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IFRS Regulators Forum: IFRS Update & Climate Financial Risks Matters

Informing the reading of IFRS financial statements: a guide for banking and financial supervisors

Pascal Frèrejacque, Centre for Financial Reporting Reform, The World Bank

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Centre for Financial Reporting Reform

World Bank Centre for Financial Reporting Reform

- Started operations in 2008, just before the financial crisis
- First technical office out of Washington
- Opened with the Support of the Ministry of Finance
- 15 years of operations
- Working across all countries of the Europe and Central Asia Region

Centre for Financial Reporting Reform in Europe and Central Asia

- Accountability and Governance of State-Owned Enterprises
- Accounting and Advisory for SMEs
- Accounting and Auditing Education
- Audit Oversight and Quality Assurance
- Financial Sector Governance and Accountability
- Public Sector Accounting and Auditing
- The Accounting Profession and Professional Bodies

Financial Sector Governance and Accountability

- Mission of the WBG to promote growth and shared prosperity

- The financial sector is an essential engine for growth

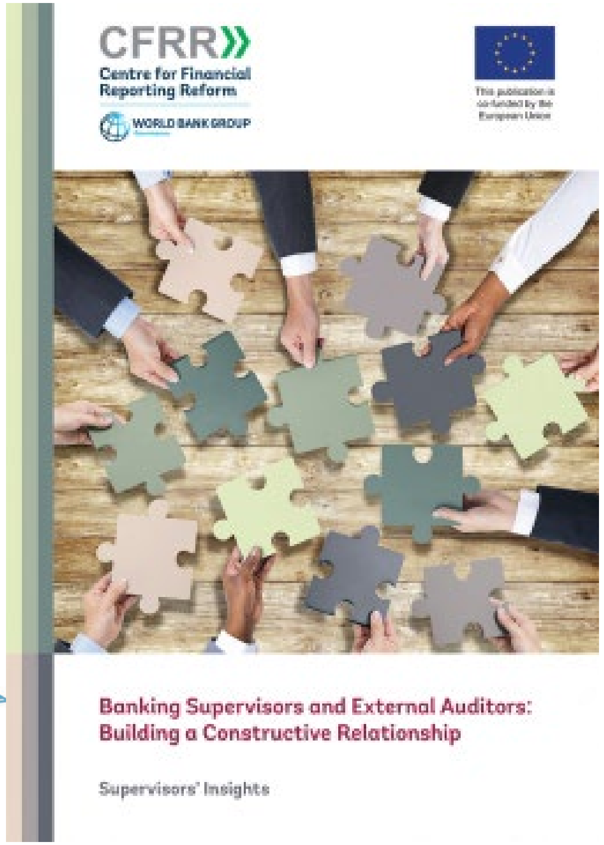
- The IFRS Regulators Form helps regulators and supervisors to better understand the importance of financial reporting and governance and how to leverage the auditors' work.

IFRS Regulators Forum

IFRS Regulators Forum

- Sponsored by the REPARIS and the STAREP initiative supported by the EU and Austria
- Three components
  - Annual workshop on IFRS, external audit, and other reporting matters
  - Punctual distance learning events updates
  - Publications to assist regulators and supervisors in their tasks

Publications to date on the use of external audit work for supervisory purposes



A new publication on critically reviewing IFRS financial statements

- » To inform the reading of IFRS financial statements
- » Providing information on how critically review financial statements of banks
- » A specific focus on IFRS 9 – Financial Instruments and ECL
- » A parallel information risks disclosure under Pillar 3 and IFRS 7

Informing the Reading of IFRS

Informing the supervision of banks and help evaluate the quality of information

» To provide practices and examples of specific accounting and auditing issues and questions to consider when monitoring and reviewing banking sector financial statements.

» 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.

Risk Based Approach in reviewing financial statements

- » For efficient use of scarce resources and more effective review outcomes:
- » Big 4 materials:
  - » disclosures checklists and Illustrative financial statements are helpful
  - » **BUT** do not provide information on how to critically review significant judgements and estimates

- » Focus more on relevant issues:
  - » Banks most financial significant judgments
  - » Current issues of concern to regulators

3 level approach to enable supervisors to review financial statements:

1. High level suggested practices for supervisors to adopt when reviewing financial statements;
2. Questions and discussions points for supervisors to consider when meeting banks and their external auditors; and
3. Financial statements disclosures and audit report items for supervisors to review and monitor.

Practical references included in the appendices

- » Key IFRS 9 requirements including suggested practices from a prudential supervision perspective
- » A summary of the recommendations from the Basel Committee on Banking Supervision of IFRS 9 Expected Credit Loss and Pillar 3 disclosures on Market Risk.

Mindsets for reviewing significant judgements and estimates

- Open-mind attitude, exerting professional scepticism
    - 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?

