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This *Auditing and Assurance Bulletin* is intended to help raise practitioners' awareness in a timely manner of significant new or emerging issues or other noteworthy circumstances related to engagements addressed by the AASB pronouncements. It is also meant to direct practitioners to relevant requirements, application and other explanatory material in the CICA Handbook – Assurance.


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auditing and assurance BULLETIN

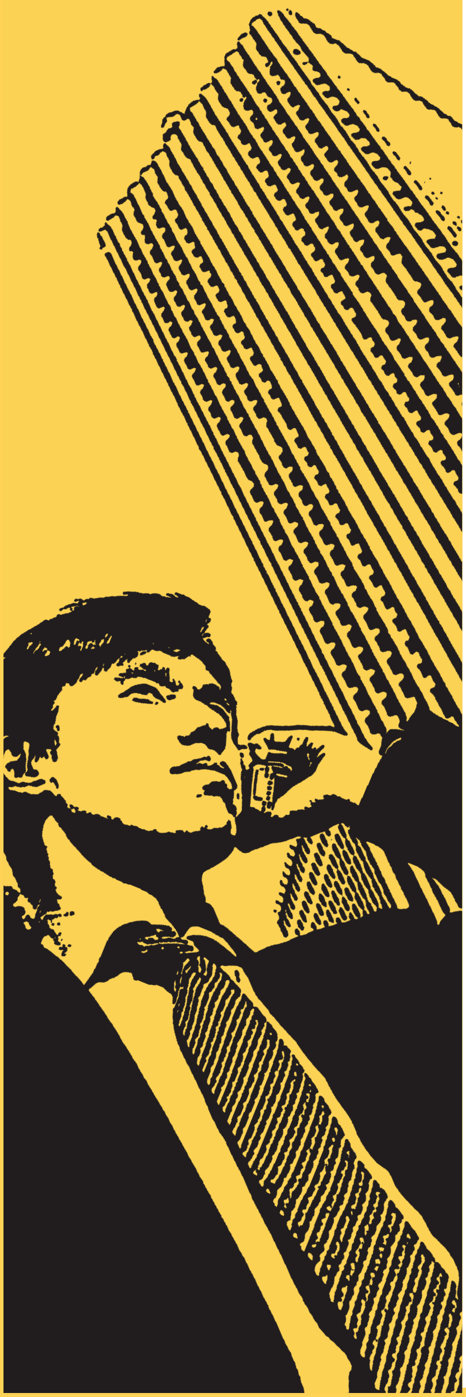
FOR PUBLIC ACCOUNTANTS PERFORMING AUDIT AND REVIEW ENGAGEMENTS


# Auditing Considerations in an Uncertain Economic Environment

## Uncertainties in the current economic environment

There is a possibility that the Canadian economy may weaken in the near term. This has been noted in various sources, including the economic forecast for Canada issued by the Organization for Economic Co-operation and Development. Heightened risks from renewed financial-market turmoil linked to the European sovereign debt crisis and high levels of household indebtedness are eroding consumer confidence.

In January 2009, staff of the Auditing and Assurance Standards Board (AASB) issued a *Risk Alert*, "Auditing Considerations in the Current Economic Environment," to highlight matters for auditors to consider when responding to higher risks of material misstatements of financial statements of entities significantly affected by the 2007/2008 downturn in the Canadian economy. This Bulletin updates the January 2009 *Risk Alert* to make reference to the Canadian Auditing Standards (CASs), as well as the uncertainties in the current economic environment.



The degree to which a particular entity, and its financial statements, will be affected by an uncertain economic environment will depend on various matters such as the following:

- *The industry in which the entity operates and the likely severity of an economic downturn on the demand for its products or services.* For example, some retail companies are suffering declines in sales because of significant cut-backs in consumer discretionary spending.
- *An entity's financing or credit arrangements, including its ability to continue to obtain financing from financial institutions and other creditors (including suppliers).* For example, some entities that have traditionally been able to obtain financing at reasonable rates with little difficulty may find that in a downturn they may face a considerable tightening in the lending practices of many financial institutions. Also, companies may no longer be able to meet the requirements of debt covenants agreed to when the economic outlook was more positive.
- *The extent to which an entity has invested in financial instruments, the market for which has been hit hard by a severe economic downturn.* For example, an entity may have significant holdings of government bonds from weaker economies.

