The role of internal auditors to implement IFRS9: Case of Lebanese banks

Oussama Chedid and Jamil Chaya*

Department of Financial Studies, Faculty of College of Business Administration, Rafik Hariri University, Lebanon.

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The implementation of IFRS9 as with any structural change to accounting policies requires a strategic development and implementation, and a concerted effort from many departments. This paper investigated the role of internal auditors at Lebanese banks in the implementation of accounting standards. The local banking system is surveyed in a targeted manner to test for significant shortcomings in the ideal strategic implementation of IFRS 9 by internal auditors. This is done by constructing a tailored survey based on the defined role of the internal auditor by regulatory agencies, external auditors, and by international standards with special attention to IFRS 9. The findings suggested that internal auditors in Lebanon did perceive themselves as having the required knowledge for the implementation and on the other hand would have benefited from an implementation plan with an emphasis on strategic synergies between key departments. In a final note, the study found that the implementation of IFRS 9 could find a value added strategic role of the internal auditor if the process of feedback and control started at the front office.

Key words: Internal audit, audit function, IFRS 9, implementation, Lebanon.

INTRODUCTION

The Norwalk Agreement of 2002 between the International Accounting Standard Board (IASB) and the US Financial Accounting Standard Board (FASB) was intended to converge International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (USGAAP). The ambition of the project turned out to be more difficult than anticipated and the agreement slowly progressed. Most significant in these changes was the standardization of revenue recognition, insurance, financial instruments, and leases (BakerTilly, 2014). After the 2008 financial crisis and the criticisms from users of financial statements and external auditors, work was accelerated in order to address the accounting issues which hid some of the pre-crisis signs especially the timeliness of expected credit losses recognition. As a result, in July 2014, the final version of a new accounting principle for financial instruments was created, and became effective as of January 2018 (early adoption was allowed) (IFRS, 2014a, b).

The rising complexity and timely implementation of the new standards pushed local and international regulators to give internal auditors a more important role within

*Corresponding author. E-mail: chayaj@protonmail.ch.

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financial institutions. Traditionally internal auditors are perceived as independent consultants within the institution who provide assurances which add value, manage risk and improve operations, controls, compliance and governance processes. This being said, given the findings of this study, it is advocated that the role of internal auditors should also encompass strategic organizational alignment.

The aim of this paper was to investigate the role of internal auditors at select Lebanese banks in the implementation of accounting standards. The role is defined by the Basel Committee on Banking Supervision Guidance (Bank of International Settlements, June 2012) and was amended to include post 2008-financial crisis practices. Independence, competency, supervisory role all increased significantly in this amended definition. The implementation of IFRS9 has significantly altered optimal banking operation; in this regard, internal auditors must be made strategic actors in the development of strategic operational plans with the goal of increasing profitability, reducing risk, and avoiding the costly repercussions of this implementation.

To accomplish this, several fundamental questions have been identified:

1. Is the role of the internal auditor clearly defined and understood within the Lebanese banking sector?
2. How do regulators perceive the role of internal auditors in Lebanese banks?
3. Is the role of internal auditor segregated from other functions?
4. Are internal auditors knowledgeable in the implementation of IFRS9?
5. Is the internal audit function strategic or supportive in the Lebanese banks? If strategic, where can it add value?

To address these questions, this paper seeks to:

1. Assess the role of internal auditors in the implementation of IFRS 9.
2. Identify the key responsibilities of the internal auditors and the value added that can be created.
3. To provide the national audit body with insight into its implementation.

LITERATURE REVIEW

International standards

To promote confidence in the local financial system and to comply with international standards, the Banque du Liban (Bdl) [or the Central Bank of Lebanon] institutionalized the implementation of IFRS 9 in the local financial sector. The application and the monitoring of IFRS 9 is one way to regain investors’ confidence that has deteriorated as a result of the financial crises (Beerbaum, 2017). This standard was implemented effective as of the 1st of January 2018 in all countries that follow the International Auditing Standards Board; and it has significant impacts on the financial industry. The newly implemented IFRS 9 will replace IAS 39, and will change banking operations materially (Carrasco, 2015). All financial institutions in Europe, MENA region, Asia, Oceania, and Africa will change the way they are calculating their impairment, provisions, and financial reporting (Ibid).

In terms of definition, IFRS 9 defines how an organization would “measure and classify its financial assets, liabilities, and methods to do their contracts to sell or buy non-financial items” (IFRS, July 2014). Financial assets are measured based on the entity’s business model and based on the “contractual cash flow” characteristics. Hence, they are either measured at amortized cost, fair value through profit and loss, or fair value through other comprehensive income. Upon any change made to the business model, the entity has to adjust the classification of the financial assets. Impairment of financial assets is recognized in stages, and is determined based on the level of the credit loss.

