

Special Audit Considerations Relevant to Financial Institutions—Issues and IAASB Working Group Recommendations

Objectives of the IAASB Discussion

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

1. To receive a briefing on audit issues relevant to financial institutions and an update on the Financial Institutions Working Group's (FIWG) activities to date.
2. To provide input on issues identified thus far and areas for further exploration.

Introduction

1. In the IAASB's *Work Plan for 2015-2016*,¹ (the Work Plan) it was noted that "The IAASB also intends to invest significant effort to respond to some of the key implementation issues identified from its ISA Implementation Monitoring project and address auditing issues of importance to supporting global financial stability, including in relation to financial institutions." To this end, the Work Plan includes a project on special audit considerations relevant to financial institutions.
2. The Appendix to this paper includes an extract from the Work Plan outlining the initiative.

Objectives of the FIWG

3. The FIWG's work covers three main areas relevant to the audit of financial institutions:
 - (a) The relationship between auditors and financial institution supervisors;
 - (b) Specific audit issues relevant to financial institutions; and
 - (c) Consideration of whether identified issues relevant to ISA 540² and other relevant ISAs are also applicable to audits of other entities.

Initial Outreach

4. To begin to raise awareness of the IAASB's initiative and to seek early input on the issues already identified, the leadership of the FIWG together with Prof. Schilder met with representatives of the Financial Stability Board, the Accounting Experts Group, the Basel Committee on Banking Supervision (BCBS), and the International Association of Insurance Supervisors (IAIS) in February, 2015.
5. While the discussions with these groups covered many topics and perspectives, there was support for the IAASB's work in this area. The following themes summarize the discussions:
 - The adoption of IFRS 9³ is a focus for regulators ahead of its implementation for annual periods beginning on or after 1 January 2018. The impending finalization

¹ www.ifac.org/sites/default/files/publications/files/IAASB-Work-Plan-2015-2016.pdf

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

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

of the IASB's insurance contracts project may also require specific focus from the IAASB.⁴

- The role and use of experts in the audit of financial institutions.
- The importance of the IAASB engaging with other stakeholders such as the International Forum of Independent Audit Regulators and the Public Company Accounting Oversight Board.
- The importance of an auditor—regulator dialogue, particularly at the beginning and at the end of the audit is key for audits of financial institutions.

Three Phase Approach

6. The FIWG plans to approach this task using in three phases:
 - Identifying all relevant issues and topics that warrant further exploration;
 - Development of guidance to address issues specific to financial institution audits; and
 - Amendments to ISAs, particularly ISA 540, while recognizing that some issues identified may not have broader relevance and may not be applicable for more than just financial institution audits.

First Phase – Process for Identifying Issues

7. The FIWG's initial brief has been informed by issues identified from the ISA Implementation Monitoring project, specific requests from banking and insurance regulators, and responses to the IAASB's Strategy Consultation Paper.
8. A key source of this input was the letter sent to the IAASB from the BCBS in March 2013. This letter was written in the context of the BCBS's work to issue guidance on the audit of banks, which culminated in the issuance of a guide, *External Audit of Banks*,⁵ in March 2014. The letter contains specific recommendations to the IAASB on enhancements to the ISAs that would address particular risks in the audit of a bank. The BCBS recognized that many of the proposed enhancements are likely to apply to all audits and not only those of banks and that some of the enhancements are already addressed by other IAASB projects and initiatives underway such as the Quality Control project. In broad terms, the areas identified include:
 - (a) Stronger quality control requirements for banks;
 - (b) Going Concern issues for banks;
 - (c) Strengthening the use of professional skepticism;
 - (d) Understanding the entity and its environment;
 - (e) Communications with TCWG;
 - (f) Disclosures issues of specific importance to banks; and
 - (g) Issues specific to ISA 540, including loan loss provisioning and management bias.

⁴ An update on the Insurance Contracts project is available at www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/2015/High-level-project-update-January-2015.pdf.

⁵ www.bis.org/publ/bcbs280.htm

The FIWG notes that co-ordination with other IAASB Task Forces and WGs will be key.

9. Audits of insurers share many of these issues. However, there may be additional issues around the impending finalization of the IASB's Insurance Contracts standard as well as those issues that may be raised during interactions with regulators and practitioners. For example, auditors of insurance entities have a special relationship with the actuarial profession, as the auditor often engages their own actuary to assist in understanding the work of the entity's actuary. Exploring these issues requires input from experts in insurance audits. A key result of the meeting with the IAIS in February 2015 was that the IAIS will identify a resource for the FIWG to assist in identifying and prioritizing such issues.
10. In addition to these two sources of information about issues that need to be considered, the FIWG also notes that many national or regional bodies have issued standards or guidance for the audits of financial institutions. In most jurisdictions, law or regulation provides an additional layer of requirements specific to the audit of financial institutions.⁶ The FIWG has commenced collecting examples of these publications and laws to assist in identifying issues that may warrant further investigation.
11. Finally, the FIWG recognizes that further stakeholder input is needed to ensure that all relevant issues have been identified. It is acknowledged that input from practitioners from different jurisdictions, regulators of financial institutions, preparers, audit committees and users will be needed to ensure that the project can be correctly scoped from the outset. Such input could be obtained through individual meetings, forums, roundtables, or discussion papers.