## Matters covered in this Bulletin

To assist auditors in considering how to deal with the greater risks associated with an uncertain economic environment, this Bulletin discusses the following matters: continuance of the client relationship;

- communications with those charged with governance;
- going concern considerations;
- planning the overall audit strategy;
- understanding of the entity and its environment, and assessing and responding to the risks of material misstatement;
- auditing accounting estimates including fair value measurements; and
- audit considerations for selected financial reporting areas.

## Continuance of the client relationship

CAS 220, *Quality Control for an Audit of Financial Statements*, requires the auditor to perform procedures regarding the continuance of the client relationship. Matters for the auditor to consider in deciding whether to continue a client relationship include the integrity of principal owners, key management and those charged with governance of the entity. Faced with major pressures created by financial difficulties, management (perhaps with the cooperation or direction of those charged with governance or other others having significant influence over the entity) may have made changes to business practices or internal controls that indicate a lack of integrity. If such indications are found to have substance, this would lead the auditor to question whether it is appropriate to continue the client relationship.

## Communications with those charged with governance

Those charged with governance play a critical role in oversight of the financial reporting process. This role is even more important in times of financial stress for entities – overseeing the establishment and maintenance of internal controls to provide reasonable assurance with regard to the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. The auditor may consider whether those charged with governance have taken steps that include some or all of the following:

- Reconsidering the risks that the entity faces and ensuring that those charged with governance have considered the impact of these new risks on their oversight responsibilities, in advance of the year end and throughout the period to the finalization of the financial statements.
- Reconfirming with management that reporting and internal control systems are in place and functioning effectively, and that resources are in place to support difficult year-end judgments.
- If the entity has heightened liquidity risk, discussing with management whether there are material uncertainties that may indicate significant doubt about whether the entity is a going concern.
- Examining the rigour of management's assessment of the entity's ability to continue as a going concern and the appropriateness of any related disclosures in the financial statements.
- In view of the volatility of financial and non-financial markets, obtaining a better understanding of management's judgments with respect to illiquid asset values and requiring more detailed analysis and supporting information than in previous years.
- Obtaining assurance from management that significant accounting and reporting judgments are supported by a degree of rigour and analysis appropriate to the circumstances.

Paragraph 16(a) of CAS 260, *Communication with Those Charged with Governance*, requires the auditor to communicate his or her views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures with those charged with governance. In these discussions, the auditor may consider whether those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates and disclosures. The auditor would also discuss the clarity and completeness of the related financial statement disclosures. For example, given an uncertain economic environment, auditors would have an increased focus on the completeness of the material measurement uncertainty disclosures in the financial statements relating to financial instruments and might consider discussing this matter with those charged with governance.

## Going concern considerations

The assessment of an entity's ability to continue as a going concern is the responsibility of the entity's management. For example, International Accounting Standard (IAS) 1, *Presentation of Financial Statements*, in Part I of the CICA Handbook – Accounting, and Section 1400, *General Standards for Financial Statement Preparation*, in accounting standards for private enterprises in Part II, require management to make an assessment of the entity's ability to continue as a going concern. In making its assessment, when management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, management is required to disclose those uncertainties in the financial statements. Also, in assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. CAS 570, *Going Concern*, requires the auditor to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In an uncertain economic environment, the reduced availability of credit and illiquidity in short-term funding may create conditions that indicate a potential problem or jeopardize the continuance of the entity as a going concern. Issues surrounding liquidity and credit risk may create new uncertainties, or may exacerbate those already existing.

In an uncertain economic environment, entities with a longstanding history of profits and availability of capital may find it difficult to obtain or renew financing. Consequently, entities that have not previously found the need to prepare a detailed analysis in support of the going concern assumption may need to give the matter further consideration. Auditors may benefit from early discussion with management regarding the nature of the assessment that the auditor would expect management to make to evidence compliance with the applicable financial reporting framework.

Other conditions that the auditor may identify that may cast significant doubt about the going concern assumption include:

- the withdrawal of credit from entities that had previously had easy access to credit whenever necessary;
- whether valuation, trading issues or a slowdown in business activities

have led to or are projected to lead to breaches in lending covenants;
- whether on-demand clauses in term loans affect the classification of such liabilities on an entity's balance sheet and whether the lenders are likely to invoke such clauses;
- whether it is reasonable to assume that lenders will roll over existing credit facilities on similar terms, if at all;
- the likely unwillingness of banks to commit to renewal of credit facilities (for example, to issue letters confirming that these facilities will be continued in the absence of unforeseen circumstances); and
- whether guarantees (for example, from those charged with governance or other group entities) will continue to be available and are of significant value.