Mindsets for reviewing significant judgements and estimates

» 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

Thematic approach on key acccounting and auditing matters to assist prudential supervisors

Themes

IAS 1 – Presentation, Going Concern
IFRS 13 – Fair Value Measurement
IFRS 7 – Risks
IFRS 9 – Financial Instruments
IFRS 10, 12 -- Consolidation, off-balance sheet structures
IFRS 40 - 16 - 5 – Investment Property, Lease, Not current assets held for sale
Audit Report

Review guide for the audit report

AUDIT REPORT

1.

Key Financial Statements items, relevant IFRS standards or audit report	■ Identification of key audit matters.
Areas of focus relevant to supervisors or questions for supervisors to consider	Auditors in the new audit report document and explain specific areas, such as risk assessment, impairment, capital management that they have identified during the audit which may need improvement.
Why is it important to supervisors?	Key audit matters are supposed to inform users of financial statements and supervisors about key risks and key issues faced by the bank. They are a complementary source of information for supervisors.
Risks to supervisory objectives	Supervisors should be aware of the key audit matters highlighted by auditors in the audit report as they could identify emerging areas of risks building up in a bank.
Actions for supervisors to consider	

Review guide for the audit report

2.

Key Financial Statements items, relevant IFRS standards or audit report	■ Qualifications of the audit report, if any.
Areas of focus relevant to supervisors or questions for supervisors to consider	Auditors must qualify the audit report they have identified significant material misstatements or areas where they were unable to audit properly.
Why is it important to supervisors?	A qualified audit report (and to a lesser extent, an auditor's emphasis of matter) are supposed to inform users of financial statements and supervisors about key risks and key issues faced by the bank. They are a complementary source of information for supervisors.
Risks to supervisory objectives	A qualified audit report could mean a number of things such as inadequacy of capital, key risks that the bank has ignored or material misstatements of assets and liabilities.
Actions for supervisors to consider	

Pillar 3 disclosures and IFRS 7

Pillar 3 and IFRS 9

- Pillar 3 requires firms to publicly disclose information relating to their risks, risk sensitivities, reserving strategies, capital adequacy and policies for managing risk.
- IFRS 7 provides information on
  - the significance of financial instruments for the entity’s financial position and performance; and
  - the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

Pillar 3 and IFRS 7

- They focus both on risks
  - Market risks
  - Interest rate risks

- They provide both qualitative and quantitative information on those risks

Difference between pillar 3 disclosure and IFRS

- Pillar 3 reporting is regulated by the Basel Committee, follows the Basel Rules and not financial reporting requirements
- Disclosed in Pillar 3 is related to a bank’s risk exposure and risk management, referred to as “risk reporting.
- Can be published in a standalone document or in a discrete section of banks’ reporting
- Pillar 3 not always audited

Summary of approach to critically read banks financial statements

Summary of approach to critically read banks financial statements

1. Understand the economic and business environment the bank operates in.
2. Understand the group structure, business models and risk profile of the bank.
3. Identify areas of focus: significant balance sheet items (and 'off-balance sheet' items), critical sources of income and key risks.
4. Understand the relevant accounting: classification, recognition (and derecognition), measurement, presentation (and disclosure).
5. Review the key accounting policies, assumptions and inputs used by senior management.
6. Question the relevance and appropriateness of the data and assumptions used by senior management.
7. Assess the impact of key accounting requirements on capital and going concern.

Focus : changing market price:

1 **Understand the economic and business environment the bank operates in.**

Understanding which market prices the bank is exposed to and anticipating the impact on the bank of changes in those market prices can be helpful in indicating areas for regulatory focus.

-Changes in which market prices (for example, particular interest rates, particular currency exchange rates and particular commodity prices) are likely most relevant to the bank?

- What are the banks market risk exposures?

- How does it manage its market risk exposures?

ESMA priorities for enforcement

1- Sustainability disclosures (FR vs NFR)
2- Impact of war in Ukraine
3- Macroeconomic environment including interest rate risk

https://www.esma.europa.eu/sites/default/files/library/esma32-63-1320_esma_statement_on_european_common_enforcement_priorities_for_2022_annual_reports.pdf

FT: ECB warns to banks to take more provisions for bad loans,

1- finds increased challenges for indebted household and governments because of inflation.
2- finds growing concerns on liquidity risk

Focus : understanding the business and how it is managed

REVIEW FOCUS

Use management reports to understand :

Organisation (group) structure and changes

- Nature and scope of activities of the bank (lines of business entities);
- Risk appetite of senior management and robustness of internal controls; and
- Management culture to drive the business.

2 **Understand the group structure, business models and risk profile of the bank.**

Exerpt of Société Générale integrated report 2021:

"In 2021, we also made progress on the roll-out of our major strategic projects,
with ambitious objectives across all our business lines and a constant and rigorous focus on execution. In Retail Banking in France, Vision 2025 – the project to merge the Societe Générale and Crédit du Nord networks – is now well advanced and will see the creation of a new bank from 2023, one with a commercially ambitious and efficient model serving 10 million clients."

