# Risk-based approach to reviewing financial statements and using audited IFRS financial information

*13-14 December 2021*

*IFRS UPDATE FOR REGULATORS*

CFRR Centre for Financial Reporting Reform

WORLD BANK GROUP Governance

STAREP

Strengthening Auditing and Reporting in the Countries of the Eastern Partnership

EU REPARIS

Road to Europe: Program of Accounting Reform and Institutional Strengthening


This event is co-funded by:

Austrian Development Cooperation

BMF FEDERAL MINISTRY OF FINANCE

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

LE GOUVERNEMENT DU GRAND-DUCHÉ DE LUXEMBOURG
Ministère des Finances

European Union

# Overview

- » Risk-based approach to reviewing IFRS financial statements
- » World Bank staff publication Informing the Reading of IFRS Financial Statements: a guide for banking and financial supervisors
- » Panel discussion: international experience sharing

# Risk-based approach to reviewing IFRS financial statements

The views expressed in this presentation are my own and not necessarily those of any organization with which I am associated.

# Why use a risk-based approach to reviewing IFRS financial statements?

- **Aim:** efficient use of scarce resources in achieving more effective review outcomes.
- **Process problem:** tick-box disclosure-checklist financial statement compliance review is unlikely to be effective in assessing the quality of accounting and reporting because generic/boilerplate disclosures mask non-compliance.
  - Misuse of 'Big 4' disclosure checklists and illustrative financial statements.
  - Consequently, at the superficial level disclosures often seem compliant.
  - However, appropriate judgements and estimates are not necessarily being made.
- Moreover, a risk-based review methodology likely will focus on more relevant issues by, for example, identifying and analysing:
  - each entity's most significant judgements; and
  - selected issues currently of concern to regulators.

# Why not a disclosure checklist approach? example, depreciation

| Disclosure checklist approach: mandatory disclosure | Reference | Test |
| --- | --- | --- |
| Depreciation methods used | IAS 16.73(b) | ✔ |
| Useful lives or the depreciation rates used | IAS 16.73(c) | ✔ |
| Gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period | IAS 16.73(d) | ✔ |
| Depreciation for the period | IAS 16.73(e)(vii) | ✔ |
| Nature and effect of a change in an accounting estimate including (a) residual values; (b) costs of dismantling etc; (c) useful lives; and (d) depreciation methods | IAS 16.76 read with IAS 8 | ✔ procedure in accounting policy note (no material change in the period evident) |

# Why not a disclosure checklist approach? example, depreciation (continued)

| Disclosure checklist approach: encouraged disclosure (about PPE that is likely no longer being depreciated) | Reference | Test |
|---|---|---|
| Carrying amount of temporarily idle PPE and carrying amount of PPE retired from active use and not classified as held for sale in accordance with IFRS 5 | IAS 16.79(a) and (c) | assume N/A and see no evidence to the contrary |
| Gross carrying amount of any fully depreciated in use PPE (encouraged disclosure) | IAS 16.79(b) | ✔ |

Conclusion: ✔ compliant (very good)–entity provides all mandatory disclosures + provides some additional voluntary disclosures.

**Concern:** non-compliance with the depreciation principle might exist because **the judgements** made by management when applying the depreciation principle might not faithfully reflect the consumption of an item's service potential in the reporting period.

# Risk-based approach to reviewing IFRS financial statements

- Who to review?
  - Risk-based sampling, eg systemic risk industry, acute risk industry, whistle-blowers, etc
  - Random sampling element so whole population is potentially included every year
  - Every company at least every x years (ie frequency back-stop/s)
- Comprehensive reviews, thematic reviews, or both?
- IFRS financial information review mindset
- Appropriate protocols for resolving queries and disputesa range of proportionate actions, from gentle reminders to reissue AFS and passing information to other relevant agencies.

# Mindset for the reviewing IFRS financial information

» Open-mind attitude, exerting professional skepticism

- » Understand management incentives.
- » Critically review judgements, estimates and risk disclosures (not box ticking!)
- » Pay attention to audit qualifications and KAMs BUT do not rely too much on the audit opinion and management letters.
- » Are MD&A disclosures consistent with AFS?

