

AUDIT AND ACCOUNTING ISSUES IN THE CURRENT ECONOMIC CLIMATE

19 March 2009

Introduction:

In response to issues arising for members we have prepared this information leaflet. As further issues arise we will issue similar information leaflets.

This Information leaflet has been put together to give guidance on the following issues which members may encounter on audit assignments in the current economic environment:

1. Going Concern issues
2. Valuation of housing stock
3. Valuation of Investments

1. Going Concern issues

Accounting Guidance:

In accordance with FRS 18, when preparing financial statements, directors should assess whether there are significant doubts about an entity's ability to continue as a Going Concern.

FRS 18 (IAS 1) requires that directors take into account "all available information about the foreseeable future". Under IAS 1, this is seen to be "at least, but is not limited to, twelve months from the end of the reporting period". FRS 18, does not specify a minimum length for the foreseeable future. Instead, it requires disclosure where the directors have considered a period of less than twelve months from the date of approval of the financial statements.

Disclosure is also required of any material uncertainties, of which the directors are aware in making their assessment, related to events or conditions that may cast significant doubt upon the entity's ability to continue as a Going Concern.

When the financial statements are not prepared on a Going Concern basis, that fact together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a Going Concern needs to be disclosed.

Auditing Guidance:

Under ISA (570 UK & Ireland) Going Concern auditors are required to consider the same period as management, when looking at Going Concern. The period considered by management should be at least 12 months from the end of the reporting period and where less, that fact should be disclosed by management in the financial statements. If not disclosed by management, that fact needs to be disclosed by the auditors in the auditor's report.

Where the auditor has concluded that there is a significant level of concern about an entities ability to continue as a going concern, ISA 570 outlines what is deemed to be adequate disclosures (which should be in addition to any disclosure which are required by accounting standards):

ISA 570 Requirement - State the financial statements have been prepared on a Going Concern basis

ISA 570 Requirement - A statement of the pertinent facts

For example:

The company is heavily dependent on borrowing to finance its operations. The current facility is up for renewal at the end of April 200X, 4 months after the balance sheet date. Without this facility the entity would be in serious financial difficulty.

ISA 570 Requirement - The nature of the concern

For example:

As lenders are more risk averse and the company operates in the construction industry it is not certain that these facilities will be renewed.

ISA 570 Requirement - a statement that the assumptions adopted by those charged with governance, which should be clearly distinguishable from the pertinent facts

For example:

As management have been in touch with their peers (who have had their facilities renewed and are in similar circumstances) and have not been in breach of any loan covenants over the last 12 months they are of the opinion that it is most likely that the facility will be renewed.

ISA 570 Requirement - Where appropriate and practicable a statement regarding plans of those charged with governance for resolving the matters giving rise to the Going Concern;

For example:

Management are aiming to confirm renewal of the facilities over the next 3 weeks.

ISA 570 Requirement - and Details of any relevant actions by those charged with governance

For example:

Management have already entered discussions with the bank. These discussions are ongoing and are at the negotiation stage.

Suggested approach:

1. Ensure Going Concern is an audit risk issue
2. Obtain external confirmation where possible of the existence and terms of bank facilities and make an assessment of the intentions of the bankers relating to such facilities
3. Currently bankers may be reluctant to confirm that facilities will be renewed. This lack of a positive confirmation does not in itself provide evidence of a material uncertainty which casts doubt on the Going Concern basis. Reasons for not giving confirmation may include:
 - The bank may have decided that in the current environment it is not giving confirmations as a matter of policy
 - The company and its bankers are engaged in negotiations about the terms of the facility
 - The bank has renewed a rolling facility immediately prior to the annual report and does not want to bear the administrative burden to confirm that the facility will be renewed at expiry

The auditor must differentiate between circumstances where a lack of confirmation reflects the existence of a material matter in respect of the Going Concern assumption and increased caution on the part of bankers that is not indicative of a material uncertainty regarding Going Concern.

4. Consider the impact on the audit report

Impact on the financial statements:

A) Directors' Report

Under the Companies Act 1986 (as amended by SI 116) there needs to be a 'principal risks and uncertainties note' in the Directors' Report. This should be a balanced and comprehensive analysis of developments during the year and show the end of year position. It should be consistent with the size and complexity of the business.

