In brief
A look at current financial reporting issues

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Second GPPC paper on the Auditor's Response to the Risks of Material Misstatement Posed by Estimates of Expected Credit Losses under IFRS 9

The introduction of the requirement to estimate expected credit losses (ECLs) under IFRS 9 *Financial Instruments* is one of the most significant changes to financial reporting by banks. A new paper from the Global Public Policy Committee (the 'GPPC paper') has been issued to promote high quality audits of the accounting for expected credit losses by systemically-important banks (SIBs), and to assist audit committees in assessing the effectiveness of auditors' response to the risk of material misstatement.

What is the GPPC?

The GPPC is the global forum of representatives from the six largest international accounting networks – BDO, Deloitte, EY, Grant Thornton, KPMG and PwC. Its public interest objective is to enhance quality in auditing and financial reporting.

Who should read the GPPC paper?

The paper is an effort to assist audit committees in their oversight of banks' auditors with regard to ECL and is addressed to the audit committees of SIBs because of the relative importance of SIBs to capital markets and global financial stability. We expect that these banks will consider the work of other international bodies on IFRS 9, such as the Basel Committee on Banking Supervision ('Basel Committee')'s *Guidance on Credit Risk and Accounting for Expected Credit Losses* ('GCRAECL') (December 2015). However, while much of the paper's content will be relevant to the audit committees of other banks and financial institutions, it does not specifically contemplate how the concepts would be applied to banks other than SIBs, and should not be applied to other banks without appropriate consideration of proportionality. The Paper focuses on SIBs' lending activities, being their core activity, as opposed to investing in securities.

What does the GPPC paper cover?

The paper includes key questions that audit committees may wish to discuss together with seven key areas of focus in assessing the audit of IFRS 9, including:

1. Fundamental concepts regarding audit responses to estimates of expected credit losses,
2. Accounting policies,
3. Procedures and internal control,
4. Information systems,
5. Models,
6. Reasonable and supportable judgements, and

7. Financial statement disclosures.

Nine questions those charged with governance may wish to discuss

Below are some questions that audit committees may wish to discuss with the auditors (and with their prudential supervisors):

1. How has the auditor identified the key sources of complexity, judgement and uncertainty in the bank's estimate of ECL under IFRS 9?

2. 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 ECL under IFRS 9?

3. 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 ECL under IFRS 9 and how has that assessment informed the auditor's approach?

4. How has the auditor evaluated the relevance and reliability of data sourced from different functions of the bank (i.e. outside of the financial reporting function) and external sources?

5. 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?

6. 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?

7. 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?

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

9. What process was undertaken by the auditor to 'stand back' and consider, in the context of the financial statements as a whole, the presence of bias in the bank's estimate of, and disclosures regarding, ECLs?

Interaction with ISA 540

This paper was prepared at the same time as the IAASB was revising ISA 540 which has resulted in the issuance of an exposure draft (ED). There are some potentially significant changes proposed in the ISA 540 ED, and this paper has to the extent possible reflected the proposed changes with that ED given the parallel drafting of the two documents and the fact that the consultation process to revise ISA 540 is incomplete. The completion of the IAASB's project to revise ISA 540 may have implications for this paper.

Where can I get more information?

The GPPC paper is available on PwC's Inform, our comprehensive online accounting resource. If you have questions about this In brief or the GPPC paper, please speak to your normal PwC contact or one of the contacts listed below.

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