» Investigator mind-set

- » Expectations informed by understanding of economic and business environment when audited financial statements were issued (and post-balance sheet events), the company and its management's risk appetite.
- » Compare accounting policies, judgements and outcomes with peer companies.
- » Review other regulators findings in similar circumstances.
- » Seek information: supervisors, accountancy firms, external auditors, audit committee

# Mindsets for reviewing significant judgements and estimates

Understand types of IFRS requirements and associated judgement mindsets.

» **Principle** accounting maps closely to raw economics.

  » Examples include fair value measurement and depreciation accounting; and restating comparatives for changes in accounting policies and to correct prior period errors and

  » Focussed critical-thinking judgement mindset is entity's accounting reflecting closely the specified economics?

» **Artificial construct** codification of old (and sometimes newly invented) conventions that do not map closely to raw economics?

  » Difficult to apply consistently unless detailed rules are specified to inform practice.

  » Absent those rules (as is sometimes the case), the BfC on a Standard can be helpful in understanding what the artificial construct is trying to capture. (Good luck!)

» **Specific rule**: blind rigidity mindset as little if any judgement.

# Example depreciation principle

Depreciation **principle** reflect the pattern in which the depreciable item's service potential is consumed by the entity (IAS 16).

Is the following change: 1) a change of accounting policy; 2) a change in accounting estimate; 3) correction of a prior period error; or 4) it depends (specify on what it depends)?

| Issue | IAS 8 and |
|---|---|
| A change in the depreciation method from straight-line to the units-of-production method. | IAS 16 |

Adapted from Appendix A to Agenda Paper 11A Review of IAS 8 - Distinction between changes in accounting policies and changes in accounting estimates, May 2015 IASB meeting.

In **02/2021** the IASB issued *Definition of Accounting Estimates (Amendments to IAS 8)* to help entities distinguish changes in accounting estimates from changes in accounting policies (effective date = annual periods beginning on or after 01/01/2023).

# Examples fair value measurement
## *applying the fair value measurement principle*

» Fair value measurement **principle**: estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). (IFRS 13.2)

» **Judgements** include, has the registrant: (i) used an appropriate model? (ii) used appropriate model inputs? (iii) taken account of all factors market participants would consider in measuring fair value? (iv) applied the model properly (without material error)?

Regulatory example: FRC (UK) required AngloEastern Plantations plc to restate <u>twice</u> the fair value measurement of its oil palm plantations!

# Examples fair value measurement hierarchy judging the boundaries of the artificial constructs

Boundary between levels 1 & 2do transactions in the market in which the identical item trades (and that the entity can access at the measurement date) take place with sufficient frequency and volume to provide pricing information on an ongoing basis? (IFRS 13. A)

Regulatory exampleJSE (following review of 2016 financial statements of debt issuers) observes:[1]

» Debt issuers inappropriately classified their own debt instruments in Level 1 given the inactivity of trade in listed notes on the South African interest rate market.

» Even when trade does occur, it is not usually of sufficient frequency and volume to satisfy a Level 1 classification.

[1] REPORTING BACK ON PROACTIVE MONITORING OF FINANCIAL STATEMENTS IN 2016

# Examples  fair value measurement hierarchy judging the boundaries of the artificial constructs

## Boundary between level 2 and level 3 – significant unobservable inputs?

Example entity-specific policy – HSBC (2020) financial statements, p292:

» “significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument’s inception profit or greater than 5% of the instrument’s valuation is driven by unobservable inputs

» ‘Unobservable’ in this context means that there is little or no current market data available from which to determine the price at which an arm’s length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used)”

Regulatory example – JSE (following review of 2016 financial statements) observed:

» issuer owned investment property and had incorrectly classified this as a level 2 fair value when it is highly unlikely that property in the South African market will meet the criteria for a level 2 fair value classification.

» incorrect classification of operational financial instruments (eg trade receivables and payables, finance leases, loans receivable and loans payable as being level 2 rather than level 3).

