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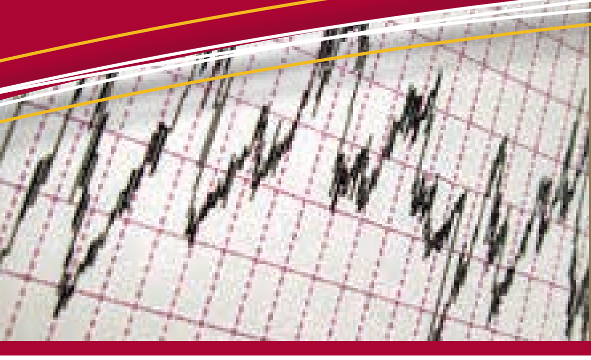


Auditing Considerations in a Prolonged Uncertain Economic Environment

August 2012

Introduction

In April 2009, the Auditing and Assurance Standards Board (AUASB) issued an AUASB Bulletin, "Auditing Considerations in an Uncertain Economic Environment,"[1] and this update is to be read in conjunction with that AUASB Bulletin. The purpose of this update is to remind auditors to remain alert to issues associated with prolonged economic uncertainty that may individually, or in combination, impact on the audit approach.

This updated Bulletin is not intended to be exhaustive in its discussion of auditing considerations in a prolonged uncertain economic environment. The degree to which such considerations are applicable to individual engagement circumstances are a matter of the auditor's professional judgement. Furthermore, the update is not intended to replace the relevant requirements and guidance contained in Australian Auditing Standards and auditors are encouraged to read the relevant Auditing Standards applicable to their audit engagements.

2009 Economic Environment versus 2012

The financial crisis of 2008-2009 affected the liquidity, credit availability, trading market and financial stability of many entities, within the United States of America and globally and consequently led to a period of economic downturn and uncertainty. Subsequent to this, several countries have also experienced a sovereign debt crisis, with their governments responding by introducing stringent economic measures to reduce the debt and prevent further escalation of the crisis. The side effects of these measures on the affected economies have been significant and include diminished consumer and business confidence with resultant economic impacts. 2012 has, for a number of reasons, seen this economic downturn continue and consequently become prolonged.

Changes to Overall Audit Strategy

Auditors when performing audits in this environment, need to understand and consider how the prolonged uncertainty may potentially affect each individual audit engagement strategy. Considerations may include the type of entity (for example, a for-profit entity or a not-for-profit entity), nature of the industry in which it operates (for example, mining, retail, manufacturing, distribution, or services), its business model (for example, low cost/high margin or high cost/low margin) and the types of products or services it offers (for example, "essential", "discretionary", or "luxury"). Once auditors obtain such an understanding, they may then plan and design an audit process that enables them to appropriately respond to (i.e. test) assessed risks and obtain sufficient appropriate audit evidence on which to base a reasonable assurance audit opinion. Auditors should consider any implications for their audit approach of the findings contained in ASIC's most recent published Audit Firm Inspection Report,[2] as well as the areas of focus announced for the current year's inspection program.

For continuing audits, all auditors need to be reminded, notwithstanding that they may have been on the individual audit engagement for a number of years, of the importance of maintaining an attitude of professional scepticism in questioning key decisions, assumptions

1 While the AUASB Auditing Standards referenced in the April 2009 AUASB Bulletin have been superseded by revised and reissued Auditing Standards (October 2009), the principles and procedures discussed in the Bulletin remain consistent between both suites of Standards.

2 Refer www.asic.gov.au for a copy of the most recent audit firm inspection report.

or explanations of management ("do not accept, but question"). They should also be informed of any assessed risks to the entity and its financial report due to the prolonged economic uncertainty, as well as the overall planned audit approach. Key audit findings should be shared within the audit team, so that the findings can be compared and evaluated for reasonableness and consistency with expectations. Senior team members (managers, directors and partners) should be involved throughout the audit process to ensure that audit work remains focused on appropriately addressing key risk areas, and is appropriately documented.

Identifying and Assessing Risk

There are certain audit risk factors[3] that, in a period of prolonged economic uncertainty, are particularly significant for auditors to consider when identifying and re-assessing the potential for the entity's financial report to be materially misstated. This is in part due to their potential to affect multiple audit assertions (for example, completeness, accuracy, cut-off, valuation and allocation) and relate to different classes of transactions, period end account balances, events and/or disclosures within the financial report (for example, going concern).

Some of these risk factors are highlighted below, and have been summarised into broad categories for ease of review, however their potential impact is not limited exclusively to these categories.

