FEE Federation of European Accountants
Fédération des Experts comptables Européens

Policy Statement

Standing for trust and integrity

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The Accountancy Profession's Contribution to the Debate on the Crisis (II)

Matters of Specific Relevance for Statutory Auditors during the Financial Crisis

This paper presents the views of FEE, the Federation of European Accountants – Fédération des Experts comptables Européens, on issues of specific relevance to the audit profession against the background of the current crisis. It aims at providing some insights into expectations from the audit profession of particular relevance for 2008 audits. Two other papers have been published, one presenting background information and analysis on the crisis (I) and another containing views of specific relevance to SMEs (III). Other papers will be issued as needed.

About FEE

FEE represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States. It has a combined membership of more than 500.000 professional accountants. In representing the profession, FEE recognises the public interest. Professional accountants work in different capacities in public practice, business, and public sector; based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in the current discussions.

Introduction

What started off as a sub-prime mortgage lending credit issue, predominantly in the United States, has quite rapidly expanded into a more complex, wider and deeper financial crisis that does not only affect the United States markets but has been exported to the worldwide financial markets and also affects the financial sector in Europe. Over the past few months it has further developed into a rapidly expanding recessions on a global scale.

Politicians have taken a greater interest into the subject, inspired by the need for governments to go as far as massive financial support for financial institutions and in certain cases bailouts or nationalisations. Not only companies have got into trouble but certain countries are also facing severe difficulties. Both on a European and on global level, governments have taken initiatives to stimulate markets, raise liquidity, inspire confidence and call for greater global coordination of governmental and prudential supervisory authorities.

Increasingly, financial reporting is being blamed for the pro-cyclical influence and thus the aggravating nature of the rules in markets that have become distressed or sometimes illiquid. Standard setters have been requested to quickly revise the reporting rules, restore the level playing field between the US and the rest of the world reporting under IFRS and, where necessary, relax the requirements.

This paper aims to provide insight into what, additionally, may be expected of auditors in the current environment. In this respect, FEE calls for implementation of a consistent regulatory environment in the financial reporting, auditing and corporate governance areas.

Elements to consider for understanding the assumptions of the underlying financial statements

Financial positions of companies or audit clients and opinions of auditors are applicable at a given point in time. Subsequent developments may put forward a different perspective but does not necessarily prove the initial judgement was wrong nor that parties were incorrectly informed.

The auditor obtains information on a confidential basis and he needs to treat such knowledge with due professionalism. More particularly this means that in addition to communicating with management of his audit client, the auditor will report relevant facts and circumstances to the governing bodies of the audit client such as the Audit Committee and the Supervisory (non executive) Board or even beyond such as to supervisory authorities, undoubtedly including issues related to the current distressed markets.

Financial statements prepared on the basis of IFRS (but equally on the basis of many other local GAAPs) contain significant information that needs to be taken into account by users before taking important decisions. Such relevant information relates to risks, risk appetite and disclosures on the various financial positions and valuations. Auditors will exercise professional judgement as to whether the disclosures and other information in the financial statements are relevant, appropriate and transparent and if necessary the auditor will report his observations and findings to the governing bodies of his audit client. Some of this information may be contained in the management report and will then be subjected to a more limited review for consistency as set out in the audit opinion on the financial statements.

Valuation of **instruments at fair value in distressed markets requires more judgement** and therefore auditors continuously employ specialists in their audit teams to deal with these complexities and issues. Auditors also discuss valuation parameters and techniques with management and governing bodies of their audit clients.

Information on instruments at fair value (either reported through profit or loss or directly reflected in equity) may be the best available value for judgement by market participants as it represent the opinion of willing buyers and/or sellers in the market. Both in markets going up and in markets going down it cannot be ignored that a certain **pro-cyclicality exists but equally IFRS made it possible to flag valuation issues on a more timely basis**. Profits that have been realised when markets were moving upwards have in many instances been distributed to shareholders and are thus not available as cover for the current losses. That does not mean that the valuation at fair value has been incorrect. It is accepted, however, that the rate of loss in distressed markets is far quicker and more severe than in good markets due to the impact on confidence created by bad news related to valuations.

Independently from the financial statements, there is already information available when new financial products are introduced to the markets (such as securitisations and other synthetic instruments). The company issuing the instrument is normally required to **prepare a prospectus** that contains information on the risks and further modalities of the instruments. Sometimes the auditor is involved in certain aspects of these processes. The investor should take good notice of the relevant information provided in the prospectus.

Public expectations on auditors are high under normal and certainly under distressed conditions. Under the professional rules and International Standards on Auditing (ISAs), auditors are required to perform their work with integrity, objectivity, professional competence and due care, but are also limited by confidentiality requirements. Auditors, unless required by law, can only report limited parts of the information shared with management and the governing bodies of their audit clients to the public at large in any form other than the audit opinion on the financial statements.

It should also be noted that as the assessment of fair values and other complexities related to auditing financial statement require substantially more judgement than the determination of a valuation at cost, auditors keep up to date through continued training and professional developments in all relevant areas.

Auditing issues of particular relevance for 2008 audits[1]

Although such issues should always be considered, with the aggravation of the financial crisis during 2008 and the economic recession taking greater weight, it will be essential that the 2008 financial statements contain all relevant information so that users of those documents can form their proper judgement. Disclosures on risk management and risks taken, both on balance sheet positions and in managing them will be essential. Companies' directors and management need to ensure that they properly and fairly estimate the value of the different elements in their companies' financial statements and prepare thoroughly for their assessment of going concern and make appropriate disclosure.