# Examples fair value measurement (continued)

If not the correction of a prior period error, are the following: 1) changes of accounting policies; or 2) changes in accounting estimates?

| Issue | IAS 8 and |
|---|---|
| A change in the option pricing model for share options from Black and Scholes to Monte Carlo. | IFRS 2 |
| A change in the assessment of own credit risk for measurement of financial liabilities at fair value; e.g. from using a credit default swap curve to using the spread of the most recent debt issuance. | IFRS 13 |
| A change of credit value adjustment (CVA) calculation to determine the probability of default. | IFRS 13 |
| A change in the valuation technique to measure fair value, eg from a market approach to an income approach (Level 3). | IFRS 13 |

Fair value measurement **principle**: estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). (IFRS 13.2)

# Examples historical cost

Historical cost **artificial construct**. If <u>not</u> the correction of a prior period error, are the following: 1) changes of accounting policies; or 2) changes in accounting estimates?

| Issue | IAS 8 and |
|---|---|
| A change in the expenditures included in the initial measurement of exploration and evaluation assets. | IFRS 6 |
| A change in the cost formula used for inventories: from FIFO to weighted average cost. | IAS 2 |

Historical cost **artificial construct**: the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment* (IAS 16.6) + the conventions specified in IAS 16.11 to 16.28 + IFRIC etc.

Adapted from Appendix A to Agenda Paper 11A Review of IAS 8 - Distinction between changes in accounting policies and changes in accounting estimates, May 2015 IASB meeting.

# Principles for risk-based reviewing of IFRS financial statements

1 - Understand the economic environment

2 - Understand the regulated entity

3 - Identify areas of focus

4 - Leverage the work of others

5 - Understand the relevant accounting

6 - Scrutinise significant judgements and estimates

7 - Formulate searching questions

8 - Observe protocols, practices and codes

**World Bank staff publication**

***Informing the Reading of IFRS Financial Statements: a guide for banking and financial supervisors***

# World Bank staff publication *Informing the Reading of IFRS Financial Statements: a guide for banking and financial supervisors*

**Objective**provide suggested practices and examples of specific accounting and auditing issues and questions that supervisors need to consider when monitoring and reviewing banking sector financial statements.

- » Aims to enable prudential supervisors to form an understanding of a bank's business drivers, risks and critically evaluate the quality of financial assets and the related provisions for credit losses using IFRS financial statements.
- » Lists regulatory areas which are connected with accounting requirements which supervisors may investigate further when reviewing financial statements.
- » **Appendix** outlining the key IFRS 9 requirements including suggested practices from a prudential supervision perspective.

» Is <u>not</u> a checklist and should not be used as a checklist with a box ticking approach.

Source: https://cfrr.worldbank.org/sites/default/files/2021-06/ifrs2021_pages.pdf (p3 & 4)

# World Bank staff publication *Informing the Reading of IFRS Financial Statements: a guide for banking and financial supervisors*

Suggested practices for supervisors to adopt when reviewing IFRS financial information:

1 – Understand the economic and business environment

2 – Understand the banking group's structure, business model and risk profile

3 – Identify areas of focus (including leveraging the work of others)

4 – Understand the relevant accounting

5 – Review accounting policies, significant judgements and estimates

6 – Question the relevance and appropriateness of data and assumptions used by senior management

7 – Assess the impact of key accounting requirements on capital and going concern.

Source: https://cfrr.worldbank.org/sites/default/files/2021-06/ifrs2021_pages.pdf (p5)

# Panel discussion: International experience sharing

# The panel

» **Moderator: Garik Sergeyan** | Senior Financial Management Specialist, World Bank

» **Sonja Carshagen** | Financial reporting specialist Issuer Regulation division, JSE Stock Exchange

» **David Grünberger** | Head of Section, European Central Bank

» **Darrel Scott** | Consultant, World Bank

» **Michael Wells** | Consultant, World Bank

# Themes

Theme 1: objectives and processes

Theme 2: recuring themes

Theme 3: outputs

Questions from the event participants