IFRS 9 also identifies a framework for measuring financial liabilities. (IFRS, July 2014) They are either measured at amortized cost or at fair value through profit and loss such as derivatives and hedging instruments, especially for those held for trading purposes. It is obligatory to reclassify financial liabilities upon initial recognition only. Entities cannot reclassify them at a later stage. On the other hand, IFRS 9 specifies special provision considerations for three types of hedging instruments such as “fair value hedge”, “cash flow hedge”, and “net investment of foreign operation”. However, entities are allowed to follow IAS 39 for hedging requirements while applying IFRS 9.

Contrary to widespread belief, IFRS 9 not only affects financial institutions. The aim of this standard is to reduce income statement volatility through measuring more assets and liabilities at fair value. It also aims for the early detection of any possible impairment or predicted future credit loss. Some entities will be highly affected by the consequences of this standard. For example, loans in banks are subject to this risk, so these institutions have to consider the possible credit loss even if it is most likely that this loan will be collectible (Price Water Cooper, 2017). The newly required disclosures will help banks optimize their balance sheet and improve their reporting, which will cut costs (Ibid). This standard brings financial stability in addition to other intended benefits and consequences (Institute of Chartered Accountants in England and Wales, 2018).

IFRS 9 goes beyond the work of accounting to impact the entity’s systems and processes. It is not only an accounting change, but a challenge for the organization as a whole (Deloitte, 2017). This paper seeks to assess the critical role of Internal Auditors in the Implementation of IFRS 9. In doing so, a discussion of the key
responsible of the Internal Audit function and then explore areas where value can be added. This study aim to obtain empirical evidence from the Lebanese banking system, as this topic is still new and evolving. Lebanese banks are obliged by the Central Bank of Lebanon (BdL), and regulatory bodies to implement the standard as of the 1st of January 2018. By this contemporaneous nature, we intend to provide the national audit body with an insight into its implementation. To achieve this aim, a mix research approach of quantitative and qualitative analysis is used. 45 surveys were distributed to concerned parties about the implementation of IFRS 9 across the diverse banks operating in Lebanon. Moreover, seven in-depth interviews were conducted to explore the contemporary implementation of this new standard in terms of improvements and difficulties faced.

Role of Internal Audit in IFRS9 implementation at banks

Due to expanding of internal audit responsibilities and in order to achieve skillfully its traditional role by providing objective assurance and consulting activities to the management of the organization in the intent to improve organization operations, the internal audit should enhance its value preservation role and develop a role in value creation by helping management in assessing risks, improving control system, and comply with required rules and regulations (KPMG, 2007).

Internal auditors help their organizations to succeed by enhancing systems design, assessing business models, and providing consulting activities in the sake of improving efficiency and effectiveness of entity operations. Expending internal audit duties enforce auditors to develop their risk-based audit plan to incorporate automated preventive audit that help enhancing control and lowered costs. Internal auditors should develop their skills and knowledge’s to become heavily finance focused in order to meet the recent requirements of accounting standards (Ibid).

The Bank of International Settlements (BIS) released a publication of the role of internal auditors in banks according to the Basel Committee (Bank of International Settlements, 2012). Internal auditors are responsible for providing independent, objective assurance and consulting activity designed to add value, improve and evaluate the effectiveness of risk management, internal control, and governance process in the organization, and are required to abide by local regulations and international standards such as those issued by the Institute of Internal Auditors (IIA). They should use a risk based approach to determine their Audit plans, and must report their findings to management (for instance, Board of Directors in the bank) and to the audit committee and senior management. According to principle 7 reported in this publication, internal auditors have to “ensure proper coverage of matters of regulatory interest within the audit plan.” They have to respond to key risk management issues and adhere to the regularity requirements as depicted in Exhibit 1:

According to the Institute of Internal Auditors, internal auditors are requested by definition to do the following: (Deloitte, 2016),

1) “Assure the presence of assets and advise on the proper safeguards to protect them.
2) Examine the soundness of the internal controls system;
3) Recommend enhancements for these controls;
4) Examine “compliance with policies and procedures and sound business practices”;
5) Assess compliance with laws and regulations.
6) Review operations and programs and check whether they are being carried out as planned and reported;
7) Investigate the occurrence of any possible fraud and other types of illegal and unethical acts such as “embezzlement, theft, waste, etc…”Figure 1 depicts a mapping of how internal auditors are engaged in the different phases of implementation.

