Audit Issues when Financial Market Conditions are Difficult and Credit Facilities may be Restricted

January 2008

BULLETIN

2008/1

The Auditing Practices Board

The Auditing Practices Board Limited, which is part of the Financial Reporting Council, prepares for use within the United Kingdom and Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The Auditing Practices Board Limited discharges its responsibilities through a Board (the APB) comprising individuals who are eligible for appointment as company auditors, and those who are not so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

Neither the Auditing Practices Board Limited nor the APB accepts any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

The purpose of Bulletins issued by the APB is to provide auditors and, where relevant, reporting accountants with timely guidance on new and emerging issues. They are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for Auditing Standards.

ISBN 978-1-84798-046-5

THE AUDITING PRACTICES BOARD

AUDIT ISSUES WHEN FINANCIAL MARKET CONDITIONS ARE DIFFICULT AND CREDIT FACILITIES MAY BE RESTRICTED

Contents | ***Paragraphs***

INTRODUCTION

1. This Bulletin provides guidance on matters that auditors may need to consider when conducting audits in the economic environment following recent developments in the financial markets commonly termed ''the credit crunch.''

2. In recent months financial market conditions have been characterised by significant trading difficulties compounded by a reduction in liquidity. Although the primary market shock arose due to defaults on sub-prime mortgages in the United States, the effect has been felt globally due to widespread use of structured securities and leveraged funding. Entities with exposure to the financial markets through debt, equity, derivative and leveraged finance activities may experience significant difficulty in trading in and thus valuing certain investments, with a consequential increase in the risk of material misstatement of financial statements. More generally, entities may find it difficult to finance their operations as a result of restricted credit facilities.

3. While the credit crunch is likely to have a particular effect on the audit of financial institutions such as banks, insurance companies and investment businesses, many entities operating outside the financial services sector could also be affected by current market conditions, especially if those entities are dependent on refinancing their operations over the coming months, or may be at risk of having current facilities withdrawn, or have significant investments that have reduced significantly in value or are difficult to value in the absence of an active market.

4. While this Bulletin may be of assistance to the auditors of financial institutions it has been written to apply more generally and focuses on the risks and uncertainties associated with:

   - Reduced liquidity in the financial markets and in particular the reduced availability of finance for those who require it. As financing arrangements expire, replacement may prove expensive or impossible, with potentially serious consequences in relation to the ''going concern'' assumption; and
   - Valuation of investments. For some investments there may be a severe curtailment or cessation of market trading, introducing particular difficulties for valuation measurements. Investment in such financial instruments may not be limited to financial institutions. It is possible that other entities, such as those with developed treasury activities and pension funds, may have invested in financial instruments that are currently experiencing severely curtailed/ceased trading which will make their valuation for balance sheet purposes difficult.

5. This Bulletin draws on existing material within APB's standards and guidance and should be read in conjunction with them. It does not establish any new requirements. Not all of the issues addressed will be relevant to all audits, and there may be other issues that auditors need also to consider that are not addressed in this Bulletin.

RISK ASSESSMENT, QUALITY CONTROL AND COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

6. While the credit crunch is most likely to be relevant to the audit of financial institutions, it may also affect audits of entities operating outside the financial services sector. Auditors, as part of their planning and risk assessment process of all entities, consider whether current market conditions could give rise to the risk of material misstatement of the financial statements and respond accordingly. The appendix to this Bulletin identifies some factors that may increase the risk of material misstatement in financial statements when financial market conditions are difficult and credit facilities may be restricted.

7. If the audited entity is at risk of material misstatement of the financial statements due to current market conditions, the audit engagement partner will have particular regard to:

   - his/her own involvement in the direction, supervision and performance of the audit when complying with the requirements of ISA (UK and Ireland) 220, paragraph 21,
   - the capabilities and competence of the engagement team (especially if the audit involves evaluation of the fair value of financial instruments) when complying with the requirements of ISA (UK and Ireland) 220, paragraph 19,
   - consultation with other professionals on difficult and contentious matters when complying with the requirements of ISA (UK and Ireland) 220, paragraph 30, and
   - the nature and timing of communications with those charged with governance when complying with the requirements of ISA (UK and Ireland) 260.

