banks. The new impairment requirements pose particular challenges for the management of banks, as well as audit committees and auditors.

This paper, following on from the GPPC's previous paper issued in 2016<sup>2</sup>, is intended to assist audit committees with overseeing whether judgements made by the auditor are reasonable and robust. It is published in recognition of the importance and complexity of the task.

## What are some of the application challenges of IFRS 9?

### Increased complexity for preparers and those charged with governance

Under IFRS 9, banks will need to provide for ECLs. While this notion is largely intuitive, it may be more difficult for audit committees to understand the detailed application, as well as the systems and controls implications. Audit committees are responsible for evaluating the effectiveness of the external auditor's response to the risks of material misstatement presented by ECL estimates, which will generally be subject to a high degree of estimation uncertainty.

### Challenges for auditors

IFRS 9 implementation is expected to be demanding for auditors in many respects. The degree of complexity in the IFRS 9 ECL estimate is expected to be greater than loan loss allowances under IAS 39 *Financial Instruments: Recognition and Measurement*, requiring greater management judgement. The GPPC paper illustrates that high-quality audit approaches, designed to respond to the significant risk of material misstatement presented by a bank's estimate of ECLs, will probably rely on documented, well-controlled, high-quality ECL estimation processes at SIBs.

### Time and effort to implement

Less than six months remain until IFRS 9's effective date. Implementation programmes at SIBs are in progress and will require significant effort from auditors to audit the transition to IFRS 9 in 2018, as well as the 2017 financial statement disclosures about the expected impact of IFRS 9 required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

2. [The implementation of IFRS 9 impairment requirements by banks: Considerations for those charged with governance of systemically important banks.](#)

**The guidance includes observations across seven areas that all have a key part to play in successfully auditing ECLs.**

## What guidance does it provide?

The paper has seven main sections.

<b>Fundamental concepts for auditing ECL estimates</b>	<ul style="list-style-type: none"> <li>– The audit committee should expect auditors to take the approach of auditing the bank’s ECL estimation process, focusing on elements that could contribute to the risk of material misstatement.</li> </ul>
<b>Accounting policies</b>	<ul style="list-style-type: none"> <li>– The auditor should understand whether the accounting policies adopted by the bank are appropriate for its portfolios, compliant with IFRS 9, and consistently applied.</li> </ul>
<b>Procedures and internal control</b>	<ul style="list-style-type: none"> <li>– Reasonable and supportable estimates of ECLs depends on robust internal controls over financial reporting including critical inputs and models.</li> <li>– Given the nature of the ECL estimate and volume of computations, the auditor will generally test key controls.</li> </ul>
<b>Information systems</b>	<ul style="list-style-type: none"> <li>– The volume of information processing to generate the ECL estimates and related disclosures under IFRS 7 <i>Financial Instruments: Disclosures</i> are expected to require a heavy reliance on information systems and controls.</li> </ul>
<b>Models</b>	<ul style="list-style-type: none"> <li>– The audit committee should assess elements such as policies and governance over model design, build and validation, ongoing model review, forward-looking data and model adjustments or overlays.</li> </ul>
<b>Reasonable and supportable judgements</b>	<ul style="list-style-type: none"> <li>– The extent and complexity of judgement involved in estimating ECLs and the estimation uncertainty associated therewith makes it a significant accounting estimate.</li> </ul>
<b>Financial statement disclosures</b>	<ul style="list-style-type: none"> <li>– IFRS 7 disclosures are extensive and are key to communicating management’s key judgements, estimates, inputs and methodologies to financial statement users.</li> </ul>

## What is its status?

The paper is not intended to amend or interpret the requirements of IFRS 9 and the GPPC is not empowered to do so.

The information in the paper is of a general nature, and banks will need to undertake further analysis to apply the standard in their own circumstances. However, we expect that the six large accountancy networks will each use the paper to enhance the quality of auditing and financial reporting.

At the time of initial publication of this paper, the International Auditing and Assurance Standards Board (IAASB) has undertaken a project to revise ISA 540. Auditors and audit committees should read this paper in conjunction with the final text of revised ISA 540 once it is completed.

Although the paper focuses on impairment, audit committees and auditors of banks will also need to consider classification and measurement of financial instruments, hedge accounting and related disclosures under IFRS 9.

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# Key questions

**Audit committees can focus their discussions with auditors using these key questions.**

## Key questions for audit committees to discuss with auditors

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### Key sources of complexity

- How has the auditor identified the key sources of complexity, judgement and uncertainty in the bank's estimate of ECLs under IFRS 9?
  - How do the skills, knowledge and resources of the audit team align with the key sources of complexity, judgement and uncertainty that contribute to the risk of material misstatement in the bank's estimate of ECLs under IFRS 9?
  - What is the auditor's assessment of the bank's controls over the key sources of complexity, judgement and uncertainty in the bank's estimate of ECLs under IFRS 9 and how has that assessment informed the auditor's approach?
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### Use of proxies

- Where the bank has made use of proxies, how has the auditor evaluated and challenged the appropriateness of these proxies and the bank's plan (or lack thereof) to eliminate their use?
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### Data and models

- How has the auditor evaluated the relevance and reliability of data sourced from different functions of the bank (i.e. outside the financial reporting function) and external sources?
  - In its testing of models, what limitations did the auditor identify, and how did the auditor satisfy themselves that such limitations were appropriately addressed by management?
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### Judgements

- How has the auditor exercised professional scepticism in testing the bank's key judgements and assumptions (such as the selection of multiple, probability-weighted forward-looking economic scenarios and the determination of significant increases in credit risk) in the estimation of ECLs?
  - What process was undertaken by the auditor to 'stand back' and consider, in the context of the financial statements as a whole, the potential for bias in the bank's estimate of, and disclosures regarding, ECLs?
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### Disclosures

- What are the auditor's views regarding the neutrality, clarity and comprehensibility of the disclosures regarding the bank's estimate of ECLs?
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