Deloitte considers that internal auditors are responsible to assess the availability and quality of data sets that will be used in Expected Credit Loss (ECL) calculations (Ibid). They should review the developed methodologies and models to make sure management is making unbiased and timely estimates. Moreover, they should evaluate practicing strong governance and control to help the bank in achieving the objectives of IFRS 9.

Actually, the globalization of banking operations and financial markets has increased the role of internal audit in evaluating reliable information and in improving sound corporate governance (Ester and García-Perez de Lema, 2012). The Sarbanes-Oxley Act has released several codes related to governance as they found a strong relationship between the quality of governance and protection of users’ interests (Callao et al., 2007). In the Spanish banking industry, new regulatory framework requested internal control to new guidelines for their internal audit functions (IAF) by issuing acts related to finance, transparency, governance, audit and sustainable economy; and enhanced recommendations for more reliable financial reporting (Aldama, 2003). Internal control has a critical role in their monitoring of proper financial reporting. They have a day-to-day role that maintains quality of management actions as well as external auditors’ work. The importance of this role was tested with and without the presence of internal controls (Prawitt et al., 2009). Results proved that sound IAF revealed an environment that is free from fraudulent financial reporting, and reduced the presence of errors by detecting them earlier prior to the external audit work. In the literature, there is limited discussion about the role of internal audit in the implementation of IFRS 9 as our topic is new; but in general, there is a proven relationship between IAF and external auditing, and IAF and financial reporting (Ester and García-Perez de Lema, 2012).
Relationship between internal and external audit

Internal auditors must understand the operational as well as the financial aspects of their entity (Martin and Lavine, 2000). Increased understanding and effectiveness in their work leads to cost savings as this will reduce external audit work. Usually, external auditors examine the soundness of the bank’s internal controls in their planning phase; and the better the controls, the less audit procedures need to be performed, which eventually decreases the external auditing budget (Krishnamoorthy, 2000). Krishnamoorthy added that when examining their work, external auditors should check the competence, objectivity, and work done by internal auditors, keeping in mind that knowledge of the international accounting standards is an essential component of their competency grade.

In the scope of the study, when internal auditors are knowledgeable about IFRS 9, they are competent and less effort will be made by external auditors which would reduce cost. If they are not applying this standard and verifying its proper implementation by the bank’s management, this will be reflected in the external auditor’s report, and incurs losses to the bank from different perspectives. The American Institute of Certified Public Accountants (AICPA) requests this coordination among both parties for a complete audit report, and eliminates the possibility of duplicate efforts (Ester and Garcia-Perez de Lema, 2012).

Internal auditors and financial reporting

Financial reporting is not the sole responsibility of the internal audit function; internal auditors play a vital role in early fraud detection (Committee of Sponsoring Organizations of the Treadway Commission, n.d.). The latter are considered the most knowledgeable parties in the entity in the scope of operational activities. Several studies have proved how they perform analytical tests to avoid irregularities in transactions of high inherent and control risk (Spira and Page, 2003; Sarens and De Beelde, 2006). However, there remains the possibility that as internal parties, internal auditors would misreport the compliance and irregularities done by management for certain incentives (Asare et al., 2008). In an overview of the role of internal auditors in financial reporting, and according to Internal Audit standards, internal auditors have two roles in reporting - strategic and operational.

The operational role involves:

1) “Being engaged in setting the policies and procedures that enhance the planning and organizing of internal audit operations.
2) Complying with the risk management framework to review their work and its impact on financial reporting.
3) Supervising administrative acts such as budgeting, HR practices, etc. to be well directed.
4) Proper technical interviewing before hiring internal auditors, which has an indirect impact on the accuracy of
financial reporting.
5) Reporting on the risk management application and procedures to senior management, as minutes of meeting regarding these issues will be used by external auditors when auditing the financial reports of the bank.
6) Maintaining a proper Quality Assurance Improvement Program to ensure better reporting”.

The strategic role involves (Internal Audit Standards from the Certified Internal Audit Program, 2018):

1) “Coping with changes, and being the catalysts for new changes to financial reporting.
2) Networking with the audit committee and executives.
3) Working as a collaborative team on business process enhancements.
4) Maintaining a proper ethical environment and investigating any ethical dilemma to assess its impact on financial reporting.
5) Educating superiors and senior management on best practices of management and compliance.
6) Coordinating their efforts as internal auditors with external auditors and regulatory bodies.
7) Assessing the bank’s performance in meeting corporate objectives and maintaining an adequate performance system.”