The economic crisis is likely to impact on the financial stability of many companies by the end of the year. IAASB, the Independent Board setting international auditing standards, has already issued a useful paper on "challenges in auditing fair value accounting estimates in the current market environment". The impact of going concern issues on the audit report is important to consider in order to avoid any overreaction that would undermine the attempt to restore the economy.

In this context, auditors will need to ensure that they fully consider the valuation of the more subjective elements in their clients' financial statement as well as the going concern assessments and only refer to going concern in their audit reports when appropriate. These assessments can be successfully performed making full use of the available International Standards on Auditing (ISAs) 540 [2], 570 [3], etc or the equivalent national auditing standards. The IAASB project to clarify the ISAs by the end of 2008 will further the usefulness of these standards.

Going Concern

The general economic situation at the present time in itself does not necessarily mean that a material uncertainty exist about a company's ability to continue as a going concern or justify auditors modifying their auditors' reports to draw attention to going concern. Nor are extensive disclosures, of themselves, indicative of the existence of a significant doubt on the company's ability to continue as a going concern. The current pressure on corporate cash-flows means that liquidity risk is likely to be a material risk for many more companies, resulting in an increased need for companies to present relevant disclosures concerning liquidity risk. Auditors will need to examine the directors' processes underlying the preparation of these disclosures which provides useful audit evidence for auditors with respect to the validity of the going concern assumption.

Auditors' consideration of the directors' assessment of going concern will encompass:

- Evaluating the means by which the directors have satisfied themselves it is appropriate to prepare the financial statements on a going concern basis, focusing on the future availability of finance, the reliability of the company's information systems, the adequacy of underlying assumptions, written representations, etc.;
- Concluding whether or not they concur with the directors' view;
- Assessing whether the financial statements contain adequate, relevant and grouped disclosures relating to going concern which are readily understandable by users.

Following this analysis, the auditor will determine the implications for his report on the financial statements:

- If auditors conclude that the disclosures regarding going concern are not adequate, a qualified or adverse opinion will need to be issued by referring to the existing material uncertainty;
- If a material uncertainty exists that leads to significant doubt about the ability of the company to continue as a going concern and these uncertainties have been adequately disclosed in the company's financial statements, the auditor is required to modify his report by including an emphasis of matter paragraph.

In this respect, it should be noted that what constitutes a material uncertainty that may cast significant doubt on the company's ability to continue as a going concern is a judgment involving not only:

- The nature and materiality of the events or conditions giving rise to uncertainty; but also
- The ability of the company to mitigate the uncertainty by adopting alternative strategies that are realistic, reasonably expected to resolve the foreseen problems and likely to be executed effectively.

Determining what constitutes a material uncertainty involves assessing both the likelihood of an event or condition occurring and the impact it will have if it occurs. For example, the lack of a positive confirmation from a bank does not of itself provide evidence of a material uncertainty that casts significant doubt on the entity's ability to continue as a going concern; it could also be increased caution on the part of the bankers.

Investors and lenders will need to be prepared to read all of the relevant information in annual reports and financial statements before making decisions. Users should also properly realise that proper and solvent entities may become rapidly affected when liquidity starts to fall short. Under such conditions the going concern assumption that is normally underlying any audit opinion may need to be considered in a different perspective. It would be advisable when the financial statements of entities that are within the boundaries of such expectations disclose these elements at such place that it will attract the attention of the user immediately.

Fraud considerations

Although the auditor should always be conscious of fraud, during times of turmoil, this could be of greater importance. The primary responsibility for the prevention, deterrence and detection of fraud rests however with both those charged with governance of the company and its management[4].

Fraud may involve sophisticated and carefully organised schemes designed to conceal it, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor and when collusion by management, even more difficult to detect as the audit evidence is false.

The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or modified but not disclosed to the auditor, or inquiries of management or those charged with governance are inconsistent, the auditor shall investigate further.

Auditors will continue to perform their work with the same good care and due procedures as they have used in the previous years. They need to continue to be alert to the possibility of self-review, management or advocacy threats arising from the provision of non-audit services in relation to refinancing or restructuring services that might jeopardise their objectivity and independence. ■

[1] For further guidance, reference is made to the UK Financial Reporting Council (FRC) "An Update for Directors of Listed Companies: Going Concern and Liquidity Risk", "Study: Going Concern and Liquidity Risk Disclosures" and "Challenges for Audit Committees arising from current economic conditions" of November 2008 and the UK Auditing Practice Board (APB) Bulletin "Going concern issues during the current economic conditions" of December 2008.

[2] http://www.ifac.org/Members/DownLoads/ISA_540_Revised_and_Redrafted.pdf

[3] http://www.ifac.org/Members/DownLoads/ISA_570_Redrafted.pdf

[4] For further guidance, reference is made to ISA 240 on the Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements: http://www.ifac.org/Members/DownLoads/IAASB-RD-ISAS-RedraftedISAs.pdf

Federation of European Accountants
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FEE
Av. d'Auderghem 22-28
1040 Bruxelles

tel: +32 (0) 2 285 40 85
fax: +32 (0) 2 231 11 12

email: secretariat@fee.be