Management's policies & procedures

- Management has not documented, or refuses to document, their assessment of the entity's ability to continue as a going concern or does not provide supporting documentation or evidence for key assumptions and calculations.
- Management appears reluctant to accept certain terms of engagement, including providing the management representation letter.
- Management has reduced operating expenses through staff redundancies in key areas which has resulted in reduced, or no, monitoring ability of key business processes, and a decrease in internal control. Examples of key areas include monitoring or supervisory activities including internal audit, information technology support, accounting, administrative services, payroll, or other "back office" roles.
- Key roles within the entity have been filled by less experienced staff.
- An environment exists where attitudes to fraud or riskier business practices appear accepted or condoned by management (for example, events or conditions have occurred that may indicate an opportunity to carry out fraud or has created incentives to perpetrate fraud.)
- Management is known to be under extreme pressure to maintain profitability or the forecast outlook regardless of current conditions.
- Management or other key staff have known personal commitments/ pressures, which may affect their business judgements or decisions, or increase their potential to commit fraud.

Operations

- The nature of the entity's operations makes it particularly sensitive to the effects of widely fluctuating or prolonged increases in currency or interest rates (for example, the entity is an exporter who is not able to lock in forward sales contracts for its products).
- The industry in which the entity operates has been severely impacted by the prolonged uncertainty through reduced demand for its products/services sold, increased price competition, increased product obsolescence, and/or increased costs of key components of the products/services.
- The entity has recently changed key aspects of its business strategy, operations or future business plans in response to the economic downturn. This may be by changing the number, type and/or nature of products/service lines offered (for example, the mix of those that are profitable or are "loss leaders"), or by expanding into new or emerging markets in which it lacks sufficient knowledge or expertise.
- Significant staff redundancies have been made or announced which call into question the ability of the entity to meet forecast expectations, or to continue operating in its current form.
- The entity utilises complex financial instruments to manage risk in its trading business and is particularly sensitive to small or adverse movements in their market valuations.
- The entity has significant assets or asset classes whose current valuations indicate they are likely to be impaired.
- The entity has significant direct or indirect exposure to the sovereign debt risk of countries adversely impacted by the prolonged economic conditions (for example, through debt holdings, being a major market for the entity's products/ services, or as a result of trading with entities with such exposure).

Financing

Obtaining finance

- Withdrawal of credit from lenders that had previously provided the entity with easy access to credit whenever necessary.
- Uncertainty over whether current or prospective lenders will continue existing credit facilities on similar terms, if at all.
- Difficulty in obtaining credit due to the nature of the industry in which the entity operates (for example, retail or manufacturing).

3 See also ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, as amended.

- Cross guarantees are not likely to be, or will no longer be, available to support the entity.
- Downgrading of the credit status of the entity by a recognised credit ratings agency.
- Excessive pressure is known to exist on management due to the need for the entity to obtain additional debt or equity financing to stay competitive (for example, to finance major research and development, or required capital or operating expenditures).
- Indications of withdrawal of financial support by creditors or parent/group entities.

Servicing finance facilities

- Indications that lenders may not renew current borrowing facilities due for repayment within the next twelve months, or may adversely change credit terms (for example, reserving the right to make all borrowings repayable on an "at call" basis.)
- The entity is currently in default in making required debt payments.
- The entity has advised it has breached, or is close to breaching, debt covenant requirements, or the terms of loan agreements.
- There has been a change in pre-existing credit terms which has adversely impacted the entity's ability to make required repayments (for example, shortened repayment time, increased loan security requirements, increased interest rate or all facilities now on an "at call" basis.)
- All, or most of, the entity's borrowings have been re-classified as current in the balance sheet during the financial year (despite not being required to be repaid within the next twelve months) resulting in a technical current net liability position, and/or breaches of borrowing covenants.
- The entity or its parent entity has indicated it may be required to honour group guarantees to assist another group entity which will put pressure on the entity's ability to make required borrowing repayments or to continue its normal operations.

Customers

- Key customers struggle to meet credit terms.
- Increased doubtful or bad debts.
- Significant declines in customer demand and increasing business failures in either the industry or the overall economy.
- *Suppliers*
- Further tightening of credit terms by suppliers (for example, from net 30 days to net 7 days).
- Key suppliers are known to be experiencing significant trading difficulties, and consequently the entity may not receive goods or services when required to meet customer demands.
- The entity has not been able to find another supplier to replace the loss of a key supplier of goods/services.
- There is continued reliance on certain key suppliers to provide goods or services in order to meet customer commitments.