IFRS9 implementation at Lebanese banks

In light of persistent global economic stagnation and regional political-economic turmoil BdL has resorted to financial engineering policies as part of its monetary policy objectives (Banque du Liban, 2016; 2017). Following an operation to acquire reserves from the banks in return for purchasing holdings of Lebanese Pound (LBP) denominated debt at prices including large capital gains for the banks (known as the “financial engineering”), international reserves reached almost US$44 billion. This covers 100% of short-term debt and the IMF reserve adequacy metrics. Banks have been asked to retain part of the profits from this transaction to meet capital requirements stemming from the adoption of IFRS 9, planned for 2018 (World Bank, 2016).

Furthermore, and in order to meet the IFRS9 requirements and Pursuant to the Code of Money and Credit, notably Articles 70, 146, 174, and 182, BdL issued Basic Circular No.143 addressed specifically to the banks, financial institutions, and external auditors. Exhibit 2 shows a summary of the aforementioned circular.

METHODOLOGY

This research used a mix research approach of quantitative and qualitative analysis. Quantitative analysis is performed utilizing a survey questionnaire. In fact, 45 surveys were distributed to concerned parties about the implementation of IFRS 9 across a sample of banks operating in Lebanon while qualitative analysis is performed based on seven in-depth interviews conducted to explore the contemporary implementation of this new standard in terms of improvements and difficulties faced.

A questionnaire designed around professional qualifications, roles and responsibilities, to assess the status of IFRS9 implementation according to internal auditors was developed and distributed to local commercial banks (Appendix A). In addition, guided interviews were conducted with members of regulatory bodies to identify the perceived role of IFRS 9 implementation by external bodies on the proper and adequate implementation and the role of the internal auditors (Appendix B). The results from the research are novel and unique in nature and can serve as a guide in the continued application and transition to regulatory requirements and the vital role played by internal auditors.

Sampling was non-probabilistic, rather convenient, as it targeted internal auditors in majority selected number of the local banks; 42 such questionnaires were distributed. Five comprehensive interviews were conducted with the heads of internal audit departments at five alpha banks. One interview was conducted with the head of the banking risk assessment group at the Banking Control Commission of Lebanon. One interview was conducted with an external auditor from the big four international auditing firms (EY, KPMG,PWC, Deloitte).

It must be noted at this point that no statistical measure beyond a simple mean per question and category is taken because of the nature of the survey. The survey was designed to gauge the landscape and contrast the results to the well-defined role of the internal auditor.

The role of internal auditors was segmented into four distinct categories under which questions were developed to quantify the perception of internal auditors with regard to those roles. These categories were derived from the definitions of roles from the IIA, Basel committee, IFRS, national regulators:

1) Audit model and risk processing
2) Development, validation, and approval
3) Specification and design
4) Implementation and monitoring.

The results from these categories would be compared to the actual expectations from regulators, the IIA, and the head of the internal audit departments. We expect that these roles effectively absorbed by the internal auditors, the results of the survey should display this integration as perceived by the respondents.

RESULTS AND DISCUSSION

General

81.8% of the respondents were between the ages of 35-45 and 62.2% male, and 46.7% holds a masters degree. A third of the respondents have less than 5 years of experience with their employer, and the remaining 67% have over 5 years of experience. 60% of respondents are members of the IIA Lebanon Chapter. 87% self-report having knowledge of IFRS 9 yet 22% report that the

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1 Arab Bank, Bank Audi, BBAC, BLB, BLC, BML, Bank of Beirut, Blom Bank, Blominvest, Capital Finance Company, First National Bank, Fransabank, Lebanon and Gulf Bank, Middle East Capital Group, National Bank of Kuwait, SAMBA Bank, SGBL.
internal audit department does not have a role in the implementation of IFRS9 as it would be a conflict of interest and the role of the internal auditor would come at a later stage. Furthermore, 51.1% of the respondents observed that their respective banks did not coordinate the role of the internal audit department and that of financial control and risk within the implementation of IFRS9. 88.9% of interviewees believe that the internal audit department has the needed capability to complete their work.

Role 1: Audit Model and Risk Processing

58% of the respondents are using internally developed Expected Credit Loss (ECL) Models. 68% of the banks are using the advanced approach with regards to ECL. Both results might suggest an advanced understanding of the IFRS9 implementation.

84.4% of respondents believed that the internal audit function should assess the design and methodology used to calculate ECL. This result is satisfactory as it is in line with the expected role of the internal auditors. It is possible that the remaining 15% of respondents believe that ECL modeling requires advanced expertise under the purview of the risk and IT departments.