CAS 570 indicates that if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor is required to obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures include the following:

- Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action:
  - — evaluating the reliability of the underlying data generated to prepare the forecast; and
  - — determining whether there is adequate support for the assumptions underlying the forecast.
- Considering whether any additional facts or information have become available since the date on which management made its assessment.
- Requesting written representations from management and, where appropriate, those charged with governance regarding their plans for future action and the feasibility of these plans.

When events or conditions that may cast significant doubt on the entity's ability to continue as a going concern exist, the nature and extent of audit evidence available are likely to be affected; for example, it may not be possible to obtain confirmation of the existence of facilities from banks and third parties. Also, the professional judgment required in assessing the effect of one or more factors on the risk of material misstatement of the financial statements may be more difficult than in prior years; for example, the ability to assess the possible effect of contractual provisions that were expected to come into effect only in exceptional circumstances.

If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, CAS 570 requires the auditor to determine whether the financial statements:

- adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor would express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

- highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and
- draw attention to the note in the financial statements that discloses these matters.

## Planning the overall audit strategy

CAS 300, *Planning an Audit of Financial Statements*, requires the auditor to establish an overall strategy for the financial statement audit. Subject to updating and amendment as more information becomes available during the course of the audit, the overall audit strategy sets out:

- types and allocation of resources to be deployed for specific audit areas;
- timing of audit procedures; and
- materiality.

### *Types and allocation of resources*

In an uncertain economic environment, an engagement partner is likely to encounter many circumstances when he or she would consider whether more experienced staff should be assigned to an audit, and whether to be more involved with the engagement as compared to prior periods.

In addition, some less experienced members of the engagement team may not be familiar with auditing in an environment of severe economic downturn and dealing with the significantly greater uncertainties and complexities associated with it. Accordingly, appropriate coaching and training may be necessary in advance of the audit to make staff aware of how their approach to the audit would change from prior periods. Also, as noted in CAS 220, direction of the engagement team involves informing members of the engagement team of their responsibilities, including the need to plan and perform an audit with professional skepticism. In an uncertain economic environment, these matters are likely to be more important than ever to the performance of an effective audit.

CAS 620, *Using the Work of an Auditor's Expert*, requires the auditor to determine whether to use the work of an auditor's expert if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence. In planning the audit, the auditor will consider the nature, timing and extent of the use of experts to assist with aspects of the audit work, taking into account how an uncertain economic environment has affected the risk of material misstatements in the entity's financial statements.

For example, the auditor may consider it appropriate to use an auditor's expert with respect to matters such as the following:

- fair value measurements;
- asset impairment calculations;
- future tax asset write downs;
- pension plan measurements and disclosures;
- fraud risk factors and audit implications; or
- matters affecting the entity's ability to continue as a going concern.

Consideration of the advice of consultants will also be particularly important in an uncertain economic environment. Paragraph 18 of CAS 220 requires the engagement partner to:

- take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
- be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- determine that conclusions resulting from such consultations have been implemented.

Paragraph A22 of CAS 220 states that it may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. The team may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

Engagement quality control reviews (EQCRs) will also become more important for many engagements. CSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*, requires the firm to establish policies and procedures requiring, for appropriate engagements, an ECQR that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. A firm may consider whether the criteria it has used when determining which of its audits are subject to an EQCR should be revised in an uncertain economic environment. Further, the firm may consider amending policies with respect to the nature, timing and extent of EQCRs. For example, it may be appropriate to place increased emphasis on having the person performing the EQCR involved in the audit at an earlier stage and to be consulted more often than normal on significant matters as they arise during the engagement.

### *Timing of audit procedures*

Higher assessed risks of material misstatement may also cause the auditor to not only expand the extent of procedures applied, but also apply procedures closer to or as of year end (particularly in critical audit areas) given the many uncertainties that are likely to underlie the financial statements of many entities.

### *Materiality*

In an uncertain economic environment, there may be circumstances that affect the determination of materiality and the evaluation of misstatements identified during the audit, such as the following:

- net income of an entity may be nominal in the current period, or be widely different from previous periods;
- misstatements that may exist in balances representing opening equity may contribute to a material misstatement in the current financial period; or
- expectations of users of the financial statements, including what they would consider to be

material misstatements, may differ significantly from prior periods.