Accounting related

- The entity extensively uses accounting estimates, particularly fair value measurements, for material asset or liability classes, which have a considerable valuation range and are sensitive to small movements.
- Equity accounted investments have not been re-valued recently, or the valuation results in no change in fair value.
- Recorded accounting estimates are more aggressive than previously used.
- The entity has experienced recurring negative cash flows from operations, reduced operating profit, a deficiency in working capital or net assets, or a deteriorating net asset position.
- There is a known continued decline in the market value of material assets.
- The entity's standard costing of inventories has not changed to meet identified longer-term changes in underlying material, labour or overhead costs, or now incorporates price or volume variances or other items not previously included.

Assessment of Materiality

The assessment of materiality[4] applicable to an individual audit engagement by auditors is especially critical in prolonged and uncertain economic times, as the materiality levels set (performance and overall) will determine the nature, timing and extent of audit procedures to be performed on account balances, transactions and disclosures within the entity's financial report.

If the overall audit is considered to be "riskier" than in previous years, the overall financial report materiality level will ordinarily be lowered. If specific risk factors have been identified (such as those identified above) that relate to particular account balances, transactions or disclosures in the financial report, then overall performance materiality at this level would also ordinarily be lowered as well. Auditors should be prepared to re-assess materiality levels during the audit if matters come to their attention that requires such a re-assessment.

4 See also ASA 320 *Materiality in Planning and Performing an Audit*, as amended.

Responding to Assessed Risks

How auditors respond to identified risks[5] is of particular importance in a period of prolonged economic uncertainty because of the increased potential for some or all of the risks individually, or in combination, to create doubts over the entity's ability to continue as a going concern. Additionally, risks that are more significant may be identified that require special audit consideration.

Some of the possible risk responses are highlighted below, and have been summarised into broad categories for ease of review, however their potential impact is not limited exclusively to these categories.

Audit Process

- Work on significant risks should be allocated to, and addressed by, more senior audit team members, with the results discussed with other team members to ensure they are taken into account in all related audit areas.
- Reviewing minutes of meetings of shareholders, board of directors and appropriate entity committees in order to understand key issues considered and decisions taken regarding the entity's current and future prospects.
- Reviewing contracts, loan agreements, leases and correspondence from regulators and other government agencies.
- Making enquiries of legal counsel, internal audit personnel and senior management concerning certain matters.
- Including a clause in the proposed management representation letter containing detailed representations by management about their assessment of the entity's ability to continue as a going concern.
- Ensuring an element of unpredictability is present in the selection of the nature, extent and timing of audit procedures so that the likelihood (risk) of not identifying intentional or unintentional errors in the financial report is reduced to an acceptable level.

Financing

- Monitoring, reviewing and evaluating available cash flow forecasts to determine whether the terms of loan agreements can be complied with.
- Identifying other potential sources of credit and avoiding reliance on one specific source.
- Obtaining supporting information concerning bank guarantees from bank confirmations.
- Inspecting relevant documents for any possible guarantees made by the entity and considering their nature, and impact on, the entity if they were to be enforced.
- Determining whether there is adequate financial support available, if required, for the entity.

Operations

- Obtaining an understanding of the business rationale for significant transactions that are outside the normal course of business.
- Ensuring there is a business plan in place to continuously identify new markets, licensees and suppliers.
- Enquiring of management as to whether there are any:
    - changes in commitments, borrowings or guarantees or other contingencies;
    - events that have occurred that indicate impairment of recorded asset values (for example, goodwill, property and infrastructure assets);
    - changes or proposed changes in the share capital or long-term debt arrangements;
    - significant developments in areas the entity had identified as key risk areas;
    - unusual accounting adjustments that have been made, or are contemplated, subsequent to the reporting date;
    - events that have occurred that affect the assumptions used in valuations and accounting estimates; and
    - events that have occurred, or are likely to occur, that may bring into question the appropriateness of accounting policies used in the financial report, as would be the case, for example, if such events call into question the appropriateness of the going concern assumption.
- Considering whether asset depreciation rates require reassessment, especially those based on units of production.
- Considering the appropriateness of the carrying amount of assets (including investments in joint ventures), and the risk that they may not be recoverable.
- Considering if there are any indicators of payment problems (for example, payroll or external suppliers).
- Determining whether the entity has actively identified other potential suppliers of required goods or services to reduce the reliance on any one supplier.
- Considering any indicators of receivables collection problems such as an increase in days' sales outstanding, the ageing of receivables, the amount of overdue receivables, and post-reporting date cash receipts review.