91% of the respondents believed that the internal audit department should test the accuracy, completeness, and reliability of data incorporated into the risk model. Thus, a major consensus among internal auditors in Lebanon that in general, they understand their responsibilities in this regard was observed. The 9% whom are neutral may represent those not implementing the standard, or implementing it without proper knowledge and understanding. These banks should enhance the internal audit awareness by encouraging them to participate in training programs related to the topic.

93% of the respondents believe that the internal audit function at the bank should test the implemented model’s consistency with the approved model. It should be noted that the main role of the internal audit is to evaluate and improve the effectiveness of governance process and banking systems in addition to ensuring that IT support and coordination with bank departments is effective and efficient. In that end, 84% of the respondents believed that the internal audit function played an important role in testing the effectiveness of IT support.

In regards to the perceptions of internal auditors in their role of testing ECL models to provide objective results and reporting, and whether there is ongoing monitoring for the whole process, all but one respondent were in agreement that this role is to be assigned to the internal audit function, as testing objectivity and ongoing monitoring of the whole process of IFRS 9 are non-negotiable. The process is on an ongoing basis, rather than a one-time ECL calculation or a one-time test for classification and measurement of assets and liabilities. This is critical for external auditors who base their audit procedures on the extent of work done by internal auditors. The lack in testing and monitoring should push external auditors to perform extensive procedures as they will not be able to depend on internal controls within the bank (Grant, 2017).

With respect to model sophistication and its consistency with the portfolio of assets, the respondents in our survey were 75% in agreement with the role of internal auditors to ensure this consistency. It is of the mind of the remaining respondents that the sophistication of the portfolio is one at the managerial strategy level.

Role 2: Design documentation

Internal auditors should ensure that design documents for model development and usage include appropriate interpretations of IFRS 9 requirements (Basel Committee on Banking Supervision, February 2015). 84% of the respondents did hold this belief, however, the remaining 16% indicate a variance in the way internal auditors deal with the implementation of this standard. This also demonstrates that auditors who did not answer questions regarding the implemented approach and the chosen model, whether simplified or advanced, did also disagree that the internal auditors should make sure that the design documents include appropriate interpretation of IFRS 9 requirements. However, making sure that the documentation of the entire project are available and contain the appropriate explanation regarding the standard is one of the essential roles of internal auditors; and the failure to apply is considered a weakness that must be addressed. Furthermore, 11% of the respondents did not have an opinion in regards to credit risk process within the design documentation. The major aim of this standard is to construct a proper ECL model that helps to expect future credit default and providing against it, in order to mitigates losses. It is the basis for the provision to be taken either at initial recognition or at further stages. Therefore, neutrality reflects a major gap among few internal auditors in Lebanon. However, 84.5% reflected that they are concerned about these crucial interpretations.

The use of forward looking information implied by the Lifetime Expected Credit Losses (unlike single period ECL) within the design documents is fundamental for a well-designed approach. Hence, of the 89% of the respondents in agreement, it is believed they are better equipped to deal with risk, provisions, and losses. The same percentage in agreement believes that the internal audit function needs to include the principles and assumptions underlying the calculations derived in the design documents. This documentation is important for regulators and external auditors.

Role 3: Governance

The internal audit function has a non-negotiable role to
comply with governance standards as it would impose the bank to be fined and sanctioned. It may also expose the credibility of the internal audit resulting in a lack of public confidence. The central bank sets the required system of operation for the whole internal audit body, and they are requested to apply it adequately in all of its aspects. In this regard, all but one respondent was in agreement. In the same spirit, internal auditors must ensure the existence of a formal policy to review and approve the design of models before going live.

Design documentation must be applied in the development process, and it is the role of the internal auditor to ensure that management control processes are in place. In this vein, 96% of the respondents were in agreement.

Role 4: Data

Internal auditors should ensure that data selection is accurate, reliable, and not manipulated. This data is specifically used in the ECL estimations and could be used to decrease provisions (Leventis and Anandarajan, 2011). In this role, 91% of the respondents were in agreement. To accomplish this, internal auditors should make sure the internal control framework is in place for data governance. 96% of the respondents were in agreement. Forward looking estimates must also be audited for accuracy and consistency, in this regard, 80% of the respondents were in agreement. In regards to high risk models, an independent validation unit is requested by the standard yet only eighty-two percent of respondents were in agreement.