Matter for IAASB Consideration

1. The IAASB is asked to share its views on the process for identifying issues outlined above. The IAASB is also asked to comment on what additional avenues could be used to reach out to stakeholders.

Second Phase – Possible Guidance on Issues Specific to Financial Institution Audits

12. After identifying the issues to be addressed, the FIWG will consider how best to address these issues. In determining the way forward, the FIWG recognizes that balance is needed between giving guidance on a timely basis via International Auditing Practice Notes (IAPNs) and strengthening audits of financial institutions by amending ISAs on a longer term basis.
13. It is proposed that FIWG begin drafting two IAPNs: one dealing with the relationship between the external auditor and the supervisory authority and one dealing with special audit considerations specific to financial institutions.

⁶ See, for example, Article 12 of EU Regulation No 537/2014 (available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>) which requires auditors to report to supervisors of public interest entities and requires the establishment of an effective dialogue between the competent authorities supervising credit institutions and insurance undertakings, on the one hand, and the statutory auditor(s) and the audit firm(s) carrying out the statutory audit of those institutions and undertakings, on the other hand.

IAPN on the External Auditor/Financial Institution Supervisory Relationship

14. The first IAPN on the external auditor/financial institution supervisory relationship is intended to provide guidance about this important relationship and how it is addressed in the context of an ISA audit. This guidance will set out the role of the auditor, the role of the supervisor, common features of law and regulation in this area, supervisory expectations, and how the relationship interacts with the auditor's relationship with management and those charged with governance.
15. In preparing this IAPN, the FIWG will draw upon the BCBS's guide, *External Audit of Banks*, as well as reviewing the withdrawn IAPS 1004.⁷ The WG will also consider national and regional guidance that may be applicable at the international level.

IAPN on Special Audit Considerations Specific to Financial Institutions

16. This IAPN is intended to provide timely education and guidance about specific issues that are of most importance to financial institution audits. This publication will allow the IAASB to assist auditors, in a timely fashion, in understanding and responding to relevant issues, including:

- (a) Loan loss provisions under an expected credit loss model; and
- (b) Use of the work of experts, particularly actuaries.

The IAPN may also reference some other matters from the BCBS letter highlighted in paragraph 8 and issues identified as part of the other outreach activities in the first phase of the project.

17. As an IAPN is non-authoritative, it may become clear that one or more of these topics may warrant an authoritative response via amendments to ISAs, particularly ISA 540, in addition to or instead of inclusion in the IAPN. Such topics would be then considered as part of the Phase 3.
18. It could be argued that addressing ISA 540 first would be preferable as it would enable an early start on the due process steps required to issue authoritative material. However, such an approach risks an inefficient process if all relevant issues are not identified and prioritized at the outset of the project – and the initial focus on preparing an IAPN will allow discussion that will assist the Board in determining which topics need an authoritative response.

⁷ International Auditing Practice Statement (IAPS) 1004, *The Relationship Between Banking Supervisors and Banks' External Auditors*. This IAPS was withdrawn in along with all other IAPS. At that time, the IAASB noted that the IAPS had not been revised for the Clarified ISAs and, as such, were no longer providing useful guidance.

Matters for IAASB Consideration

2. What views do members have on the FIWG's proposal to pursue IAPNs in the first instance, including on:
 - (a) The proposed IAPN on the external auditor/financial institution supervisory relationship;
 - (b) The proposed IAPN on special audit considerations specific to financial institutions.
3. Are there other aspects of the audit of financial institutions that should be considered for guidance?

Phase 3 – Amendments to ISAs

19. The third phase involves consideration of issues identified from Phases 1 and 2 and whether there is a need for an authoritative response by amending ISA 540 or other ISAs. This involves considering whether the issues identified are unique to financial institutions or whether they have broader implications for other entities.
20. Also, as noted in the Work Plan, this phase of the project will also consider some issues that have already been identified, including:
 - (a) The use of professional scepticism when dealing with fair values;
 - (b) The work effort on accounting estimates not identified as significant risks;
 - (c) Fraud; and
 - (d) The implications of using third party pricing sources in valuations.
21. To gather additional input to this stage of the project, and to make sure that the IAASB is targeting the right issues in its standard-setting work, the FIWG believes that there may be merit in issuing a Discussion Paper to stimulate debate and reactions from key stakeholders. This Discussion Paper could then be the subject of specific outreach activities to further elicit views.

Matters for IAASB Consideration

4. How best can the IAASB inform itself about the issues that should be considered in this phase of the project? In particular, does the IAASB support the notion of a Discussion Paper to stimulate debate?
5. Are there other issues that should be considered for an authoritative response?

