South African Reserve Bank
From the Office of
the Registrar of Banks

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To banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies

Guidance Note 3/2017 issued in terms of section 6(5) of the Banks Act 94 of 1990

Audit implications of the expected credit loss model for the auditors of banks

Executive summary

The purpose of this guidance note is to bring to the attention of banks, branches of foreign institutions, controlling companies and eligible institutions (hereinafter collectively referred to as 'banks') and the auditors of banks the Staff Audit Practice Alert issued by the Independent Regulatory Board for Auditors (IRBA) on the audit implications of the expected credit loss model for the auditors of banks.

1. Background

1.1 The International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS) 9, *Financial Instruments* in July 2014, replacing International Accounting Standard 39 (IAS 39). IFRS 9 becomes effective for financial periods beginning on or after 1 January 2018. The main change introduced by IFRS 9 is that it is no longer necessary for a credit event to occur before credit losses are recognized, but an entity is required to account for expected credit losses determined either over 12 months or over the lifetime of the asset, depending on the credit risk associated with that asset.

1.2 While IAS 39 impairments also involved the use of assumptions, the expected credit loss (ECL) model that becomes effective after 1 January 2018 will require even more subjective judgement, especially with regard to the forward-looking macro-economic information that will have to be considered in determining the ECL provisions. This creates challenges from a financial statement preparation as well as audit perspective that should be addressed as far as possible through appropriate guidance from the relevant authorities.

2. International Auditing and Assurance Standards Board (IAASB).

2.1 As stated above, impairments generally involve the use of assumptions and management judgement; and as such the audit of impairments is currently governed by International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures*, issued by the IAASB. However, as it currently stands, ISA 540 does not provide adequate guidance on the audit of forward-looking information required to estimate ECL.

2.2 The IAASB recognises the need for additional guidance and has established a task force that is in the process of revising ISA 540 to address the requirements of a number of new accounting standards, including IFRS 9. The expected finalisation of the revision of ISA 540 may, however, not leave sufficient time for auditors of banks to implement the guidance related to the audit implications of the ECL model by the effective date of IFRS 9.

3. Prudential supervision of Banks

3.1 Impairments affect banks' capital and are therefore of particular interest to banking regulators. Principle 10 of the 'Guidance on credit risk and accounting for expected losses', issued by the Basel Committee on Banking Supervision (BCBS) in December 2015[1], states that: *"Banking supervisors should be satisfied that the methods employed by a bank to determine accounting allowances lead to an appropriate measurement of expected credit losses in accordance with the applicable accounting framework".*

3.2 Paragraph 86 of the above BCBS guidance document states that supervisors may make use of the work performed by internal and external auditors in reviewing a bank's credit risk assessment and ECL measurement functions.

3.3 As the South African banking regulator, the Bank Supervision Department (BSD) relies to a great extent on the work of external auditors to obtain comfort around the appropriateness of a bank's impairments. During its consultations with the banking industry and auditing profession, the BSD expressed the need that the auditors of banks should have sufficient and appropriate guidance to ensure appropriate interpretation and application of IFRS 9 and the ECL model in their audits.

4. IRBA Staff Audit Practice Alert

4.1 In response to the need for appropriate and timely guidance on the audit of ECL, the IRBA established the IFRS 9 ECL Task Group to produce audit guidance to South African banks and their auditors on the audit implications of the ECL model. The IRBA issued a Staff Audit Practice Alert [2]relating to the audit implications of the ECL model for the auditors of banks during September 2016.

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[1] See https://www.bis.org/bcbs/publ/d350.htm
[2] See https://www.irba.co.za/guidance-for-ras/technical-guidance-for-ras/staff-practice-alerts

4.2 The aim of the IRBA Staff Audit Practice Alert is to assist auditors in their preparation of the audits of ECL impairments. It addresses the IAASB's objective of consistent high audit quality work by registered auditors and taking such measures necessary to promote and protect public interest.

4.3 The IRBA Staff Audit Practice Alert provides registered auditors with:

4.3.1 The background to the risks and audit implications of IFRS 9 and the ECL model in the banking environment;

4.3.2 A checklist that can be used by the engagement team when considering certain audit implications of the ECL model; and

4.3.3 Related notes.

4.4 It should be noted that the IRBA Staff Audit Practice Alert does not constitute an authoritative pronouncement from the IRBA, nor does it amend or override the International Standards on Auditing, South African Standards on Auditing, South African Auditing Practice Statements or South African Guides.

4.5 Banks and auditors of banks are requested to consider the guidance provided in the Staff Audit Practice Alert relating to the audit implications of the ECL model for the auditors of banks by the IRBA when planning audits of ECL impairments.

4.6 This Office will continue to engage with banks and auditors of banks through the relevant industry forums on the readiness of respective banks and auditors for the implementation IFRS 9 and may, if deemed necessary, issue further guidance or requirements regarding the implementation of IFRS 9 by banks.

5. Acknowledgement of receipt

5.1 Two additional copies of this guidance note are enclosed for use by your institution's independent auditors. The attached acknowledgement of receipt duly completed and signed by both the chief executive officer of the institution and the said auditors should be returned to this Office at the earliest convenience of the aforementioned signatories.

Kuben Naidoo
Deputy Governor and Registrar of Banks

Date: 3/5/2017

The previous guidance note issued was Guidance Note 2/2017, dated 7 February 2017.