GOING CONCERN

8. One impact of the 'credit crunch' may be to limit finance available to companies and other entities, with, in extreme cases, potentially serious consequences in relation to the ''going concern'' assumption. Past experience of obtaining necessary financing cannot be relied on alone to provide sufficient evidence of an entity's ability to obtain financing in the future. Lenders may be more risk averse when considering whether to provide or renew finance facilities and may establish new criteria and/or may increase interest rates.

9. Against that background, auditors will have regard to ISA (UK and Ireland) 570, which establishes standards and provides guidance on the auditor's responsibility with respect to consideration of the going concern assumption used in the preparation of the financial statements. In particular, the guidance on the auditor's examination of borrowing facilities in paragraphs 21-2 and 21-3 may assist.

   - Paragraph 21-2 states: 'The auditor might be more likely to decide that it is necessary to obtain confirmations of the existence and terms of bank facilities, and to make an independent assessment of the intentions of the bankers relating thereto, in cases where, for example there is a low margin of financial resources available to the entity', and

- Paragraph 21-3 states: 'The auditor considers whether any inability to obtain sufficient appropriate audit evidence regarding the existence and terms of borrowing facilities and the intentions of the lender relating thereto, and/or the factors giving rise to this inability, need to be:
  - Disclosed in the financial statements in order that they give a true and fair view; and/or
  - Referred to in the auditor's report (by way of an explanatory paragraph, or a qualified opinion if the auditor believes that the disclosures in the financial statements are not adequate).

10. Standards and guidance on explanatory paragraphs (e.g. to highlight a material matter that is disclosed in the financial statements regarding a going concern problem) or qualified opinions (e.g. where there is inadequate disclosure in the financial statements of a going concern problem) in the auditor's report are provided in ISAs (UK and Ireland) 570 and 700.

11. Additional considerations apply to the audit of listed companies. Directors of listed companies are required by the Listing Rules[1] to make a statement in the annual financial report that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with "Going Concern and Financial Reporting: Guidance for directors of listed companies registered in the United Kingdom," published November 1994[2]. APB Bulletin 2006/5[3] emphasises the importance of ensuring that the directors' statement on going concern is not inconsistent with any disclosures regarding going concern in either the financial statements or the auditor's report thereon.

VALUATION AND DISCLOSURE OF FINANCIAL INSTRUMENTS

12. A second impact of the 'credit crunch' may be to impair the value of some investments or, especially when they are required to be measured at 'fair value', make their valuation for balance sheet purposes difficult (e.g. when trading in a particular investment has been severely curtailed and current market values are difficult to establish). Against this background, auditors will have regard to ISA (UK and Ireland) 545, which establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. The use of experts with particular knowledge of the valuation of complex financial instruments may be appropriate and, in such cases, the standards and guidance in ISA (UK and Ireland) 620 will be relevant.

---

1 Listing Rule 9.8.6R (3)

2 This guidance was a publication of the Cadbury Committee and can be accessed at http://www.icaew.com/index.cfm?route=117590

3 Bulletin 2006/5 "The Combined Code on Corporate Governance: Requirements of Auditors under the Listing Rules of the Financial Services Authority and the Irish Stock Exchange".

13. When the auditor determines there is a significant risk related to fair value, the auditor should evaluate whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures (ISA (UK and Ireland) 545, paragraph 39). This evaluation includes consideration of whether these assumptions reflect current market conditions and information.

14. Particular difficulties may arise where there is a severe curtailment or even cessation of market trading in certain investments. For example, in these circumstances, investments that have previously been marked to market may need to be valued using a model. If management has changed the valuation method, the auditor considers whether management can adequately demonstrate that the valuation method to which it has changed provides a more appropriate basis of measurement.

15. Auditors also need to evaluate whether the disclosures about fair values made by the entity are in accordance with the financial reporting framework (ISA (UK and Ireland) 545, paragraph 56). In the current environment, it will be important that disclosures of material risks and uncertainties related to fair value measurements are appropriate to the entity.

16. For entities applying International Accounting Standards, IAS 1, ''Presentation of Financial Statements,'' disclosure requirements include:

    - The judgments, apart from those involving estimations (see the next bullet), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.
    - Information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment in the carrying amount of assets and liabilities within the next financial year.