5 See also ASA 330 *The Auditor's Responses to Assessed Risks.*

Evaluation of Management's Going Concern Assumption

The 2009 AUASB Bulletin identified management's use of the going concern assumption[6] in the preparation of the entity's financial report as one of the key issues which may be affected by the economic uncertainty and it continues to remain so when that uncertainty is prolonged. Again, the exercise of professional judgement and scepticism by auditors throughout the evaluation process remains critical in ensuring the appropriate evaluation of management's assessment and conclusion on the appropriateness, or otherwise, of the going concern assumption.

Auditors need to be mindful of their responsibility to critically question and evaluate management's use of the going concern assumption in every engagement and not to merely review and accept it. This includes auditors challenging the logic of management's approach, its completeness (does it address key issues or concerns?), the reasonableness of all key assumptions underlying the assessment (are they consistent with other evidence obtained?) and methodology (does it make sense?). Auditors should also consider possible alternatives to the options selected by management by considering audit evidence already obtained, or in performing additional audit procedures (for example, if there is a potential material uncertainty). Refer Appendix 1 to this Bulletin for an updated illustration of the relationship of the auditor's going concern considerations with the different types of audit opinions.

Special audit considerations to take into account in evaluating management's going concern assessment in a prolonged environment of economic uncertainty include:

- If management has not prepared such an assessment or does not agree to do so, enquire of management the basis for the intended use of the going concern assumption in the preparation of the financial report.
- Has management documented in writing its assessment and supported it with current and available documentation? Documentation could include the entity's current business plans, cash flow forecasts, forward budgets, terms of loan agreements, and a detailed analysis of the prospects of key financial statement line items (for example, examining the forward order book for evidence of contracted sales), the results of which have been taken into account in the assessment.
- Has management adapted its assessment to suit the continued economic uncertainty and business reality reflected in the financial report? If the approach taken by management in assessing going concern is the same as in prior years, auditors should evaluate if this is appropriate, given their understanding of the entity gained through the audit process.
- Are there known internal or external pressures on management to maintain a positive (less conservative and more aggressive) future assessment of the entity despite the uncertain economic conditions?
- If the entity depends on external financing to fund its existing business activities, has management made an assessment of the likelihood of the current facilities being continued (if they are due in the next twelve months) on the same terms or of the likelihood of obtaining other facilities on the same terms?
- Is management's assessment consistent with the auditor's understanding of the entity and its prospects? For example, are assets and liabilities recorded on the basis that the entity will be able to realise its assets, discharge its liabilities, and obtain refinancing (if necessary) in the normal course of business?
- If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, has the auditor performed additional audit procedures (including consideration of any mitigating factors) to confirm the existence of a material uncertainty?
- Has the auditor evaluated the reasonableness of all assumptions used in the assessment through the use of other audit procedures (i.e. analytical procedures, enquiry, or other testing, such as recalculating key financial ratios)?
- Has the auditor considered whether any additional facts or information have become available since the date of the initial going concern assessment and up until the audit signoff date, which may cast doubt on the appropriateness of the going concern assumption?
- Does the auditor agree that the financial report disclosures regarding going concern are adequate?

6 See also ASA 570 *Going Concern*, as amended.

Documentation Requirements

In a prolonged period of economic uncertainty, auditors need to be especially vigilant to include sufficient and appropriate documentation[7] in the audit file to support all conclusions on the work performed. This would include, for example, documentation supporting the evaluation of management's going concern assessment (including challenges made to key assumptions made, or alternative options considered to those chosen by management). Such documentation ensures that auditors have a sufficient and appropriate record of the work performed to support the conclusions reached and the opinion in the auditor's report. It also demonstrates that the audit was performed in accordance with Australian Auditing Standards and applicable legal and regulatory requirements.