CAS 320, *Materiality in Planning and Performing an Audit*, requires the auditor to determine materiality for the financial statements as a whole and performance materiality. Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

Paragraph A4 of CAS 320 provides examples of benchmarks in determining materiality for financial statements as a whole. It indicates that profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Paragraph 11(b) of CAS 450, *Evaluation of Misstatements Identified during the Audit*, requires the auditor to consider the effect of uncorrected misstatements related to prior periods when determining whether uncorrected misstatements are material. Therefore, if a substantial reduction in an entity's profit before tax from continuing operations suggests the use of a significantly lower materiality level than that used in the previous audit, the auditor would pay particular attention to the level of misstatement that may exist in balances representing opening equity. These opening balances would have been audited to the previous (higher) performance materiality level, which may contribute to a material misstatement in the current financial period.

Also, in evaluating the effect of misstatements, qualitative considerations may result in misstatements of relatively small amounts having a material effect on the financial statements. Some qualitative factors the auditor may consider relevant to determining materiality (particularly in an uncertain economic environment) include:

- the potential effect of the material misstatement on trends, especially trends in profitability;
- a misstatement that changes a loss into income or vice versa;
- the potential effect of the misstatement on the entity's compliance with debt covenants, other contractual agreements, and regulatory provisions;
- the existence of statutory reporting requirements that affect materiality thresholds;
- a misstatement that has the effect of increasing management's compensation;
- the significance of the misstatement or disclosures relative to performance measures such as earnings per share or net income relative to expectations; and
- the motivation of management with respect to the misstatement such as managing earnings or smoothing earnings trends.

## Understanding the entity and its environment, and assessing and responding to the risks of material misstatement

General economic conditions may have a significant effect on the risks of material misstatement of the entity's financial statements. The nature and extent of the effect will depend on matters such as industry conditions, the competitive environment, supplier and customer relationships, and the regulatory environment. Uncertain economic conditions may make the entity's financial statements more susceptible to material misstatement because:

- operations of the entity are exposed to volatile markets (for example, exposure to volatility in stock markets, commodity process, or exchange rates);
- there are going concern and liquidity issues including the loss of significant customers;
- there are constraints on the availability of capital and credit;
- events or transactions give rise to significant measurement uncertainty;
- there have been significant disposals of assets or restructurings that impact operations;
- there have been significant changes to the control environment (for example, if the entity's control consciousness becomes lax because management is distracted by other operating issues); or
- there have been changes to management's risk assessment processes, and control and monitoring activities (for example, in cases when, as a result of significant staff reductions, activities are no longer being performed, being performed less frequently, or being performed by less experienced staff).

An important overall consideration in an uncertain economic environment is the increased risk of material misstatement resulting from management bias. With or without fraudulent intent, there may be a natural temptation for management to bias judgments underlying estimates and disclosures toward the most favourable end of what may be a wide spectrum of possible decisions. On the other hand, management may bias judgments toward the least favourable end of the spectrum, taking the opportunity of an uncertain economic environment to overestimate the write-down of assets.

The incentive in doing this would be for management to manage earnings or smooth earnings trends.

### *Risk assessment procedures*

Set out below are examples of how auditors may need to reassess the nature, extent and timing of risk assessment procedures in an uncertain economic environment:

- Auditors may consider making inquiries of the entity's valuation experts that the entity may have used or review reports by analysts, banks or rating agencies to obtain information about the entity. If the work of the entity's valuation expert is used as audit evidence, CAS 500, *Audit Evidence*, provides the requirements and guidance relating to the use the work of management's expert.
- CAS 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, requires the auditor to perform analytical procedures as part of the risk assessment procedures to provide the auditor with a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. In an uncertain economic environment, it may be more difficult to develop meaningful relationships among various types of information. Usually, meaningful relationships are those that are relevant to the entity's business and are expected to continue. However, this may not be the case in an uncertain economic environment. Auditors may need to:
  - — reconsider analytical procedures performed in previous years in assessing whether there are meaningful relationships among various types of information that will enable the auditor to form expectations for comparison with recorded amounts;
  - — consider whether analytical procedures are as effective as in prior periods in identifying risks of material misstatement;
  - — interpret results of analytical procedures more carefully; and
  - — consider supplementing analytical procedures with other risk assessment procedures.
- The relevance of information the auditor used in prior periods about the entity's organizational structure, business and controls may have to be reassessed.
- Identifying the susceptibility of the entity's financial statements to material misstatements may be difficult due to the complex interplay of different direct and indirect economic factors that may have a sudden significant impact on the entity. The discussion among the engagement team required by paragraph 10 of CAS 315 may need to be more extensive as compared to previous years. The discussion enables the team members to exchange information about the business risks to which the entity is subject and about how the financial statements might be susceptible to material misstatement.