17. In addition, recent developments in accounting standards will affect the extent and nature of disclosures relating to some financial instruments for audits of financial statements for periods commencing on or after 1 January 2007[4]. The disclosures required are extensive and potentially complex including:

    - Qualitative disclosures such as the exposures to risk arising from the financial instruments,

---

4 FRS 29 'Financial Instruments: Disclosures' and IFRS 7 'Financial Instruments: Disclosures' contain substantially the same requirements. Reporting entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) currently applicable are exempt from FRS 29.

- Quantitative disclosures such as summary data about the exposures at the reporting date, and
- Market risk information such as a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date.

18. APB Practice Note 19 ‘The Audit of Banks and Building Societies in the United Kingdom’ provides guidance, in paragraphs 113 to 125, on auditing the disclosure of market risk information under IFRS 7 and FRS 29, and whether the risk measurement method adopted has been applied reasonably[5].

DISCLOSURE OF RISK IN DIRECTORS’ REPORT

19. Section 234ZZB of the Companies Act 1985[6] requires that the Directors’ Report for all companies (except small companies) contain a business review that includes:

    (a) a fair review of the business of the company, and

    (b) a description of the principal risks and uncertainties facing the company.

    The review is required to be a balanced and comprehensive analysis of the development and performance of the business of the company during the financial year, and the position of the company at the end of that year, consistent with the size and complexity of the business.

20. It is likely that companies affected by the credit crunch will decide to make some reference to the risks and uncertainties facing the company in the business review, such as those relating to the availability of financing and the valuation of financial instruments where relevant. ISA (UK and Ireland) 720, which establishes standards and provides guidance on the auditor’s consideration of other information in documents containing audited financial statements, will be particularly relevant in these circumstances.

21. ISA (UK and Ireland) 720 has two sections. Section A applies to all other information in documents containing audited financial statements. Section B contains additional standards and guidance in relation to the auditor’s statutory reporting responsibility in relation to Directors’ Reports.

---

5 The same guidance is in the current Exposure Draft of Practice Note 19(I) ‘Banks in the Republic of Ireland’ (paragraphs 101 to 113).

6 The requirements of Section 234ZZB have been carried over to section 417 of the Companies Act 2006. Section 417 has some additional requirements for quoted companies and relief when disclosures could be seriously prejudicial to the interests of the company or certain persons.

22. In the UK and the Republic of Ireland, legislation requires the auditor of a company to state in the auditor's report whether, in the auditor's opinion, the information given in the Directors' Report is consistent with the financial statements. Omission of information from the Directors' Report is not classed as an 'inconsistency' in ISA (UK and Ireland) 720 but Section B, paragraph 4, states 'The auditor is not required to verify, or report on, the completeness of the information in the directors' report. If, however, the auditor becomes aware that information that is required by law or regulations to be in the directors' report has been omitted the auditor communicates the matter to those charged with governance'.

IMPLICATIONS FOR THE AUDITOR'S REPORT

23. If the financial statements include a note that discusses a material matter regarding a going concern problem, the auditor is required to highlight that matter by adding an emphasis of matter paragraph to the auditor's report (ISA (UK and Ireland) 700, paragraph 31). If there is a significant uncertainty[7] (other than a going concern problem) disclosed in the financial statements, the resolution of which is dependent upon future events and which may affect the financial statements, the auditor is required to consider adding an emphasis of matter paragraph to highlight that uncertainty (ISA (UK and Ireland) 700, paragraph 32). Significant uncertainties relating to the valuation of financial instruments may be matters that exist and give rise to such an emphasis of matter.

24. In determining whether an uncertainty is significant, the auditor considers:

    (a) the risk that the estimate included in financial statements may be subject to change;

    (b) the range of possible outcomes; and

    (c) the consequences of those outcomes on the view shown in the financial statements.

25. The inclusion of an emphasis of matter paragraph in the auditor's report does not affect the auditor's opinion and is not a substitute for either:

    (a) a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of a specific audit engagement; or

    (b) disclosures in the financial statements that are required by the applicable financial reporting framework.

ETHICAL ISSUES

26. The APB's Ethical Standards (ESs) are based on a 'threats and safeguards approach' whereby auditors identify and assess the circumstances, which could adversely affect the

7 An uncertainty is a matter whose outcome depends upon future actions or events not under the direct control of the entity but that may affect the financial statements.

auditor's objectivity ('threats'), including any perceived loss of independence, and apply procedures ('safeguards'), which will either eliminate the threat or reduce it to an acceptable level, that is a level at which it is not probable that a reasonable and informed third party would conclude that the auditor's objectivity is impaired or is likely to be impaired.

