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Industry Insights – *Banking*

Industry Insights

This publication is part of CPAB's *Industry Insights* series developed to support audit committees in their oversight of the audit by enhancing the dialogue between the audit committee and auditor.

Industry Insights – Banking discusses certain common areas of focus for an audit of a company operating in the banking industry. These areas may be considered together with the audit committee's knowledge of the industry and the company. Audit committees may also wish to refer to guidance on external audits of banks issued by the Basel Committee.

An audit approach is a matter of professional judgment influenced by auditing standards, industry risks and specific characteristics of the company. This publication is not intended to prescribe an audit approach or the areas of focus in an audit. It considers International Financial Reporting Standards (IFRS) currently in effect and does not address IFRS 9 or other published IFRS standards available for early adoption.

Common Areas of Audit Focus in the Banking Industry

1. Allowance for loan losses

The allowance for loan losses is made up of allowances against individually significant impaired loans and a collective allowance against all other loans that do not have an individual allowance.

a. Allowance for loan losses – individual

Individually significant loans are evaluated by management for impairment indicators and if impaired, the carrying value reduced through an allowance account. This allowance reflects the size of the loan and the extent of the default after considering the potential for recovery from guarantees and collateral. The determination of recoverability against guarantees and the liquidation value of collateral may be complex.

In planning and executing the audit in this area, the auditor may consider:

- Testing management's controls over the identification of impaired loans and the estimate of loan losses.
- Selection of a sample of loans that management does not consider impaired to test for indicators of impairment.
- Selection of a sample of loans that management considers impaired to test the allowance amount. Testing by the auditor may include evaluation of the extent of loan loss including assessing the valuation and enforceability of any loan collateral or guarantees and the timing of any future cash flows. Such assessment may involve the evaluation of work done by a management expert or use of an auditor's expert.

b. Allowance for loan losses – collective

The collective allowance is intended to estimate incurred loan losses for all loans except for those that have an individual allowance discussed above. For calculation purposes some companies may split that into a collective assessment of loans that are not individually significant, and a collective assessment of individually significant loans excluding those that have an individual allowance. In both cases, the collective allowance is intended to determine loan losses that are already incurred although these losses may not yet have emerged, sometimes referred to as incurred but not identified.

The collective allowance estimate may be based on a historical numerical model with or without a qualitative adjustment made by management to account for factors not present in historical data or not addressed by the model. The qualitative adjustment is based on management judgment and can be highly subjective. Factors considered in developing the model and the adjustment may include historical data, economic conditions (for example affecting the probability of default and valuation of underlying assets), changes in the credit quality of the loan portfolio (for example due to changes in management's underwriting standards), or changes to loan terms and conditions.

The collective allowance may involve significant data analysis. Certain of the inputs into the model may be complex including evaluating parameters such as the probability of default of loans in the portfolio and the amount of loss should a default occur. Evaluating these parameters may also involve the use of an expert. In the audit of the collective allowance, the auditor may find it necessary to use IT specialists to assist with verifying the integrity of management reports and testing of system controls over the underlying data used in the loan loss model. The auditor may require significant judgment to assess the factors used in developing the model and adjustment.

2. Valuation of financial instruments

The company may hold, lend or issue a variety of debt, equity or derivative products for which quoted prices are not readily available in active markets. As a consequence, management may need to estimate the fair values of these financial instruments using public data or internally developed valuation models or through pricing services. Certain inputs to the models may not be readily observable and accordingly may require significant judgment. Management may also make certain fair value adjustments to the valuation of instruments to address credit risk or funding costs associated with the financial instrument. These fair value adjustments are often calculated separately from the valuation of the financial instrument. The valuation process may involve the use of an internal or third party expert by management.

For large portfolios of instruments, the audit team may find it necessary to test management's controls over valuation. The auditor may evaluate the controls over segregation of duties between the issuance, settlement and price verification of the financial instruments. The auditor may also test controls over the assessment of valuation models by management's expert. The auditor may find it necessary to use IT specialists to assist with evaluating IT systems and application controls involved in the valuation including both models and data sources.

In planning and executing the audit in this area, the auditor may consider:

- Performing substantive procedures to test the existence and key terms of the financial instruments on a sample basis.
- Assessment of management's valuation approach for a sample of financial instruments and procedures to assess whether the data used in performing the valuation are appropriate.
- For certain instruments, such as complex derivatives or unlisted debt or equity investments, the audit team may involve valuation specialists to perform procedures such as independent revaluation of a sample of instruments or to evaluate a sample of management models.
    - When determining the types and number of financial instruments to test, the auditor may consider the risk that instruments are undervalued rather than just selecting instruments with larger values.

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3. Income tax strategies

The company may adopt strategies to optimize taxation that involve complex arrangements across multiple jurisdictions. The types of taxes that the company is subject to, and the complexity of certain tax strategies, may require specialized knowledge. These arrangements may also require management to determine the price for exchanging services (transfer price) between affiliates in cases where certain functions or services are provided from one affiliate to another. The company may also be subject to uncertain tax positions including on-going audits by tax authorities and tax positions for which legislation is unclear. Management applies judgment to determine the amount of the liability for such tax positions and must also consider updates to treaties, interpretations and court decisions relevant to clarifying legislation.

The audit team may involve tax specialists to evaluate the income, commodity or other tax consequences of certain transactions and to evaluate the accounting for complex tax strategies. The auditor may find it necessary to use IT specialists to assist with verifying the integrity of management reports and testing of system controls over the underlying data used to determine the tax provision. The auditor may also conduct procedures to evaluate the recoverability of deferred tax assets.