### *Internal control considerations*

Given the possible changes to the control environment, specific control activities and risk assessment process as a result of an uncertain economic environment, the auditor's assessment of the controls relevant to the audit, their design and effectiveness in preventing, or detecting and correcting, material misstatements may also change. Auditors may need to pay particular attention to the adequacy of an entity's existing internal controls for determining significant estimates and assumptions as these areas require management exercising a substantial amount of judgment.

### *Assessing the risks of material misstatement*

Due to an uncertain economic situation, there may be more significant risks that require special audit consideration. In such an environment, an area where risks are likely to be more significant relates to judgments that management must make in developing accounting estimates and disclosing material uncertainties in the financial statements.

Paragraph A72 of CAS 315 notes that some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. Therefore, weaknesses in the control environment may require an overall response from the auditor.

### *Responding to assessed risks*

Because an uncertain economic environment may increase inherent and control risks, the auditor may need to modify his or her planned further audit procedures from those performed in past audit engagements. For example, the auditor may need to:

- look for opportunities to perform more effective substantive procedures that provide more persuasive audit evidence, such as external conformations;
- change the timing of substantive procedures towards the period end date; and
- change the extent of tests of controls and substantive procedures to reflect the changing control environment and higher risk of material misstatement.

*Fraud considerations*

An uncertain economic environment may trigger certain risk factors that affect the risk of material misstatement due to fraud. The following are examples of such factors:

- Financial stability or profitability is threatened by economic, industry or entity operating conditions, such as (or as indicated by):
  - — high degree of competition accompanied by declining margins;
  - — high vulnerability to rapid changes, such as changes in interest rates;
  - — significant declines in customer demand and increasing business failures in either the industry or the overall economy;
  - — operating losses making the threat of bankruptcy, foreclosure or hostile takeover imminent; and
  - — recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
  - — need to obtain additional debt or equity financing to stay competitive (including financing of major research and development or capital expenditures);
  - — inability to meet exchange listing requirements, or debt repayment or other debt covenant requirements; and
  - — perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

These factors may present pressures for manipulation of input and assumptions used in models to calculate fair value measurements and other accounting estimates including items such as asset impairments, inventory write downs, future tax asset write downs and pension obligations.

*Management override of controls*

Paragraph A4 of CAS 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, indicates that fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. This may include inappropriately adjusting assumptions and changing judgments used to estimate account balances such as using assumptions for fair value accounting estimates that are inconsistent with observable marketplace assumptions. In illiquid markets, the increased use of models and lack of market comparisons may present opportunities for manipulation or override of amounts calculated by brokers or experts.

*Responding to fraud risks*

Possible responses to such fraud risks include the following:

- Emphasize to the engagement team the importance of an attitude of professional scepticism when performing the audit in an uncertain economic environment.
- Focus the discussion among the engagement team more extensively on the susceptibility of the entity's financial statements to material misstatement due to fraud.
- Evaluate whether the entity's anti-fraud programs and controls have responded to the increased fraud risks relevant to an uncertain economic environment and any specific fraud risks identified by such programs.
- Incorporate an element of unpredictability in the selection of the nature, extent and timing of audit procedures, including the use of the auditor's valuation experts.
- Obtain an understanding of the business rationale of significant transactions that are outside the normal course of business.

## Auditing accounting estimates, including fair value measurements

In an uncertain economic environment, a primary area for increased risk of material misstatement relates to fair value measurements and accounting estimates, particularly those involving management judgment. Examples include fair value measurements of certain financial assets and impairment calculations for assets such as long-lived assets, accounts and loans receivable, and goodwill. A major focus of the auditor's procedures to respond to the increased risk of material misstatement associated with these calculations will be on evaluating the assumptions and data used by management in the fair value measurements or other accounting estimates.

When evaluating the assumptions and data used by management in the fair value measurements and other accounting estimates, auditors may find the following helpful.