Way Forward

Possible 2015 Timeline

22. Based on initial discussions, the FIWG expects to return to the Board in September and December 2015. As can be seen from the table below, the three phases overlap to some extent as one phase begins to come to a close while another phase begins.

Date	Activity
April-August 2015	<ul style="list-style-type: none"> Stakeholder outreach to develop inventory of issues
September 2015	<ul style="list-style-type: none"> IAASB and Consultative Advisory Group discussion on the IAPN on the relationship between the auditor and banking and insurance supervisors

	<ul style="list-style-type: none"> • Project Proposal on revision of ISA 540 • Further consultation on issues that should be addressed
December 2015	<ul style="list-style-type: none"> • IAASB discussion/approval on the IAPN on the relationship between the auditor and banking and insurance supervisors • IAASB discussion on IAPN on the audit of banks and insurers • IAASB discussion on issues in ISA 540 • Preliminary input on draft Discussion Paper

Next Steps

23. The FIWG has identified several actions that need to take place in the near term. These include working out the appropriate scope of the project – that is, what is a “financial institution”? Should the project extend beyond banks and insurers to other prudentially regulated entities such as pension funds?
24. Given the focus on financial institutions, which are likely to be among the more complex audits and involve the very largest entities, it is also important to recognize that the ISAs apply to all audits of financial statements. Therefore, the FIWG and the IAASB will need to balance maintaining the proportionality of the ISAs while strengthening audits of financial institutions. The FIWG also notes that, as ISAs do not contain requirements applicable only to a particular industry, responding to calls to strengthen audits of financial institutions will need to be balanced with the potential effect on audits in other industries.

Matters for IAASB Consideration

6. Are there other comments that members wish to make?

Appendix

Extract from the IAASB's Work Plan for 2015-2016

Special Audit Considerations Relevant to Financial Institutions

Issues that May Be Addressed

1. Issues identified from the ISA Implementation Monitoring project coupled with specific requests from banking regulators (and to some extent from insurance regulators), as well as responses to the Consultation Paper, relevant to financial institutions include:
 - (a) In relation to special considerations relevant to audits of banks—The need to clarify and enhance the relationship between the banking supervisors and the bank's external auditors, as necessary and appropriate in light of the related efforts of BCBS in this area; and address issues of particular significance in audits of banks or other depository or investment institutions. For example, the BCBS has suggested consideration should be given to these entities' use of fair value accounting and related estimates, including but not limited to impairment and loan loss provisioning, as well as other ISAs particularly relevant to the audits of banks and other financial institutions, including International Standard on Quality Control (ISQC 1),⁸ ISA 250,⁹ ISA 260,¹⁰ ISA 315 (Revised),¹¹ ISA 540, ISA 570¹² and ISA 620.¹³
 - (b) In relation to issues arising in the insurance industry—IAIS has highlighted the need for consideration of audit issues of particular relevance to insurers, particularly given the accounting developments in this area and the significance of these changes to insurers.¹⁴
 - (c) In relation to other ISA 540 issues—Further consideration may be needed as to whether the issues relating to ISA 540 that have been highlighted as particularly relevant to audits of banks and other financial institutions are more broadly applicable to other entities. In addition, other specific issues relating to ISA 540 identified include the application of professional skepticism (e.g., how auditors obtain audit evidence, challenge and test management's assumptions and considerations about possible management bias), work effort on accounting estimates and fair values that have not been identified as significant risks, fraud, and the implications of the use of third-party pricing sources.

⁸ ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

⁹ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

¹⁰ ISA 260, *Communication with Those Charged with Governance*

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

¹² ISA 570, *Going Concern*

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

¹⁴ The IAIS notes that the accounting for technical provisions is expected to significantly change as the IASB and the US Financial Accounting Standards Board complete their work on the accounting standards addressing insurance contracts.

Standards that May Be Addressed

2. Possible amendments to ISA 540 and other ISAs as necessary.

Possible Other Outputs

3. IAPN(s) or other non-authoritative guidance to address issues related to financial institutions, including the relationship between the banking supervisors and the bank's external auditors and matters relevant to the insurance industry.

Preliminary Views on the Approach to the Project

4. Staff, and as necessary, a Working Group (including experts in this area), will initially focus on considering the suggestions of the BCBS on areas where more is needed to address audits of banks (including the relationship between banking supervisors and auditors). The wider applicability of these potential changes beyond financial institutions (including to ISA 540 or other ISAs as necessary, and to insurers) will also be considered as part of the initial information gathering activities. At the same time the IAASB will continue its discussions about issues arising from the insurance industry and the process to develop non-authoritative material, including IAPNs, to enable this Working Group to be in a position to be able to recommend an appropriate way forward to address special audit considerations for financial institutions.
5. Information-gathering activities will commence in 2014, with an initial discussion by the IAASB on the topic planned in early 2015.