

Essential guidance for the 2009 financial year end

Introduction

As the 30 June financial year end approaches for many entities, the impact of current economic conditions on all parties involved in preparing, auditing and using financial statements, will require significant focus. Our accounting and auditing standards are principles based, requiring the exercise of professional judgement in their application to specific circumstances. This guidance has been developed to assist in applying some key standards in light of the prevailing economic climate.

Three significant areas to focus on are fair value, asset impairment and going concern. These areas are more important than ever due to their potential complexity and the extent of judgement involved. Preparers and directors should aim for disclosures which are clear, contain relevant information and are specific to the business. Transparency is the key if confidence in corporate reporting is to be maintained.

Fair value

Fair values are required to be reported in a number of key areas – investments, derivatives, other financial instruments, property, plant and equipment and investment property in some circumstances, and agriculture assets. As the number of transactions in the market place decreases, fair values have been harder to determine. Transactions that are occurring may reflect 'fire sale' values rather than prices between willing buyers and willing sellers. How should preparers and directors distinguish such transactions in order to arrive confidently at numbers to include in the financial report? How do auditors sign off on these? Preparers should engage in discussion early with their auditors regarding the principles they plan to apply.

Guidance on determining fair values for financial instruments can be found in:

- > AASB 139 *Financial Instruments: Recognition and Measurement*
- > International Accounting Standards Board (IASB) staff guidance *Using judgement to measure the fair value of financial instruments when markets are no longer active*
- > IASB Expert Advisory Panel guidance titled *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*.

For other assets measured at fair value, requirements and guidance is available in the respective standard for that asset, for example for land and buildings, refer to AASB 116 *Property, Plant & Equipment* and for investment property, refer to AASB 140 *Investment Property*.

Regardless of the type of asset, key considerations in relation to fair value include:

- > Assessing whether an active market exists ie, whether transactions take place regularly on an arm's length basis

- > Understanding the various indicators of an inactive market, which include significant decline in volume and level of trading and available prices varying significantly over time or among market participants
- > Updating the valuation model and management assumptions used in determining fair value to reflect current market conditions and where possible, using inputs based on observable market data
- > Ensuring related disclosures are made in accordance with relevant accounting standards
- > Considering whether an expert is required to perform the valuations.

Asset impairment

Increased incidence of write downs is inevitable as changes to economic outlooks and revised cash flow projections trigger impairment reviews, in some cases for the first time. Particularly at risk of impairment will be goodwill, intangibles, investment properties and financial assets. Although for some entities all assets may require review for impairment.

The requirements and guidance for impairment are addressed in: AASB 139 which covers financial instrument impairment and AASB 136 *Impairment of Assets* which covers non-financial assets. Given current market conditions, it may be difficult to argue that impairment indicators for non-financial assets or objective evidence of impairment for financial assets do not exist. Where such evidence or indicators exist, an impairment calculation is required to be performed.

For financial assets, the key considerations on whether there is objective evidence of impairment include:

- > A significant decline in fair value below the original cost of an equity instrument
- > A prolonged period over which fair value of an equity instrument has been below original cost
- > The issuer/borrower is facing financial difficulty
- > There is a breach of contract, such as a default in interest or principal payments.

For non-financial assets, impairment indicators include:

- > An entity's net assets are more than its market capitalisation
- > There has been a significant decline in profit or sales compared to budget
- > An entity's market value has declined significantly
- > Significant changes in the technological, market, economic or legal environment have an adverse effect on the entity.

Goodwill and indefinite life intangible assets must be tested annually for impairment, regardless of any impairment indicators.

An impairment calculation of the asset's recoverable amount is required where indicators of impairment are present. Determining a recoverable amount can be extremely difficult. In today's climate, preparers may have difficulties in determining future cash flows, selecting a discount rate and explaining their assumptions to the directors and to auditors and users. AASB 136 provides the requirements and guidance on how recoverable amounts must be determined, of which key considerations include:

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- > The determination of cash generating units (CGUs), which cannot be larger than an operating segment determined in accordance with AASB 8 *Operating Segments*
- > Determining the appropriate discount rate to use, given changes to the capital structure, future funding costs and the relative risk of the individual CGU to the business as a whole
- > Determining the appropriate growth rate to use, given that many countries are currently in a recession.