- CAS 540, *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures*, requires the auditor to obtain an understanding of how management makes the accounting estimates, including the assumptions underlying the accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates may include:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (i.e., that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

• For accounting estimates that give rise to significant risks, CAS 540 requires the auditor to evaluate whether the significant assumptions used by management are reasonable. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates may include the following factors:
  - Where relevant, whether and, if so, how management has incorporated market-specific inputs into the development of assumptions.
  - Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
  - Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
  - Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

• If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, CAS 540 requires the auditor to develop a range with which to evaluate the reasonableness of the accounting estimate. The auditor may develop a point estimate or a range in a number of ways, for example, by:
  - using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model;
  - further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions;
  - employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions; and
  - making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

## Audit considerations for selected financial reporting areas

The following is a discussion of selected financial reporting areas may be affected by an uncertain economic environment. This discussion assumes that the applicable financial reporting framework has established requirements relating to these financial reporting areas. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to comply with the requirements of the financial reporting framework. If the applicable financial reporting framework establishes minimal or no requirements relating to the financial reporting areas, the auditor nevertheless needs to be satisfied that the financial statements achieve fair presentation (for fair presentation frameworks) or are not misleading (for compliance frameworks). The following discussion is not intended to be all inclusive of financial reporting areas affected by an uncertain economic environment.

### *Subsequent events*

In an uncertain economic environment, financial conditions can change rapidly. Therefore, there is an increased likelihood that there may be events occurring after the reporting period that indicate a need to adjust items or make specific disclosures in the financial statements to comply with the applicable financial reporting framework.

Examples of matters about which the auditor would inquire that are particularly relevant in an uncertain economic environment include whether:

- new commitments, borrowings or guarantees have been entered into;
- there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned;
- there have been any developments regarding contingencies;
- any unusual accounting adjustments have been made or are contemplated;
- any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption;
- any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements; and
- any events have occurred that are relevant to the recoverability of assets.

### *Long-lived assets*

The applicable financial reporting framework may require management to test long-lived assets for impairment whenever circumstances indicate their carrying amount may not be recoverable or that may be impaired. Examples of such circumstances may include:

- a significant decrease in the market price of the long-lived asset;
- a significant adverse change in the extent or manner in which a long-lived asset is being used;
- a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset;
- an accumulation of costs significantly in excess of the amount originally expected for its acquisition or construction;
- a current-period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast that demonstrates continuing losses associated with its use; or
- a current expectation that it will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

Throughout the audit, the auditor would be alert for the existence of these and other circumstances indicating the carrying amount of long-lived assets may not be recoverable.

### *Accounts and notes receivable*

The applicable financial reporting framework likely requires management to provide an allowance for doubtful accounts for accounts and notes receivable whenever an entity expects losses to be incurred in collecting accounts and notes receivable. In an uncertain economic environment, there is likely to be an increased risk of non-collection of receivables. In obtaining sufficient appropriate audit evidence regarding management's valuation of accounts receivable, the auditor would consider indicators of collection problems such as an increase in days' sales outstanding, the aging of receivables, or the amount of delinquent receivables.

### *Loan impairments*

The applicable financial reporting framework may require recognition of loan impairments when the entity no longer has reasonable assurance of timely collection of the full amount of principal and interest. The auditor evaluates management's conclusion about the need to recognize in earnings an impairment for deterioration in credit quality. Factors that may indicate such a deterioration in the current environment include:

- financial statements that portray a decline in the current financial position of the borrower or guarantor, particularly its liquidity, as evidenced by severe losses in the current year or recent years, a serious deficiency in working capital or cash flow, or an excess of liabilities over assets;
- independent credit reports that indicate concerns about an entity's ability to meet its continuing obligations;
- a current default in making interest or principal payments when due on debt obligations;
- a failure to meet debt covenants on existing debt obligations;
- downgrading of the credit status of the borrower or guarantor by a recognized credit rating agency; and
- a decline in the market value of a traded debt instrument issued by the borrower or guarantor that is unrelated to a change in market interest rates.

### *Goodwill*

The applicable financial reporting framework may require management to test the goodwill of a reporting unit for impairment either annually or if events or changes in circumstances indicate that the asset might be impaired. When management performs the applicable impairment tests, auditors would be alert for circumstances when the estimated future cash flows used in determining fair values are substantially lower due to the economic circumstances than estimates used in prior periods. Auditors would also be alert for circumstances when the estimated future cash flows used in determining fair values are not substantially lower than estimates used in prior years when there are indications that they should be. Management may find it particularly difficult to perform such calculations in an uncertain economic environment. It is important for auditors to consider the audit implications of an inability by management to perform the appropriate calculations. Some other key management assumptions which will come under pressure in an uncertain economic environment are growth rates, discount rates, control premiums and earnings multiples.