4. Impairment of goodwill and intangible assets

Economic changes, competitive factors, regulatory costs and reputational risk factors may impact the profitability of certain business segments or products and the valuation of associated intangible assets or goodwill. The company may discontinue certain products, or adjust its geographic coverage or participation in other jurisdictions which may result in impairment of goodwill and intangible assets.

Evaluating the indicators and extent of impairment may involve the use of cash flow forecasts. Key assumptions made by management would include the discount rate, projections of revenue and expenses, and determining a terminal value or growth rate.

Auditors may focus their work over goodwill and intangible assets to those assets considered to have the highest risk of impairment with scaled procedures over lower risk assets. For larger entities, the auditor may find it effective to test management's controls.

Evaluating the assumptions and models used by management to value these assets may involve the use of auditor's experts and require significant judgment about the feasibility of budget forecasts and timing of the goodwill impairment testing.

5. Information technology

Financial institution audits may place extensive reliance on information technology controls as well as on electronic audit evidence such as system reports. Management is responsible for developing and maintaining the company's system of internal controls, including controls over IT systems. Where IT systems are complex, auditors may respond to the risks by involving IT specialists to assist in the assessment of the effectiveness of the IT general controls and the IT environment. Audit firms may use IT specialists to perform or assist with code reviews and enhanced data analytics, if any, in addition to traditional IT testing techniques.

Audit teams may use an approach where not all IT systems are tested each year, or where the extent of annual testing is reduced (known as benchmarking). Under this approach, the auditor may test IT change monitoring controls each year, together with either periodic retesting of individual systems or the use of professional judgment to determine when retesting may be required.

6. Structured entities

The company may use transactions with various structured entities for financing, risk transfer, tax or leverage purposes. Evaluating the accounting for transactions with these entities and the consolidation or off-balance sheet treatment of these entities may require significant judgment. Management may find it necessary to monitor the company's transactions to identify any new entities or changes to relationships with existing entities.

The auditor may find it effective to test management's controls evaluating the accounting treatment of these entities. The auditor may evaluate the accounting conclusion reached by management for a sample of these entities or transactions.

Additional considerations

The auditor will consider the skills and experience required by the audit team members and identify the need for any auditor's experts. In significant risk areas the extent of use of internal audit in completing audit procedures may be reduced and the involvement of specialists and auditor's experts (like valuations, income and commodity taxation and IT) may be increased to effectively audit these areas.

Questions for Audit Committees

Depending on the risks and materiality in the particular business, audit committees may choose to discuss the following questions with their auditor.

Interaction with regulators

1. How has the auditor addressed any announcements, findings or concerns, whether general or specific to the company, raised by the regulator(s) as part of the audit approach?

2. What audit quality concerns have arisen from CPAB and how has the auditor addressed these concerns as part of the audit approach?

Pervasive factors

1. What procedures did the auditor take to validate independence from the financial institution including for all relevant personnel of the audit firm, across all relevant component locations?

2. Describe the areas where the auditor used the work of internal audit, if any, and the extent of review and re-performance work done to support such use?

3. How did the auditor identify the internal controls the auditor intends to rely on? Discuss how the auditor ensures that the internal controls operate at a sufficient level of precision for audit purposes? What deficiencies did the auditor note in its testing of internal controls?

4. Did the auditor consider the risk of material misstatement on accounts with potential valuation bias and consequential effects on regulatory ratios?

5. To what extent did the auditor apply data analytics techniques in the audit of large volumes of transactions, valuations and journal entries, and what was their approach?

Allowance for loan losses

1. How has the auditor incorporated changes in the nature or quality of the loan portfolio into the audit approach? Has management changed any of the critical assumptions used to value the allowance for loan losses compared to the assumptions used in the previous year?
2. What procedures did the auditor use to test the components of the allowance for loan losses?

    a. What approach did the auditor take to testing each of the components of the allowance?

    b. What are the critical assumptions used in the model and judgment-based adjustment and how have these been addressed? Did the auditor compare the level of the allowance against industry peers or develop an expectation? How has the auditor applied professional skepticism to those assumptions and adjustments?

    c. If the auditor considered a range of acceptable allowance amounts, where within the range is the current and prior year allowance?

    d. For multi-jurisdiction audits, how did the group auditor ensure that component auditors applied similar high quality audit procedures?

Valuation of financial instruments

1. What financial instrument valuations did the auditor assess as the highest risk or most complex? What new products or model changes did the auditor focus on?

    a. What was the extent of use of auditor's experts if any?

2. How did the auditor satisfy themselves that management's valuation estimate falls within the reasonable range for each product? Where within the reasonable range does the auditor believe management's estimate falls?

3. What approach did the auditor take to fair value adjustments made by management?

4. In the auditor's view, are the methodologies used for the models consistent with leading industry practice?

Income tax strategies

1. What tax strategies did the auditor assess as more complex and how were these tested?

2. What procedures did the auditor perform over the recoverability of deferred income tax assets?

Impairment of goodwill and intangible assets

1. What intangible assets did the auditor assess as requiring closer examination?

2. What were the critical assumptions and how did the auditor assess their appropriateness?

Information technology

1. Which IT systems were evaluated by the auditor this year? What specific issues were noted, if any, in the auditor's review of IT systems? What impact did these issues have on the audit plan?

2. Did the auditor identify any other areas of IT risk and how did they address those risks through the audit?

Structured entities

1. What approach did the auditor take to identifying new structured entities and reconsideration events during the year?

2. What significant accounting judgments did the auditor make regarding consolidation or off-balance sheet treatment of these entities?

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