Auditing Considerations in an Prolonged Uncertain Economic Environment

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. Its purpose 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 update 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 initial financial crisis in 2008-2009 affected the liquidity, credit availability, trading market stability and financial stability of many entities, in the United States of America and globally and consequently led to a period of economic downturn and uncertainty. 2012 has seen this climate of economic uncertainty continue, resulting in an environment of prolonged downturn largely emanating from conditions in Europe.

Changes to the overall audit strategy

Auditors performing audits in this environment need to understand and consider how the prolonged uncertainty may potentially affect each individual engagement audit strategy. Considerations may include the type of entity (for example for-profit entity or 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 the auditor obtains such an understanding, the auditor may then able to plan and design an audit process that enables them to appropriately respond to (test) assessed risks and to obtain sufficient and appropriate audit evidence on which to base a reasonable assurance audit opinion.

[1] While Auditing Standards referenced in the 2009 Bulletin have been superseded by Clarity Auditing Standards, the principles and procedures discussed in the Bulletin remain consistent between both suites of Standards.

For continuing audits, all auditors will need to be reminded notwithstanding that they may have been on the audit engagement for a number of years, of the importance of maintaining an attitude of professional scepticism in questioning key decisions, assumptions or explanations of management ("do not accept, question"). They should also be informed of any assessed risks to the entity and its financial report due to the continued 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 or partners) should be involved throughout the audit process to ensure that audit work remains focused on appropriately addressing, key risk areas, and is adequately documented.

Identifying and Assessing Risk

There are certain audit risk factors that in a period of prolonged economic uncertainty are particularly significant for auditors to consider when identifying and reassessing 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 or allocation); relate to different classes of transactions, account balances, events, and/or disclosures within the financial report; including going concern.

Some of the risk factors are highlighted below, and have been summarised into broad categories for ease of review, but 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.

- 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 such as monitoring or supervisory activities including internal audit, information technology support, accounting, administrative services, payroll, other "back office" roles, which has resulted in reduced or no monitoring ability of key business processes. Internal control has been diminished.

- Key roles within the entity have been replaced by less experienced staff.

- An environment exists where attitudes to fraud or riskier business practices appears 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 maintain the forecasted outlook regardless of current conditions.

- Management or key staff has known personnel commitment pressures, which may affect their business judgements or decisions.

Operations

- The nature of the entity's operations makes it particularly sensitive to the effects of fluctuating or prolonged increased currency or interest rates (for example it is an exporter who is not able to lock in forward 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 (for example, number and type of product or services lines offered) or future business plans in response to the economic downturn. This may be by changing the type and/or nature of products/service lines offered (for example, the mix of those that are profitable or are "loss leaders"), expanding into new or emerging markets which it lacks sufficient knowledge or expertise in.

- Significant employee redundancies have been made or announced which call into question the ability of the business to meet forecast expectations or continue operating in its current form.

- The entity utilises complex financial instruments to manage risk in its trading business and is sensitive to small or adverse movements in their mark to market fair value valuation.

- The entity has significant assets or asset classes whose current valuations indicate they are likely to be impaired.

- The entity has significant indirect or indirect exposure to the sovereign debt risk of countries adversely impacted by the 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 exposure).

Financing

Obtaining:

- Withdrawal of credit from lenders that had previously provided easy access to credit whenever necessary.

- Cross guarantees are not likely to be, or will no longer be, available to support the entity.

- Uncertainty over whether current or prospective lenders will roll over existing credit facilities on similar terms, if at all.

- Downgrading of the credit status of the borrower or guarantor by a recognised credit rating agency.

- Excessive pressure known to exist on management due to the need to obtain additional debt or equity financing to stay competitive (for example financing of major research and development or required capital or operating expenditures).

Servicing:

- Indications of withdrawal of financial support by creditors or parent/group entities.

- 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 a "at call" basis).

- The entity is currently in default in making required debt payments.

- 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 existing credit terms which has adversely impacted the entity's ability to make required repayments (for example shortened repayment time, increase in loan security requirements, increased interest rate or all facilities now on a "at call" basis.)

- All the entity's borrowings have been reclassified 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 net liability position, 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 (e.g. from net 30 days to net 7 days).

- Key suppliers are known to be experience significant trading difficulties, and the entity may not receive goods or services when required to meet customer demands.

- The entity has not been able to find an alternate 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, without alternatives available at short notice, if at all.

Accounting related

- The entity 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 valued recently, or the valuation results in no change in its fair value.

- Recorded accounting estimates are more aggressive than previously.

- 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 by the auditor 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 financial report. If the auditor considers that the overall audit will 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 during the audit if matters come to the auditor's attention that require such a re-assessment.

Responding to Assessed Risks

The auditor's response to identified risks 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 or cause questions 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, but their potential impact is not limited exclusively to these categories.

Audit Process

- 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, directors and appropriate 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 the auditor not identifying intentional or unintentional errors in the financial report is reduced to acceptable levels.

Financing related

- Monitoring, reviewing and evaluating available cash flow forecasts on a regular basis to determine whether the terms of the loan agreements can be complied with.

- Identifying other potential sources of credit and avoiding reliance on a specific source only.
- Obtaining supporting information concerning bank guarantees from bank confirmations.
- Inspecting other 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 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, e.g. goodwill, property and infrastructure assets;
  - change or proposed change 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 subsequent to the reporting date, or are contemplated;
  - 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 validity 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 (employee payroll or external suppliers).
- Determining whether the entity has actively identified other potential suppliers of required goods or services to reduce reliance on any one supplier.
- Considering indicators of 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.

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Evaluation of Management's Going Concern Assumption

The 2009 AUASB Bulletin identified management's use of the going concern assumption 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 auditor's exercise of professional judgement and scepticism throughout the evaluation process remains critical in ensuring the auditor appropriately evaluates management's assessment and concludes on its appropriateness.

Auditors are reminded of their responsibility to critically question and evaluate management's use of the going concern assumption in all engagement circumstances and *not* to merely review and accept it. This includes the auditor 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?). The auditor should also consider possible alternatives to the options selected by management by considering audit evidence already obtained through existing or additional audit procedures.

Special audit considerations to take into account in evaluating managements' 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, 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, the auditor should evaluate if this is appropriate, given the auditor's understanding of the entity gained through the audit process.

- Are there particular 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 as currently or of the likelihood of obtaining other facilities on the same basis?

- Is management's assessment consistent with the auditors 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?

- Has the auditor evaluated the reasonableness of all assumptions used in the assessment through the use of other audit procedures (analytical procedures, enquiry or other testing, for example, recalculating key financial ratios)?

- Has the auditor considered whether any additional facts or information have become available since the date of which 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?

Documentation requirements

In a prolonged period of economic uncertainty, auditors need to be especially vigilant to including sufficient and appropriate audit evidence in the audit file documentation to support all audit conclusions on work performed. This includes the auditor's documentation of their evaluation of management's going concern assessment, for example their challenges to key assumptions made or alternative options considered to those chosen by management. Such documentation will ensure that the auditor has a sufficient and appropriate record of the work performed to support the conclusions reached and the opinion included 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 are reminded that in a prolonged economic environment of uncertainty it is particularly important they exercise professional judgement and professional scepticism in identifying and assessing the potential, and actual, impact of the prolonged economic environment of uncertainty on the individual entity's financial report. This will also help ensure that the audit procedures the auditor designs and performs in response adequately addresses the assessed impact and ensures that the auditor obtains sufficient appropriate evidence on which to conclude, with reasonable assurance, whether the financial report as a whole is free from material misstatement.