### *Inventories*

The applicable financial reporting framework may require inventories to be measured at the lower of cost or net realizable value. Management's estimates of net realizable value may be based on evidence available, at the time the estimates are made, of the amount the inventories are expected to realize. The auditor would assess whether the assumptions that management reflects in these estimates appropriately incorporate the impact of an uncertain economic environment on the entity's business.

### *Future (or deferred) income tax assets*

The applicable financial reporting framework may require that the carrying amount of future income tax assets be reduced to the extent that it is no longer likely to be realized. The uncertainty in the economy and the possibility of a recession could have an adverse effect on income. This in turn could affect the likelihood that sufficient taxable income will be generated to utilize any future tax assets. Evaluating whether and when to record or write down a future tax asset or set up a valuation allowance requires significant judgment on the part of management. The auditor will need to obtain sufficient appropriate audit evidence about management's judgments in light of current circumstances affecting the entity.

### *Defined benefit pension plans*

The components of relevant calculations of defined benefit pension plans are complex, often requiring the services of an actuary. The components of the cost of a defined benefit plan include, for example:

- current service cost;
- interest cost on the accrued benefit obligation;
- expected return on plan assets;
- gain or loss on a settlement or curtailment; and
- expense recognized for a termination benefit.

These and other components of the calculation will be significantly affected by uncertain market conditions.

Further, the amount of an obligation under a defined benefit plan for employee future benefits may be determined from actuarial valuations performed periodically. In the years between valuations, an extrapolation of the actuarial valuation of the obligation may be used. The applicable financial reporting framework may require management to annually review matters such as changes to the plan, the actuarial assumptions, occurrence of settlements and curtailments, changes to the employee group and the rate of return on plan assets to determine whether such matters necessitate any adjustments to the extrapolations. When the effect of any change is significant, a new valuation may be necessary.

In an uncertain economic environment it is likely that in many cases new valuations will be warranted. Further, judgments by management, even with the assistance of an actuary, may be difficult because of the level of measurement uncertainty involved. Often, auditors may need to consider engaging their own pension actuary to assist in auditing elements of the financial statements affected by an entity's defined benefit plan.

### *Contingencies and guarantees*

In an uncertain economic environment, there is likely to be an increased risk of unidentified or undisclosed contingencies related to, for example:

- pending or threatened litigation;
- guarantees of indebtedness of others;
- guarantees to repurchase receivables or property previously sold;
- violations of laws or regulations; and
- guarantees of contractual performance of others.

For litigation and claims, paragraph 9 of CAS 501, *Audit Evidence — Specific Considerations for Selected Items*, requires the auditor to design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- reviewing legal expense accounts.

For other contingencies and guarantees, examples of audit procedures that may assist auditors in identifying contingencies and guarantees include:

- reading contracts, loan agreements, leases and correspondence from regulators and other governmental agencies;

- making inquiries of internal audit personnel;
- obtaining information concerning guarantees from bank confirmations; and
- inspecting other documents for possible guarantees by the client.

In a significant number of cases, the uncertain economic environment may warrant a more detailed approach to performing these types of procedures and greater involvement of more experienced members of the engagement team.

### Documentation

All significant aspects of the auditor's work related to matters noted above will need to be documented in accordance with CAS 230, *Audit Documentation*.

## Conclusion

This Bulletin highlights some audit areas and applicable auditing considerations that are relevant in an uncertain economic environment. It does not address all issues that might arise when auditing in such an environment.

Auditors are reminded that each set of financial statements to be audited is likely to be affected, to some degree, by uncertain economic conditions. In many cases, the risks of material misstatement of financial statements will be significantly higher than in prior years, increasing the importance of the need to exercise professional skepticism and to take more extensive and different steps to prevent audit failures. Such steps will include effective assessment of, and responses to, the higher risks of material misstatement.

Overriding matters to consider include an increased focus on making sure that staff with appropriate training and experience are assigned to each audit, as well as being satisfied that the levels of the following are appropriate to the circumstances of each audit:

- direction, supervision and review by the engagement partner;
- consultation and quality control review;
- documentation of significant matters; and
- communications among members of the engagement team.