Subprime and Credit Crunch – Financial Reporting and Auditing Issues

Q. As a preparer of financial statements or as an auditor, what are the financial reporting and auditing issues that I have to look out for in current market conditions?

A. In recent months, financial market conditions have been characterized by significant volatility compounded by a liquidity crunch in certain jurisdictions. Although the primary market shock arose from defaults on subprime mortgages in the United States in the middle of 2007, the effect has been felt globally due to the widespread use of structured securities and leveraged funding. Accordingly, you should watch out for risks and uncertainties in preparing or auditing financial statements. In particular, you should pay close attention to issues associated with the valuation of financial instruments and reduced liquidity.

In relation to the valuation of investments, the current market conditions may result in difficulties in measuring certain investments at "fair value." In particular, you need to identify the period in which the fair value of a financial instrument changed. In some cases it will be difficult to determine the extent to which the value changed during the reporting period. You will also need to consider whether any changes that have arisen since the end of the reporting period should be disclosed in your after balance date note.

The Global Public Policy Committee issued a paper dated 13 December 2007 *Determining Fair Value of Financial Instruments under IFRS in Current Market Conditions* which can be found at http://www.pwc.com/extweb/ncpressrelease.nsf/docid/00B25E49FECD10A2852573AD006E8C84/$File/PwC_GPPC.pdf

This paper discusses those aspects of IFRSs (and consequently HKFRSs) that are most likely to be relevant in establishing fair values. In the case of required disclosures, the paper identifies the most relevant parts of HKFRS 7 *Financial Instruments: Disclosures* and HKAS 1 *Presentation of Financial Statements* where particular care needs to be taken.

Another paper that you may find relevant is the Canadian Institute of Chartered Accountants paper issued on 18 January 2008 *Non-Bank-Sponsored Asset-Backed Commercial Paper: Year-End Reporting Issues* which can be found at www.acsbcanada.org/download.cfm?ci_id=42571&la_id=1&re_id=0.

This paper may appear to be less relevant, although it is addressing the same issues, as this paper references Canadian standards rather than international standards.

For auditors, you are referred to HKSA 545 *Auditing Fair Value Measurements and Disclosures,* which establishes standards and provides guidance on auditing fair value measurements and disclosures in financial statements.

As well as affecting valuations, reduced liquidity may limit finance available to companies and other entities, with, in extreme cases, potentially serious consequences in relation to the "going concern" assumption. Past experience of obtaining necessary financing cannot be relied on alone to provide sufficient evidence of an entity's ability to obtain financing in the future. In particular, lenders may be more risk averse when considering whether to provide or renew finance facilities and may establish new criteria. Given this, auditors are referred to HKSA 570 *Going Concern* which establishes standards and provide guidance on the auditor's responsibility with respect to consideration of the going concern assumption used in the preparation of the financial statements.

You can find further information from a paper issued by the United Kingdom Auditing Practices Board Bulletin 2008/01 *Audit issues when financial market conditions are difficult and credit facilities may be restricted* http://www.frc.org.uk/images/uploaded/documents/Bulletin%202008-1%20_for%20website_.pdf

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