27. In the current circumstances, where financial market conditions are difficult and credit facilities may be restricted, auditors need to be alert to the possibility of a "management threat" arising that might jeopardise their objectivity and independence. There is a danger that, if asked to provide advice or assistance that could result in them undertaking work that involves making judgments and taking decisions which are the responsibility of the entity's management, the audit firm may become closely aligned with the views and interests of management and the auditor's objectivity and independence may be impaired, or may be perceived to be, impaired (ES 1, paragraph 28[8]).

---

8 In October 2007 the APB issued a draft of revised Ethical Standards for Auditors. The intention is that the revised standards will apply to audits for accounting periods commencing on or after 6 April 2008. These include the proposal, to meet the requirements of the Statutory Audit Directive, to add a specific requirement in ES 1 for the audit firm to establish policies and procedures to require partners and employees of the firm to take no decisions taking that is that are the responsibility of management of the audited entity.

APPENDIX

RISK FACTORS

This appendix identifies some factors that may increase the risk of material misstatement in financial statements, especially when financial market conditions are difficult and credit facilities may be restricted. There are many ways in which the current market conditions could impact the financial statements of an entity and its ability to continue as a going concern and other risk factors may exist in the particular circumstances of each entity.

These risk factors may also be relevant in connection with an auditor's review of interim financial information in accordance with ISRE (UK and Ireland) 2410.

Going concern

- Obtaining external financing
  - Entity has experienced difficulties in the past in obtaining external finance facilities and/or complying with the related terms and covenants
  - Finance facilities are due for renewal in the next year but have not yet been agreed
  - Management have no plans for alternative arrangements should current facilities not be extended
  - Borrowing agreements or executory contracts include clauses relating to debt covenants or subjective clauses (e.g. a "material adverse change clause") that may trigger repayment
  - Entity has breached some of the terms or covenants giving rise to the risk that the facilities may be withdrawn or not renewed
  - Terms or covenants of renewed financing are changed and more difficult to comply with (e.g. increased interest rates or charges)
  - Finance facility is secured on assets (e.g. properties) that have decreased in value below the amount of the facility
  - For financial institutions, reduced deposits from retail customers or reduced availability of funding from wholesale financial markets
- Management plans to overcome financing difficulties include disposal of assets
  - Plans developed prior to current market conditions have not been updated
  - Lack of evidence that management can sell the assets at the values included in the plans
- Entity provides significant loans or guarantees
  - Guarantees may be called in

  - Borrowers may be unable to make payments
- Entity dependent on guarantees provided by another party
  - Guarantor no longer able/prepared to provide the guarantee
- Future cash flows
  - Uncertain or volatile
  - Customers taking longer/unable to pay
- Entity dependent on key suppliers
  - Suppliers facing financial difficulties not able to provide essential goods/services
  - Entity unable to find alternative suppliers

Fair Values

- Fair values are affected by current market conditions
  - Entity needs to change valuation model and/or management's assumptions to reflect current market conditions
  - Active market no longer exists, requiring use of a model for valuation purposes
  - Inputs to a model are not based on observable market inputs but rather are based on the entity's own data
  - Impairment of non-financial assets held at fair value (e.g. properties)
  - Suspension of external valuation indices triggering a need for alternative valuation approaches
  - Entity uses an external pricing service for fair value measurements that needs to change its valuation model and/or assumptions to reflect current market conditions
  - Entity does not have necessary expertise to undertake valuations

Other Risk Factors

- Impairments of assets other than those held at fair value (e.g. need for increased doubtful debts provisions)
- Impairment of the carrying value of purchased goodwill
- Pension obligations of an entity increased by reduction in values of assets in a related defined benefits pension scheme
- Hedging arrangements no longer effective
- Effects on accounting for Special Purpose Entities and other off balance sheet arrangements

NOTICE TO READERS

ISBN 978-1-84798-046-5

9 781847 980465

CODE: UP/APBD-BI8212

Further copies, £6.00, post-free, can be obtained from:

FRC Publications
145 London Road
Kingston upon Thames
Surrey
KT2 6SR

Telephone: 020 8247 1264
Fax: 020 8247 1124
E-mail: customerservices@cch.co.uk
or ordered online at: www.frcpublications.com