Going concern

A major concern of preparers, directors, auditors and users alike is whether an organisation will 'survive' through the global economic downturn. The reduced availability of credit along with the current economic conditions will require the directors to reconsider whether the going concern basis is appropriate. What if the company doesn't have any earnings or has a refinancing hurdle in 18 months? How will that impact the directors' assessment and the disclosures in the financial report and the audit report?

As outlined in AASB 101 *Presentation of Financial Statements*, management needs to assess whether the entity can continue as a going concern. Issues to consider in making this assessment include:

- > Assessing funding sources – review of banking arrangements and availability of external finance and whether any assets can be sold for cash
- > Checking compliance with debt covenants. If in breach, this must be rectified **before** the reporting date otherwise the loan must be classified as current
- > Confirming that any guarantor is still able to provide the guarantee
- > Checking that significant customer and supplier relationships (which the entity depends on) are still able to continue, eg. a supplier may be in financial difficulty
- > The overall impact current economic conditions have had on the industry in which the entity operates, eg. decline in sales
- > Updating forecasts and budgets to reflect market conditions to enable identification of any deficiencies, and determining how these may be rectified/addressed with appropriate planning
- > Ensuring that forecasts and budgets are prepared to take into account the fact that the auditor must consider going concern of the entity for at least the 12 months from the date of the audit report, and not merely until the next annual reporting date (30 June 2010).

Directors and management should clearly explain any issues arising in their assessment when communicating their results to the market and where required in a note to the financial report.

For auditors making a going concern assessment, there are several potential outcomes, each of which will have different implications for the audit report:

1. No material uncertainties are identified and the going concern basis is appropriate. The implication is an unqualified audit report
2. Some uncertainty with regard to going concern, but there is a reasonable expectation of the entity being able to continue as a going concern, with any mitigating circumstances adequately explained in the notes to the financial report. The

implication if adequately explained is for an unqualified and unmodified audit report

3. If the mitigating circumstances are **not** adequately explained, this may lead to a qualified audit report on the basis of inadequate disclosure
4. Material uncertainties are identified, but it is **not highly improbable** that the entity may not be able to continue as a going concern, with mitigating circumstances which are adequately disclosed in the financial report, and the going concern basis is still appropriate. The implication is an audit report containing an 'emphasis of matter' paragraph
5. In this situation, if the mitigating circumstances are not adequately explained, the implication would be for an audit report that is qualified, or it could be what is termed an 'adverse' opinion, meaning the auditor has reached the conclusion overall that the financial report is not 'true and fair'
6. The going concern basis is not appropriate. The implication is that the audit report could be an 'adverse' one, on the basis that the going concern basis is not appropriate.

AASB 101 does not define material uncertainty, although ASA 570 *Going Concern* does state that a material uncertainty exists when the magnitude of its potential impact is such that [in the auditor's judgement], clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial report not to be misleading. Professional judgement is needed to assess both the probability of an event occurring (for example loss of customers) and impact it will have if it does occur. To assist auditors conducting audits of financial reports in times of economic uncertainty, the Auditing and Assurance Standards Board (AUASB) released a bulletin, *Auditing Considerations in an Uncertain Economic Environment*, which provides an overview of the significant issues and areas auditors should consider when undertaking their work.

Other

While going concern, asset impairment and fair value are three significant reporting issues, a number of other areas also need attention. These are highlighted below:

- > Fraud risk may well be higher. The entity should ensure internal control processes and procedures are operating effectively. Auditors are required to consider fraud in accordance with ASA 240 *The Auditor's Responsibility to Consider Fraud* in an Audit of a Financial Report
- > Ethics – adherence to the Code by both preparers of financial statements, as well as the auditors. Independence requirements are a particularly important aspect
- > Changes to accounting standards increase the risk associated with preparing a financial report, as implications of these changes need to be assessed and disclosed in the financial report prior to the change being implemented. The following reporting period will bring changes to nearly 30 accounting standards, which need to be adequately disclosed in the current reporting period.

Quality review

The three significant areas of focus will be reviewed in detail during the review of audit engagement files as part of the Institute's Quality Review Program. The Institute will publish the findings arising from the reviews.