The following example is taken from the appendix to the APB Bulletin 'Going Concern Issues During the current Economic Conditions'. This Appendix contains the FRC document 'An update for Directors of same document Listed Companies: Going Concern and Liquidity Risk' and illustrate the principles in paragraph 55 of the same document (which describe how Going Concern and liquidity risk disclosures can be brought together and the usefulness of bringing them together in a single section).

It is important to remember that disclosures should be specific to the individual circumstances of each company.

Example – A group with complicated circumstances, considerable exposure to the current economic uncertainties and either a current material bank overdraft or loan which requires renewal and perhaps an increase in the year ahead.

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in the Chief Financial Officer's Review on pages P to Q. In addition note A to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

As described in the directors' report on page X the current economic environment is challenging and the group has reported an operating loss for the year. The directors consider that the outlook presents significant challenges in terms of sales volume and pricing as well as input costs. Whilst the directors have instituted measures to preserve cash and secure additional finance, these circumstances create material uncertainties over future trading results and cash flows.

As explained on page X, the directors are seeking to sell a property to provide additional working capital. The group is in negotiations with a potential purchaser but there can be no certainty that a sale will proceed.

Based on negotiations conducted to date the directors have a reasonable expectation that it will proceed successfully, but if not the group will need to secure additional finance facilities.

As explained in the Business Review on Page Y, the group has commenced discussions with its bankers about an additional facility that may prove to be necessary should the sale of the property not proceed or should material adverse changes in sales volumes or margins occur. It is likely that these discussions will not be completed for some time. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming, but have not yet secured a commitment.

The directors have concluded that the combination of these circumstances represent a material uncertainty that casts significant doubt upon the group's and the company's ability to continue as a Going Concern. Nevertheless after making enquiries, and considering the uncertainties described above, the directors have a reasonable expectation that the group and the company have adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the Going Concern basis in preparing the annual report and accounts.

B) Basis of preparation

In the statement of accounting policies the financial statements should state the basis on which they are prepared

C) Auditor's Report

Where there is a material uncertainty about the company's ability to continue as a Going Concern and the company have made the relevant disclosures in the financial statements the auditor issues an unqualified opinion, and places an emphasis of matter paragraph as the last paragraph in the Opinion Section of the Audit Report.

Emphasis of matter- Going Concern

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosures made in note x to the financial statements concerning the company's ability to continue as a Going Concern. The company incurred a net loss of €x during the year ended 31 December 200X and, at that date the company's current liabilities exceeded its total assets by €y. These conditions, along with the other matters explained in note x to the financial statements, indicate the existence of a material uncertainty which may cast doubt about the company's ability to continue as a Going Concern. The financial statements do not include the adjustments that would result if the company was unable to continue as a Going Concern.

Break up basis of accounting

If the accounts cannot be prepared on a Going Concern basis they need to be prepared on a break up basis.

2. Valuation of housing stock:

Scenario:

Your client is a property developer with 3 houses on its books at year end which are unsold. At the yearend these houses were valued at cost of €250k. There have been no sales post year end. A similar development with similar houses sold 2 houses post year end. These houses sold for €180k. Costs to sell these houses were €10k.

Accounting Guidance:

SSAP 9 states as follows in paragraph 1;

"If there is no reasonable expectation of sufficient future revenue to cover cost incurred (e.g. as a result of deterioration, obsolescence or a change in demand) the irrecoverable cost should be charged to revenue in the year under review. Thus, stocks normally need to be stated at cost, or, if lower, at net realizable value."

You will need to assess with directors what the best estimate for net realisable value is. It is defined as follows:

"Net realisable value: The actual or estimated selling price (net of trade but before settlement discounts) less:

- A) All further costs to completion; and
- B) All further costs to be incurred in marketing, selling and distributing."

Auditing Guidance:

It may be difficult at the moment to value housing stock as the market may be inactive. Any valuation placed on the stock will be a judgement based on the evidence which has been gathered up to the date of the auditors report.

Based on the above example the houses on the books of your client appear to be overvalued at €250k. The houses need to be valued at Net Realisable Value at year end. The correct value on the houses should be €180k less costs to sell which are €10k, so €170k.