Focus: Identify key activities in the financial statements

3 **Identify areas of focus: significant balance sheet items (and 'off-balance sheet' items), critical sources of income and key risks.**

REVIEW FOCUS
Supervisors should review key balance sheet items and disclosures and highlight:
- key business segments,
- key sources of income and related key risks faced by the bank

Key risks disclosed in the financial statements are in line and consistent with their understanding of the business model and risk profiles of the bank.?

QUESTIONS FOR AUDITORS

Significant items on balance sheet:

- What are the key items in the balance sheet of the bank?
- Are there significant 'off-balance sheet' exposures?

Key drivers of income:

- What are the key drivers of income for the bank?
- Which line of business is generating more income?
- Which line of business is generating less income?
- Which line of product is generating less income?
- Has there been a recent change in the most profitable line of business or products?

Focus : Measurement

REVIEW FOCUS

Has the bank:

- Identified the appropriate level of the fair value hierarchy?
    - if a bank uses Level 1, is there an identical item? And is the market in which that identical item trades an active market?
    - If a bank uses Level 2, have no significant unobservable inputs been used? And does the bank specify its policy for identifying fair value measurements that have no significant unobservable inputs? Are other banks using the same level for the identical or similar items?
- used an appropriate model?
    - Does the model maximise the use of observable inputs?
    - Are **other banks using the same model** for identical or similar items?
- Are changes in the inputs **compared with prior years** consistent with your understanding of economic changes?

QUESTION TO AUDITORS

The question on the review focus can be addressed to the auditors during the annual or semi annual discussion

4	**Understand the relevant accounting: classification, recognition (and derecognition), measurement, presentation (and disclosure).**

Banks are required to disclose major sources of estimation uncertainty. (paragraph 125 of IAS 1).

Focus : measurement and financial performance

REVIEW FOCUS
1. Accounting methodology versus regulatory methodology;
2. Accounting practices versus regulatory practices;
3. Financial statements and regulatory disclosures;
4. Valuation drivers
5. Market trends;
6. Industry benchmark, practices and knowledge; and
7. Point estimates used with long run average or industry average

QUESTION FOR AUDITORS

Measurement of key balance sheet items and financial performance items:

Has the bank used the appropriate assumptions and estimates to value the assets and liabilities?

Have the assumptions and estimates been reviewed and assessed by independent third parties e.g. external auditors, land and building surveyors, etc.

5	**Review the key accounting policies, assumptions and inputs used by senior management.**

- Has the bank performed comprehensive impairment testing on relevant assets by using the latest available market information and estimates?
- Were the impairment tests reviewed and audited by the internal and external auditors?
- What were the highlights of their review

Focus : differences between accounting and prudential requirements

REVIEW FOCUS

1.Accounting methodology versus regulatory methodology;

2.Accounting practices versus regulatory practices;

3.Financial statements and regulatory disclosures;

4.Valuation drivers

5.Market trends;

6.Industry benchmark, practices and knowledge; and

7.Point estimates used with long run average or industry average

QUESTIONS TO AUDITORS

Use of judgements and estimates and assumptions and linkages between accounting and prudential data:

- Do the IFRS requirements for recognition and valuation of significant items differ from the regulatory requirements?
- Are there any prudential adjustments or prudential filters?
- Has senior management, the audit committee and the board understood clearly the impact and implications of the different requirements between IFRS and the regulatory framework?
- Did the bank explain clearly in the financial statements the impact of key accounting requirements on regulatory capital?
- Did the bank provide clear and meaningful disclosures reconciling the IFRS treatment and regulatory requirements?

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

Focus : Indications on credit risk assessment processes, loan impairment calculations and impact on capital.

REVIEW FOCUS

1.Credit risk assessment and mitigation techniques;

2.Assumptions and inputs used to determine cash flows, effective interest rate, valuations of collateral for the calculations of loan impairment;

iii. Adequacy and impact of loan impairment on capital and going concern status;

iv. Adequacy and impact of valuations of significant portfolio of financial instruments on capital and going concern; and

v. Did the bank appropriately consider all post-balance sheet events and make the appropriate adjustments and disclosures (including going concern assessment effects)

QUESTIONS FOR AUDITORS

Credit risk assessment:

Has the audit committee and the board fully discussed and understood the impact of impairment on the going concern of the bank and the impact on regulatory capital?

Is the impairment testing of loans sufficient and adequate?

What is the impact of loan impairment on profitability and capital requirements?

Did auditors consider the impact on going concern and regulatory capital?

Post-balance sheet events:

Are there any post balance sheet events?

Are the post-balance sheet events affecting the going concern determination?

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

DISCUSSION

THANK YOU FOR YOU ATTENTION

https://cfrr.worldbank.org/sites/default/files/2021-06/ifrs2021_pages.pdf