FEE
Federation of European Accountants
Fédération des Experts comptables Européens

Policy Statement

Standing for trust and integrity

December 2011

Professional Accountants' Contribution in the Current Economic Difficulties: Enhancing Transparency and Confidence

The current policy statement is first and foremost addressed to FEE Member Bodies to enable them to reach out to their members, being accountants in business, auditors or others with a helpful reminder on topical issues in their day-to-day work. It is also designed to appeal to and be of interest to a broader audience including accountants in the public sector, regulators and policy makers to inform them and contribute to the successful fulfilment of their responsibilities in the current economically difficult environment. We also believe the policy statement demonstrate the critical role professional accountants play in reinforcing transparency and confidence in the market.

Introduction

Europe is undergoing a profound and unprecedented crisis involving financial markets, public finance and the economy. The crisis has had drastic social impacts, in turn destabilising Member States' political systems and raising probing questions on the European Monetary Union and the governance of the EU, perhaps even the European project itself. Public confidence in markets, banks, business, media and regulators has been negatively affected.

In particular the sovereign debt crisis dictates the financial agenda and severely impacts capital markets. These are times to act with integrity and responsibility: all stakeholders have a responsibility to unite and act with due consideration for the public interest. The times that sovereign debt was regarded as risk-free are over. As the end of the year approaches, when many entities in the private and the public sector will have to prepare financial reports, FEE believes that the **European accountancy profession needs to play a key role by contributing to the transparency and reliability of financial and non-financial information**, therefore enabling better decision-making and contributing to restoring public and financial market confidence. Therefore, FEE emphasises challenges facing both private and public sector management, accountants preparing financial statements, as well as auditors, in these difficult economic circumstances.

In a policy statement of December 2008[1], FEE highlighted matters of specific relevance for statutory auditors in a period of financial crisis. Unfortunately, the comments made three years ago remain broadly valid although the cause of the financial turmoil is different. Therefore it is worthwhile reiterating the most relevant issues that FEE highlighted then.

This paper is aimed at informing FEE Member Bodies and sharing views with stakeholders; it does not intend to provide guidance or professional advice applicable to individual circumstances.

What is particularly relevant to preparers?

High quality financial and non-financial reporting is essential to proper decision-making

Professional accountants working in public and private sector entities have a key contribution to make. The public expects entities and their professional accountants to provide reliable financial information, irrespective of whether they are listed entities, small, medium or large private entities, financial institutions or public sector bodies.

It is critical that the information provided is fair and transparent to allow users to apply their own judgement and ultimately make sound and unbiased economic decisions. Professional accountants are frequently involved in the preparation and interpretation of accounting information to support important business decisions. Sound decisions are the cornerstone of future economic prosperity and robust decisions are dependent upon the availability of relevant, accurate and timely information.

Without being comprehensive, FEE wishes to draw preparers' attention to issues which it believes require particular consideration in the current challenging economic circumstances.

[1] The Accountancy Profession's Contribution to the Debate on the Crisis – Three FEE Policy Statements http://www.fee.be/publications/default.asp?library_ref=4&content_ref=943

Measurement of assets

Consistent application of the **recognition and measurement principles** to all assets, especially financial instruments, including sovereign debt, related financial instruments such as guarantees, credit default swaps and other derivatives, is a pre-requisite for reliable and fair financial information. This is particularly important in the current challenging macro-economic climate with potentially strained funding and volatile financial markets.

Therefore, it is an absolute necessity to recognise and fairly measure **existing exposures to sovereign debt of countries with stressed financial positions**, including proper consideration of any known indirect effects. Any information available that could have an impact on the probability of the receipt of future cash flows, like the existence of a draft restructuring plan, needs to be carefully considered.

Moreover, it is also worth noting that preparers should take special care when **valuing receivables and other assets due from counterparties in countries with stressed financial positions**. The use of market indicators in the determination of fair values, wherever required, should be maximised.

This is important for SMEs too as European Commission research has shown that about 40% of these entities are engaged in cross border transactions as buyers or sellers. Individual transaction values may be modest but the impact of delayed or non-payment can be significant for the small entity concerned.

Impairment of financial and non-financial assets

In the above context, the **principle of impairment** needs to be properly applied mainly in relation to available for sale assets, but also to assets held at amortised cost. Objective evidence of impairment includes, amongst others, disappearance of an active market, financial difficulty of the obligor and decrease in the estimated future cash flows. Significant or prolonged decline of the fair value of equity investments below its cost also indicates impairment. In performing impairment tests, management needs to support their assertions with evidence.

