technical factsheet 143

The impact of the credit crunch in the audit of small companies

This factsheet provides an overview of the credit crunch and of its possible impact on audit risk, with examples of circumstances that may generate a risk of material misstatement of the accounts of small entities.

The guidance reviews the Auditing Practices Board's response to the credit crunch conditions as set out in *Bulletin 2008/01* issued in January 2008. The factsheet then develops various examples of circumstances capable of increasing the risk of material misstatement of financial statements and affecting the going concern assumption of the accounts, together with an analysis of possible auditor's procedures that could be taken in response.

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THE CREDIT CRUNCH AT A GLANCE

Over the past few months the expression “credit crunch” has reverberated almost endlessly in the media and has now become familiar to a large part of the general public that has never experienced such an economic event.

The term “credit crunch” refers to the crisis currently affecting the credit markets almost on a global basis, a crisis that has stemmed from the defaults of sub-prime mortgages in the US and that has brought a number of large financial institutions to the verge of collapse.

The main effect of the credit crunch is that it diminishes the liquidity available in the financial markets and therefore reduces the opportunities available to businesses and individuals to raise finance.

A reduction in accessible finance has a negative effect on the overall economy and for that reason the central banks of several countries have acted by cutting interest rates and by injecting liquidity in the markets.

This action seems designed more to instil confidence in the markets than to have a lasting effect on the level of finance and the terms on which such finance is available on the market.

In the UK financial institutions have in fact raised the cost of finance notwithstanding the cuts in the official bank rate operated by the Bank of England after the crisis began. Lenders have reacted to an increased risk of default by raising interest rates and adopting more restrictive criteria for granting finance. Businesses and individuals are therefore faced by the double whammy of more restricted financing options available at an increased cost. In fact many users of finance with anything less than a spotless credit history or whose operations are classified as slightly higher risk could be refused funding even for the renewal of current facilities.

THE IMPACT OF THE CREDIT CRUNCH ON AUDIT RISK

The main impact of the credit crunch on the audit of small companies is that such entities may find it difficult to obtain the finance needed for their operations; that is particularly relevant for smaller entities that cannot offer any asset as security against credit. In reality also the companies that are able to raise finance secured on property may find it difficult to renew long term finance arrangements or to extend their current facilities, which are normally based on the value of the property secured, as a side effect of the current economic climate is that property prices have been sliding. More problematic access to the means of finance for small companies increases directly the exposure to business risk.

In addition the increased cost of loan capital raises the finance risk for small companies. Finance risk is the risk posed to a company’s profitability by the variation of interest rates. In general terms the more a company finances its activities by resorting to debt capital the greater the risk to the company’s profitability arising from an increase in interest rates.

From an auditor’s perspective an increase in the business and finance risk of a company has in most cases an effect on the risk of material misstatement of its financial statements. A higher risk of material misstatement has also a direct impact on the audit risk, which is the risk that the auditor expresses an inappropriate opinion on materially misstated financial statements.

Audit risk is defined by ISA (UK and Ireland) 200 ‘Objective and general principles governing an audit of financial statements’ as a function of the risk of material misstatement and of the risk that the auditor will not detect such misstatement, the so-called detection risk.

If there is increased risk of material misstatement at the overall economy level, such as that arising from the credit crunch, the auditor should assess the specific risk of misstatement for each audited entity and limit the detection risk by designing and performing appropriate audit procedures.

Although the risk is increased at the economic system level, the auditor of a small company needs to establish how the credit crunch can impact on the accounts of the entity being audited. If the impact is potentially significant to the company audited, for instance by generating considerable pressure on the management to maintain the level of profit, then there is a higher risk that the accounts can be materially misstated. In this case the auditor can only reduce the risk of not detecting material misstatements by performing further audit procedures, such as tests of internal controls and/or substantive procedures, aimed at the identified risky areas of the accounts. If for instance the management of the audited company is under pressure to maintain the profit level, then there could be the risk of sales being inflated by recognising revenue in respect of goods ordered but not yet delivered. In such circumstances the auditor could reduce the audit risk by carrying out substantive procedures such as obtaining external confirmations of the amounts outstanding and of the delivery dates.

The auditor should consider the impact of the credit crunch on the accounts of the entity and verify the risk of material misstatement both at the overall level of the financial statements and at the level of the single class of transactions, accounts balances and disclosures.

Many possible material misstatements could derive from the credit crunch in respect of assertions contained in the financial statements of a company and some of these are discussed in detail later.

The most worrying material misstatement that could occur at the financial statements level is that the going concern basis may not be appropriate. In a situation of difficult and more expensive access to finance, perhaps this is the area that should require the most attention from the management and the auditor, as the going concern assumption may not be appropriate or there might be a fundamental uncertainty affecting the ability of the entity to continue as a going concern that would need to be disclosed in the accounts.