Suggested approach:

1. Ensure Going Concern is an audit risk issue
2. Obtain external valuations where possible re the housing stock
3. Gather audit evidence to confirm that these values are correct **or** incorrect
4. Consider the impact of other players in the industry (ISA 315). (Can use your knowledge of the local market and any knowledge of clients you may have in that industry. Consider the relevance of any issues identified on other assignments for this client.)
5. Document any issues of relevance in allowing you to carry out 3 (ISA 230).

3. Valuation of Investments:

Regarding the valuation of investments these are generally valued at cost less provisions for impairments in value.

Company Law Guidance:

Part II, 7.1 The Companies (Amendment) Act 1986, states that where a financial asset has diminished in value, provisions for diminution in value may be made in respect of it and the amount to be included in respect of it may be reduced accordingly; and any such provisions which are not shown separately in the profit and loss account should be disclosed in a note to the financial statements.

It is important to ensure that the accounting policy adopted is consistent with previous years.

Accounting Guidance:

In the current environment your audit clients may be in a situation where investments which they hold have declined in value between the balance sheet date and the date the financial statement are authorized for issue. So what do you do?

In accordance with FRS 21, 'Events after the balance sheet date', an Entity is required to adjust the amounts recognised in the financial statements to reflect adjusting events after the balance sheet date.

The following terms are used in this Standard with the meanings specified:

Events after the balance sheet date are those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. Two types of events can be identified:

- (a) those that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and
- (b) those that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

The key consideration is whether or not the decline in value of the investments is related to conditions of the investments at the balance sheet date.

In accordance with FRS 21 'the decline in market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the balance sheet date, although it may need to give additional disclosure under [paragraph 21](#).'

If you have decided that the diminution in the value of investments after the balance sheet date is a non adjusting event, where this event is material it is important that this is disclosed.

In accordance with paragraph 21 of FRS 21:

If non-adjusting events after the reporting period balance sheet date are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non- adjusting events after the reporting period balance sheet date:

- (a) the nature of the event; and
- (b) an estimate of its financial effect, or a statement that such an estimate cannot be made

However whether or not the decline in value of the investments is related to conditions of the investments at the balance sheet date is a matter for your professional judgment. Auditors are advised to document how they have arrived at their decision.

Suggested Approach:

1. Prepare a schedule of opening and closing balances and movement during the period for each contract
2. Agree detail of any new investments to supporting documentation (contracts)

3. Agree income from investments to supporting documentation (agreements/ bank statements)
4. Ensure that the value of investments has not suffered a permanent diminution in value*
5. For listed investments obtain the market value**
6. Ensure that treatment and disclosure is in accordance with accepted accounting practice

**Impairment may be required re value of some investments*

***Measuring investments at fair value may be difficult if there is an inactive market. Auditors need to look to ISA 545 for guidance in relation to the audit of fair value measurements. If necessary use experts (ISA 620)*

In determining if there is a significant risk related to the fair value of investments you need to consider any significant assumptions used by management. Are they a reasonable basis for fair value measurements? Do they reflect current market conditions?

If there is a change in the valuation method used is the new method more appropriate?

Disclaimer:

This information bulletin is intended to be used as a guide only. The Institute of Certified Public Accountants in Ireland cannot be held liable for any error or for the consequences of any action, or lack of action arising from this information leaflet.

Bibliography:

FRS 18 Accounting Policies

FRS 21 Events after the balance sheet date

APB Bulletin – ‘Going Concern issues during the current economic conditions’

Companies (Amendment) Act, 1986

ISA 570 Going Concern

Other Useful Documents:

APB Bulletin - [Audit issues when financial market conditions are difficult and credit facilities may be restricted](#)

IAASB Practice Alert - [Challenges in auditing fair value accounting estimates in the current market environment](#)

IAASB Practice Alert - [Audit Considerations in respect of Going Concern in the current economic environment](#)

[ISA \(UK and Ireland\) 570, Going Concern](#)

ICPAI [Sample Audit Reports](#)

[ISA 540 \(Revised and Redrafted\). Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures](#), which was influenced by the changes in the credit markets during 2007. While not effective until audits of financial periods commencing on or after December 15, 2009, it includes guidance that is likely to be useful to auditors planning their 2008 engagements

Challenges for audit committees arising from current economic conditions

An update for directors of listed companies: Going concern and liquidity risk

IASB -Measuring and disclosing the fair value of financial instruments in markets that are no longer active

To access the above documents please log on to our [Credit Crunch Resource](#) on the CPA Website.