In addition, **impairment of goodwill and other intangible assets** should be reflected upon. Numerous entities have significant amounts of goodwill and other intangibles acquired before the current crisis on their balance sheets, the value of which could be impacted by the current developments. We should not forget that the short-term economic outlook for many entities, as well as the prospects for the underlying national economies, remains negative.

Going concern issues

Under the current circumstances – with the continued pressure on corporate cash flows due to nervous capital markets and limited access to finance – **the credit and liquidity risks are likely to be material** for many more entities than before. The fair value of the future expected cash flows on financial assets can be at risk. Therefore, liquidity should be assessed with due care as it may impact future viability of the entity.

Having that in mind, entities' management has to assess whether the entity can continue in the foreseeable future as a going concern. All the **material uncertainties** of which management is aware or which it expects, related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern, should be considered. They can relate to macro-economic conditions (access to finance, possibility to refinance current obligations, etc.) as well as internal factors (counterparty risk, recoverability of assets, maturity analysis of assets and liabilities, financial support of the parent undertaking, etc).

Continued access to finance for SME businesses, which might be perceived as being of relatively high risk, may be a particular concern when banks' balance sheets are under pressure. It is indeed important to note that going concern and impairment issues are not only relevant to larger entities, but also to Small and Medium sized Entities (SMEs).

Disclosures

Having satisfied themselves with due professional scepticism that the financial data are fair, accountants also need to ensure that the disclosures and explanations provide users with relevant and transparent information, use understandable language and are not overly complex. In particular the following disclosures should be encouraged:

- **Nature and extent of direct exposures to sovereign debt** of individual countries with stressed financial positions, including all kinds of financial instruments referenced to such debt;
- **Known effects resulting from indirect exposures to sovereign debt** of individual countries with stressed financial positions;
- **Nature and extent of exposures to other counterparties** from relevant distressed countries;
- **Estimation uncertainties and judgements** made as to the assessment of whether there is objective evidence of **impairment and recoverability of financial assets**, which should include transparency on the risk adjustment made to the business planning for accounting purposes.

Standard disclosures may not be sufficient to restore the confidence of the public in the presented information. Preparers need to understand that the more transparent financial reports are, the more satisfied and confident stakeholders will be, from which the entity will benefit.

Financial institutions aspects

Over the last few years – due to exceptional financial difficulties - various financial institutions across Europe received substantial governmental bailout support. Governments injected additional resources in an effort to recover the financial stability of the whole economy.

As public interest entities, financial institutions are highly regulated businesses. Accountants preparing their accounts not only need to ensure compliance with the relevant financial reporting framework, but also **adherence to regulatory and capital requirements**.

In the process of preparing financial reports, preparers should give due consideration to relevant guidance issued by national, European and global organisations. In this respect, reference can for example be made to the recommendation included in the European Securities and Markets Authority (ESMA) Public Statement on Sovereign Debt in IFRS Financial Statements of 25 November 2011[2].

What is particularly relevant to auditors?

Transparent, reliable and audited information is instrumental to restoring confidence

> Whether they audit public sector entities – including governments – or entities in the private sector – financial, industrial, large or small – auditors will play an instrumental role in restoring public confidence.

Although it is the responsibility of management to prepare financial statements, all parties involved in the financial reporting chain have a contribution to make to enhance the accuracy, completeness and transparency of financial information.

Continuous communication with governing bodies

Auditors have a significant role in **communicating with management boards, supervisory boards and audit committees**, not only to obtain a better understanding of the **key risks** faced by the entity, the way the entity mitigates or intends to mitigate those risks, but also to challenge management's assumptions and estimates with a professional and sceptical mindset.

Areas of particular attention

Without being comprehensive, FEE wishes to draw auditors' attention to the areas that need particular consideration when performing audit procedures in the current challenging economic circumstances:

- Reasonableness and viability of key judgements and estimates made by management;
- Recognition, measurement and disclosure of sovereign debt and other financial assets;
- Impairment of goodwill and other intangible assets;
- Probability of expected future cash flows and other factors that could impact negatively on the liquidity of an entity;
- Adherence to regulatory and capital requirements.