Data is also collected on the model performance itself using Key Performance Indicators (KPIs) for monitoring. 76% of the respondents were in agreement. This is indicative that almost a quarter of the sample has not started monitoring the implementation of IFRS 9 using KPIs. However, this has to be done in the near future as KPIs give the internal auditors as well as bank management strong insights into the consequences of this implementation in order to be able to take proper corrective actions in advance.

RECOMMENDATION

Within the framework documentation, data, compliance, and model methodology constructed in this paper to assess the role of the internal auditor in the implementation of IFRS in Lebanon in the fiscal year 2018, it can be concluded that internal auditors within banks self-report to have sufficient knowledge and capacity to implement IFRS 9. Any self-perceived shortcoming in the implementation in regards to roles and responsibilities they should perform can be explained by a lack of experience and may be addressed by further training and mentoring from within the bank.

IFRS 9 implementation did require a concerted effort from the credit, Information Technology (IT), and internal audit department. In this regard, the development and formalization of an audit program may have ensured a more successful coordination across departments and a strategic alignment of implementation, all while conscious of conflicts of interest that may arise. This could have augmented the efficacy of the following bank functions with respect to the dramatic changes caused by IFRS 9:

1) Portfolio strategy: strategic loan duration, collateral quality, borrower profile
2) Lending policies: emphasis on short term loans and early redemption
3) Credit risk assessment: improve early warning system, increase monitoring
4) Credit policy: introduce new risk limits, improve the link between bank risk appetite and loan agents
5) People management: change incentive policy and performance metrics, provide trainings.

CONFLICT OF INTERESTS

The authors have not declared any conflict of interests.

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APPENDIX

Appendix A - Questionnaire

SECTION 1: GENERAL INFORMATION
1. Gender [ ] M [ ] F
2. Age [ ] 25-34 [ ] 35-45 [ ] 45 and above
3. What is your highest academic qualification?[ ] Diploma [ ] Degree [ ] Masters[ ] other, specify_______________________
4. Name of the Bank you work for:____________________________________________________________________
5. How long have you been working in the aforementioned Bank?[ ] Less than 5 years [ ] Between 5-10 years [ ] Between 11-20 years[ ] Over 20 years
6. How long have you been working in the audit department?[ ] Less than 5 years [ ] Between 5-10 years [ ] Between 11-20 years[ ] Over 20 years
7. Are you a member of IIA- Lebanon chapter?[ ] Yes [ ] No
8. Do you have an overall knowledge about IFRS9?[ ] Yes [ ] No
9. Do you believe that the Internal Audit departments should assist in the implementation of IFRS9?[ ] Yes [ ] No
10. Did the Internal Audit department in the above mentioned Bank play the role of coordinator between the concerned departments, mainly Financial Control and Risk Department, in the implementation of IFRS9?[ ] Yes [ ] No
11. Did the Internal Audit department complete the IFRS9 audit?[ ] Yes [ ] No
12. Do you think that the Audit Department has the needed capability and authority to finalize their work in an independent, efficient and proficient way?[ ] Yes [ ] No
13. Regarding calculation of ECL, is the Model used internally developed?[ ] Yes [ ] No
14. What is the model your bank is using to calculate ECL?[ ] Simplified Approach [ ] Advanced Approach
15. Explain the advantages of the chosen approach?

SECTION 2: FACTORS AFFECTING AUDITORS’ HIGH QUALITY PERFORMANCE
A.1 this is to determine if the Audit program content is effective, accurate and in line with international standards requirement. Please choose the most appropriate response whether you agree or disagree with the below statements. Use 1-5 as follow:

1- Strongly disagree 2- Disagree 3- Neutral 4- Agree 5- Strongly agree

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<th>Audit the model and process risks</th>
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<td>A.1.1. The Internal Audit department should assess the design and the methodology used to calculate ECL.</td>
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<td>A.1.2. The Internal Audit department should test the accuracy, completeness and reliability of data incorporated into the risk model.</td>
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A.1.3. The Internal Audit department should test that the implemented model is consistent with the approved model.

A.1.4. The Internal Audit department should test that the model in place provides objective results and reporting, and there is an ongoing monitoring for the whole process.

A.1.5. The Internal Audit department should test the effectiveness of IT support.

**SPECIFICATION AND DESIGN**

A.2.1. The Internal Auditors should make sure that design documents include appropriate interpretations of IFRS9 requirements.

A.2.2. The Internal Auditors should make sure that design documents include appropriate credit risk processes.

A.2.3. The Internal Auditors should make sure that design documents include complete and accurate forward looking information.

A.2.4. The Internal Auditors should make sure that design documents include key principles on how calculations are determined.