Summary

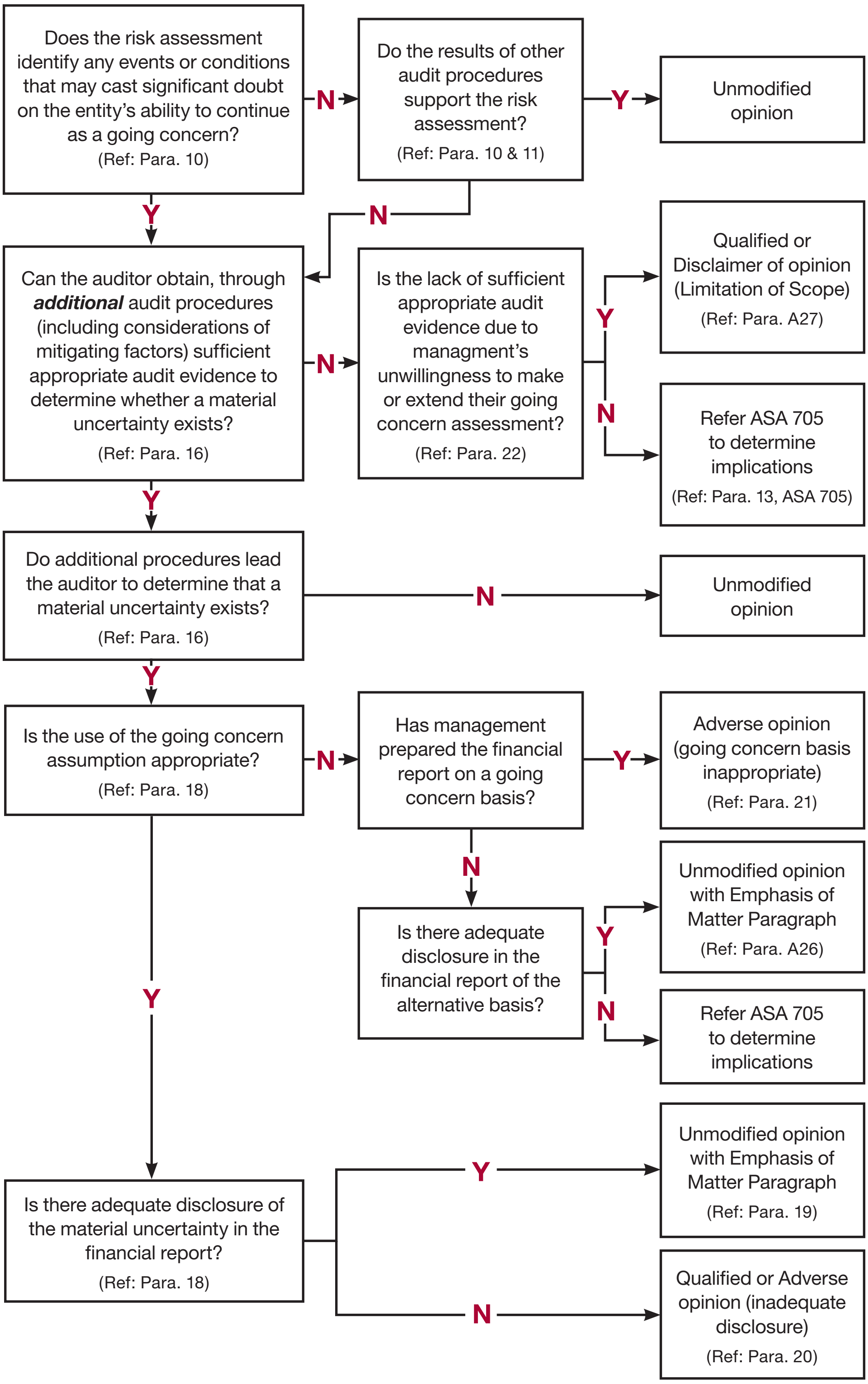
Auditors need to be mindful that in a prolonged period of economic uncertainty, it is particularly important they exercise professional judgement and professional scepticism in identifying and assessing the potential and actual impact of such an environment on the individual entity's financial report. This will also help auditors design and perform audit procedures that adequately address the assessed impact and ensure they obtain sufficient appropriate evidence on which to conclude, with reasonable assurance, whether the financial report as a whole is free from material misstatement.

Disclaimer

AUASB Bulletins are issued to raise a general awareness of matters that are of interest to auditors and assurance practitioners. They do not provide authoritative guidance and do not amend existing Auditing Standards and Guidance Statements. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this AUASB Bulletin, or for any errors or omissions in the document.

7 See also ASA 230 *Audit Documentation.*

Appendix 1: Linking Going Concern Considerations with Types of Audit Opinions[8]



Note: Audit opinions referred to in this diagram must comply, as appropriate, with:

ASA 700 *Forming an Opinion and Reporting on a Financial Report.*
ASA 705 *Modifications to the Opinion in the Independent Auditor's Report.*
ASA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.*

8 See [Aus] Appendix 1 of ASA 570 *Going Concern*, as amended.

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PO Box 204
Collins Street West
Melbourne 8007
Australia

Phone: +61 3 8080 7400

Fax: +61 3 8080 7450

Email: enquiries@auasb.gov.au