THE APB'S RESPONSE TO THE CREDIT CRUNCH CONDITIONS, BULLETIN 2008/1

In response to the increase in audit risk posed by the credit crunch, in January 2008 the Auditing Practices Board issued guidance to assist auditors with the completion and planning of current and future audits in the form of Bulletin 2008/1 'Audit Issues when financial market conditions are difficult and credit facilities may be restricted'.

In particular the Bulletin alerts the auditors of all companies to issues relating to the reduced availability of finance and the difficult valuation of some assets for balance sheet purposes, especially those measured at fair value.

The Bulletin does not establish any new requirements for audits but rather draws on material within existing Standards and Practice Notes and frames existing principles and guidance within the context of the credit crunch.

The appendix to the Bulletin lists a number of factors that may arise under the credit crunch circumstances and that may result in increased risk of material misstatement of the accounts.

The overall approach that the APB's guidance recommends, if the accounts of an audited entity are at increased risk of material misstatement, is for the engagement partner to have particular regard to:

- his/her own involvement in the direction, supervision and performance of the audit,
- the capabilities and competence of the engagement team,
- the need for consultation with other professionals on difficult and contentious matters,
- the nature and timing of communications with the entity's management.

It is important to note that once the auditor has conducted an assessment of risk factors, such as those included in the appendix, and has identified significant risks that require special audit consideration, in addition to a general approach as outlined by the Bulletin, he should also respond to the specific risks identified. In fact under the provisions of ISA (UK and Ireland) 330 'The auditor's procedures in respect of assessed risks', the auditor should design and perform further audit procedures, such as tests of controls and substantive procedures, that are specifically responsive to the assessed risks. Therefore, as highlighted above, if a specific risk is identified - whether it relates to a balance, a class of transactions or to the overall financial statements, such as the going concern assumption - the auditor will need to carry out further procedures to reduce the overall audit risk.

The Bulletin contains some further guidance relevant to the audit of small companies. In particular it considers the impact of the credit crunch on the going concern basis of the accounts and the implications for the auditor's report.

The guidance points out that limitation to the finance available to companies may generate potentially serious consequences in relation to the appropriateness of the going concern assumption. Past records of obtaining necessary funding cannot reliably indicate an entity's ability to obtain finance in the future, as lenders may be more risk averse when considering whether to provide or renew finance facilities.

Auditors should refer to the guidance of ISA (UK and Ireland) 570 'Going concern' and in particular should obtain confirmations of the existence and terms of bank facilities and assess the intentions of the bankers in cases where there is a low margin of financial resources available to the entity.

If the auditors are not able to obtain sufficient appropriate evidence about the existence and terms of borrowing facilities and the intentions of the lender, then such uncertainty should be disclosed in the accounts and/or referred to in the auditor's report by way of an explanatory paragraph or a qualified opinion if the disclosures in the accounts are not adequate.

The implications for the auditor's report are that, if the financial statements contain a note that discusses a material matter regarding a going concern problem or another fundamental uncertainty, the auditor is required to add an emphasis of matter paragraph. In any case an emphasis of matter paragraph is not a substitute for a qualified opinion in the auditor's report or appropriate disclosures in the financial statements.

EXAMPLES OF FINANCIAL STATEMENTS MISSTATEMENT RISKS

The risk of material misstatement of financial statements may arise from a large number of circumstances and can be signalled by various factors typical of a situation of reduced availability of finance such as the credit crunch.

A few examples of such circumstances and some auditor's procedures that could be performed in response to the risk assessed are highlighted below:

Trade debtors discounting (existence of debtors)

Scenario

Your audit client is a family run regional company that manufactures wall and floor tiles for the low and medium end of the market. The company produces on order for some regional chains of tiles shops and for a number of subcontractors to the building industry in respect of sizeable commercial and residential building contracts. In addition the company sells its tiles via its factory shop, which is part of its only industrial building situated on a busy suburban road. The company also supplies independent shops with tiles that are normally kept in stock. Direct sales to the public and sales to independent shops make up about 50% of the company turnover and therefore require the maintenance of a substantial amount of stock.

Income is recognised and invoiced when the tiles are despatched to the customer except for cash sales in the factory shop. The credit terms are to allow a maximum payment limit of 30 to 60 days depending on the client.

Part of the working capital requirement of the company is financed by a lender specialising in invoice discounting. The company receives cash advances from the lender against the presentation of outstanding invoices or a copy of the sales day book listing. The lender does not administer the company's sales ledger or chase and collect outstanding trade debtors. Unlike invoice factoring the invoices are not assigned to the lender and the arrangements are confidential and not disclosed to customers. Receipts from customers are paid directly into a trust account set up by the lender, which then remits the balances monthly net of the initial advances and its charges.

Impact on audit risk

In respect of the current period of accounts you are auditing you are expecting that the impact of the credit crunch on the building industry and on the private market for home improvements to reduce sales and increase stock levels compared with prior years. The accounts actually show a substantially stable level of sales and an increase in stock.