All of the above considerations may impact not only on the results and financial position but also on the going concern of the entity in the foreseeable future and ultimately it is the auditors' responsibility to assess whether the **going concern assumptions** are realistic for any entity being audited.

Communication with external stakeholders

Auditors need to reflect on how to best communicate their findings in the **external audit report to address the public expectation** for the report to be transparent and comprehensive. This is key to ensure public trust and confidence in the audit profession which is expected to act with scepticism and objectivity. It is highly probable that the **standard communication might not suffice**.

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.

The standard audit report might also not suffice as far as **communication with regulators** is concerned (depending on the nature of activities of the entity and national regulations). Apart from standard reporting to regulators required in some countries by law, frank and open dialogue with relevant regulators can contribute to enhanced transparency and understanding of the risks faced or to be faced by the relevant industry and market participants.

In the case of **group audits**, auditors need to ensure a consistent audit approach in relation to the areas of importance as indicated above, not only at a group or parent company level, but also at the level of every audited subsidiary in all countries.

Auditors should also take into account **subsequent events** up to the moment they issue their audit report and in the current volatile climate these events are likely to be of increased importance.

Regulatory aspect

FEE strongly believes that regulators play an ever **increasing role in promoting as well as ensuring consistency and transparency**. They possess a broader perspective of the relevant industries on national and European level and should have an appreciation for systematic risks. Therefore, auditors, like preparers, should actively solicit and carefully take into account any guidance received or issued by national and European regulators and engage in a professional dialogue with regulators.

[2] http://www.esma.europa.eu/index.php?page=groups&mac=0&id=13

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Specific aspects to consider in the public sector

Stakeholders, taxpayers and markets have legitimate high expectations in public sector governance, reporting and auditing

Transparency and accountability play a critical role for any entity active on capital markets, but the sovereign debt crisis has reminded all, but especially governments, that this also applies to the public sector.

Accrual accounting improves the quality of financial information

The financial crisis underlined the importance of the availability of **timely and reliable financial, fiscal and other information**, and emphasised the seriousness of the consequences of insufficient financial management and reporting in the public sector.

Governments were sometimes forced to play an important role in the efforts to restore financial stability through unprecedented bailouts, takeovers and guarantees of various kinds, which are likely to result in new liabilities and other obligations.

Therefore, the regular public availability of timely and accurate financial information about the government's operations and financial position is essential to enable users and investors in government bonds to effectively make sound economic decisions.

Government accounting on a cash basis is still a widespread practice and European Union Member States are at different stages of implementing accrual accounting. **Striving for accrual based accounting would provide a firmer base to understanding economic activity of the government at all levels.** This would support better decision-making and enable better public services which in turn results in greater public and investor confidence.

Importance of investing in appropriate internal controls

FEE emphasises the importance of a well functioning internal control system which should be an integral part of the government's management, financial and governance infrastructure. Internal controls should be reinforced as they play a significant role in **enforcing rules, minimising the risk of errors in public financial reporting and detecting fraud.**

Importance of audited financial information

The quality of publicly available financial information and accounting systems, including internal controls, must be enhanced by the involvement of independent auditors (Court of Auditors or accounting firms). By providing an **objective assessment of whether public resources are faithfully and effectively managed**, the public sector auditor has an important role to play to achieve integrity and instil confidence among citizens and investors in public securities.

The general public expectations are that public sector organisations serve the public interest and that public expenditures, income, assets and liabilities are controlled and stewarded skilfully. In this respect, government auditors should pay particular attention to the assessment of governmental programs, policies, their operation and results, not only by conducting financial audits but also performance value for money audits and investigations.

Audited financial statements should be available, as it is in the private sector, within a reasonable period of time in order to demonstrate the accountability of public sector entities.

Closing remarks

Both in the private and in the public sector, appropriate decision-making requires timely, verified and reliable information. More than ever in a crisis situation, management's and governments' decisions should be supported by information provided through high quality accounting and other information systems, including effective and efficient internal controls.

Reliable accounting will not solve the crisis, but will create transparency to identify significant matters, thus providing evidence of such and helping their resolution. The transparency principle lies at the basis of policy decision-making. It should equally apply to the private and the public sector.

About FEE

FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) is an international non-profit organisation based in Brussels that represents 45 institutes of professional accountants and auditors from 33 European countries, including all of the 27 EU Member States. FEE has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big accountancy firms, businesses of all sizes, government and education, who all contribute to a more efficient, transparent and sustainable European economy.