A.2.5. The Internal Auditors should make sure that the bank uses appropriate governance standards.

A.2.6. The Internal Auditors should make sure that the bank is abiding by a formal policy to review and approve the design of models before going live.

A.2.7. The Internal Auditors should make sure that the model approach is:
- Consistent with IFRS9
- Reflecting the sophistication of the portfolio
- Designed by experts

**DEVELOPMENT, VALIDATION AND APPROVAL PHASES**

A.3.1. The Internal Auditors should ensure that the design documents are applied in the development process and that management control processes are in place.

A.3.2. The Internal Auditors should make sure that the data selected is accurate and reliable, and cannot be manipulated.
A.3.3. The Internal Auditors should make sure that an internal control framework is in place for data governance (assessing the data manipulated, and key parameters used in credit modeling).

A.3.4. The Internal Auditors should make sure that the forward-looking estimations are accurate and consistent.

A.3.5 The Internal Auditors should make sure that an appropriate detailed testing for high risk models is being conducted by independent validation unit in order to test overall process, including:
1. Methodology used in development
2. Accuracy of the model used
3. Sources of data

A.3.6 The Internal Auditors should make sure that there is a set of procedures to prevent data modification / manipulation without proper approval and documentation.

IMPLEMENTATION AND MONITORING

A.4.1 The Internal Auditors should make sure that the data used to calculate ECL is complete, accurate and reliable.

A.4.2 The Internal Auditors should make sure the reporting process is approved and authorized.

A.4.3 The Internal Auditors should make sure that the codes and parameters used can't be changed or manipulated.

A.4.4 The Internal Auditors should make sure that the approved assumptions are correctly applied.

A.4.5 The Internal Auditors should make sure that appropriate KPIs were selected to monitor model's performance.

In your opinion, what are the other possible actions that Internal Auditors should take in order to enhance their role in the implementation of IFRS9?

_______________________________________________________________________________________________
_______________________________________________________________________________________________
_______________________________________________________________________________________________
_______________________________________________________________________________________________

Thank you for your time
Appendix B

Summary of Interviews Conducted Internal Auditors
• There is no Audit Program prepared for IFRS9 implementation.
  • Almost 50% of respondents said that they participated in the committee established for implementation of IFRS9, and the remaining interviewees consider this as a conflict of interest and the role of internal auditors become at a later stage before implementation.
  • Most of them assured that the assumptions are reasonable and supportable and based on justifiable information.
  • All of them assured that the methodology used is in accordance with IFRS9
  • They assured that the collected historical data are sufficient and reliable.
  • They checked all policies prepared for the implementation (credit rating policy, staging policy, impairment methodology, risk appetite, risk limits, percentage of each and every investment from the approved total investment).
  • They also did the assessment of the business model (classification of investment).
  • They reviewed the risk factors that affect the loans, and the criteria used to classify them and change this classification.
  • They checked the ECL calculation and made sure that the formula used is within the approved scenario.

Interview with Regulator
• There is no direct role of the Internal Audit Department in the implementation of IFRS9, but they encourage auditors to play the coordination role between concerned departments.
  • It is a joint effort between Risk and Finance, the internal auditor may assist in the committee.
  • The regulator asks internal auditor through BDL circular # 77 to check the policies and procedures for the entire bank operation, and no need to remind them about their role, and the regulator expects that the overall implementation is reviewed and assessed by the internal auditors in order to meet the IFRS9 requirements.
  • The regulator doubt was about the conflict of interest faced in different local Lebanese banks, where the external auditor is the supplier who provides the software used in staging and calculating ECL.
  • The regulator asks why banks used the PD/LGD methodology to calculate ECL? (Bearing in mind that this is beyond their responsibilities)
  • The regulator did not oblige any bank to use any methodology, in their opinion IFRS9 is an accounting treatment and their role is concentrated regarding the way they organize the effect of this standard on banks profitability and equity.
  • There is new circular that may be published later on, that is going to add stage I to tier 2 equity.
Exhibit 1. Key risk management issues.

a) Risk Management: Internal auditors have to ensure that the bank adheres to regulatory provisions and implements safe business practices by including in their scope of work actions related to credit concerns, interest rate risks, and liquidity issues, legal and operational risks. They have to assess risk tolerance and make sure that the bank abides by the approved risk appetite, and ensure a proper reporting of actions done by the risk management team. They also have to evaluate the processes performed by this team, their integrity, verify risk models, and approve the consistency and reliability of data used.

b) Capital Adequacy and Liquidity: As requested by international regulatory framework internal auditors have a major role in strengthening capital, and enhancing liquidity. They should assess the adequacy of capital and ensure that the bank solvency is within Basel requirement. The Internal Auditor should also review management procedures to check, monitor and review the risk profile of the organization as referred to as an internal audit function and should fall under its umbrella.

C) Regulatory and Internal Reporting: This represents the responsibility of ensuring timely reporting and calculation of ratios especially ratios related to capital adequacy. The internal auditors are also responsible to make sure that the bank abide by Basel requirement regarding pillar 3 (market discipline) and issuing easily identifiable reports to users, they are also responsible to confirm that proper regulatory disclosures such as the guidelines on disclosure requirements on IFRS9 transitional arrangements and internal governance in order to enforce the importance of transparency and market self-restraint.

d) Compliance: The bank’s compliance (operational, legal and AML compliance) should be assessed periodically by internal auditors who should promote the proper application of policies and procedures and encourage implementation of internal and external laws and regulations.

e) Finance: Internal auditors increase data accuracy and improve the reliability of financial statements; internal auditors take responsibility for evaluating calculation of some ratios, profit and loss estimation, and assessing the bank’s practices. They

Exhibit 2. Circular No. 143.

| Article 1 | All banks and financial institutions are obliged to start applying IFRS 9 and the amended version related to disclosures regarding financial instruments as of the effective date January 1, 2018. They should comply with this international financial reporting standard in all of their financial statements, both individual and consolidated. |
| Article 2 | Banks are requested to document their adoption to a business model that aligns with IFRS 9 requirements of financial assets and their corresponding contractual cash flows. |
| Article 3 | To sell financial instruments, the bank has to adopt a business model that has an objective that meets these cash flows and that allows them to do this trading. Otherwise, this transaction should be reported as exceptional. |
| Article 4 | To sell financial instruments, the bank has to follow the “derecognition” requirements of this standard, and to follow the market rules and market value. If the instrument is not listed, the bank should practice due diligence to assess its selling price. |
| Article 5 | Related specifically to the accounting department, and discusses methods of amortization of swap, its profits, and operations related to selling or buying financial instruments. |
| Article 6 | Discusses credit loss and corresponding provisions to be taken by the bank. Each is determined by the classification of the asset or liability, and any significant change in the related risk. In determining this risk, several approaches such as the “Historical Loss Approach”, or the approach based on both the “Probability of Default” and the “Loss Given Default parameters” can be adopted. |
| Article 7 | Discusses the way credit risk should be taken, and how it should be assessed periodically through a three stage process: performing assets & liabilities not exposed to risk, underperforming the latter that showed an increase in risk, non-performing credit impaired assets and liabilities into substandard, doubtful, and bad debts. |
| Article 8, 9 & 10 | Discusses the responsibility of the board of directors, audit committee, executive level management and risk management unit role in IFRS 9 implementations. |
| Article 11 | This article is the bedrock of our study as it discusses the role of the internal audit unit to independently assess the level of compliance with IFRS 9. It has to assess the proper implementation of the required policies and procedures, and those related to calculations of expected credit loss, specifically provisions. All of these should be performed as required by the standard. |
| Article 12 | Provisions on assets and liabilities should be taken in the currency of reporting on the (on and off balance sheets). |
| Article 13 | Banks should take the provisions based on the balance as at 31 December 2017. Collective provisions are to be taken on the surplus resulting from selling LBP financial instruments or the purchase of foreign currency ones. |
| Article 14 | If the reported amount of provisions regarding credit loss as of 1 January 2018 is below what is expected, it should be covered using the general reserve. |
| Article 15 | If the reported provisions balance exceeds what is expected, it should be reclassified to an account named “general provisions” or it may be transferred to the income statement; and all released provisions will be shown under the general reserve that will be discussed in the following article. |
| Article 16 | The bank should establish the account of general reserve based on the credit portfolio of performing loans rather than the retail ones. “Un-distributable General Reserve” should be transferred to “Un-distributable Retained Earnings”. The conversion of reserves taken in LBP to other currencies is prohibited. |
| Article 17 | The bank should take collective provisions on foreign currency credit losses under the account “foreign currency reserves”. |
| Article 18 | External auditors are requested to express their opinions about the bank’s implementation of IFRS 9. |
| Article 19 | The central bank should provide banks with models of balance sheets that show the provisions accounts and a guide for proper compliance. Article 20 and 21: This decision should come into effect upon issuance, and it should be published in the official gazette. |

Source: (Banque du Liban, 2017).