You are aware that since the beginning of the credit squeeze some businesses have resorted to fraud by borrowing money against fictitious invoices – 'fresh air invoices'. Apart from totally fictitious invoices it could be that the company has been invoicing sales before the goods were despatched.

As your client is resorting to invoice discounting to finance its working capital requirement there is a significant risk of material misstatement of the sales figure and the trade debtors' balance.

Possible responses to assessed risks

The auditor's response could be to carry out tests of controls in respect of the company's sales system. Sequence test checks can be carried out on invoices, despatch note and orders especially for those raised near the end of the accounting period. For specific invoices the receipt and acceptance of the order can be checked against the company's internal control system and referenced to the corresponding despatch note.

Substantive procedures can be carried out on debtors' balances at the year end instead of or in addition to tests of controls. Under the circumstances highlighted above aged debtors may pose a lesser risk than debtors arising close to the year end as the focus of the testing is on the existence of the balance as opposed to its valuation. Obtaining direct confirmation of balances from clients, via the circularisation of items in the sales day book listings that have been used to obtain finance around the year end, is one of the most effective substantive procedures. The circularisation must be carried out on the client's authority but under the control of the auditor, so if the client refuses to co-operate that would provide a further indication that the accounts may be misstated.

Stocks cost and valuation (manipulation of production overheads)

Scenario

Your client is a small company that manufactures traditional handmade English pottery. The products are sold in two directly owned shops on the high street of two large local towns and via the company's website. In addition the company supplies some specialist shops in the region and some large department stores in London. The company is majority owned and managed by the founder, Mrs A, who as well as taking care of the general management parties involved in the design, marketing and supervision of the delicate production process. The company employs on a stable basis about 30 skilled people in manufacturing, one in design, three in marketing, four work full time in the shops, five carry out administrative duties such as managing receipts and delivery of goods and looking after facilities, whilst a small finance department of three, including a qualified financial controller, deals with debt collection, orders and purchases processing, payroll and accounting functions. The company funds its working capital requirements via an overdraft facility with a local bank.

The first analysis of the company accounts shows a slight decrease in sales compared with the prior year and a decrease in distribution and administrative costs while the value of closing stocks has significantly increased. The working papers relating to the stocktaking show an increase in the volume and value of stocks.
As the employment levels have stayed consistent over the current and prior year, you question the financial controller about the reduction in the admin and distribution costs. The controller replies that, on the request of Mrs A, the basis of allocation in the accounts of the director's remuneration and of the cost of the administration and finance departments had been changed. The previous allocation of Mrs A's remuneration, which was agreed with the auditor, followed an estimate of the time she spent performing various functions and 30% of her salary was allocated as production overheads with the remainder split between marketing and general administration. As she claimed to have reduced the time she spent outside the factory she asked for 50% of her salary to be charged as production overheads and therefore in the cost of stocks. Similarly she revisited the basis of allocation of the cost of the two central support departments, admin and finance. She requested that 40% of the cost of the admin department was charged to the cost of stocks as production overheads compared with the previous 25%, and that 40% of the finance department's cost was treated as production overheads compared with 20% previously.

The result in the accounts of the new allocation is that some costs that were previously included as admin and distribution costs were transferred to the cost and closing value of stocks.

Impact on audit risk
The risk of material misstatement of the accounts is that the new basis of overheads allocation is inappropriate and amounts to an attempt to manipulate accounting policies in order to keep profits steady by diverting some costs from the profit and loss accounts to the balance sheet as closing stocks.

Possible responses to assessed risks
In this case the auditor should question the management of the company about the assumptions underlying the new basis of allocation and verify whether the new basis is appropriate. Under the provisions of the FRSEE and SSAP 9, for smaller organisations the costs of management may fairly be allocated on suitable bases to the functions of production, marketing, selling and administration. Likewise the allocation of central services departments' overheads should depend on the function(s) that the department is serving and therefore only those costs that can be reasonably allocated to the production function should be included in the cost of stocks. The auditor should discuss the new basis of overheads allocation with Mrs A and seek evidence that such basis is appropriate by, for instance, reviewing the pattern of Mrs A's behaviour in terms of time spent on each function. That could be done by checking the direct costs of marketing compared with the prior year or by ascertaining how many meetings she attended in respect of the preparation and auditing of the accounts. Direct observation of the time she spent on the factory floor can also be gauged during audit visits.

Similarly the support provided to each function by the central services can be tested by questioning staff and observing patterns of behaviour even subsequent to the year end. If the auditor concludes that adopting the new allocation basis would result in a material misstatement of the accounts, he should ask Mrs A to change the accounts and inform her that otherwise he will qualify the auditor's report. If the new allocation basis is found to be appropriate the change would not constitute a change in accounting policies under FRS 18.

Another area that the auditor needs to discuss with the management is the fact that the stocktaking has highlighted an increase in stocks volumes. Stocks need to be stated in the accounts at lower of cost and net realisable value and an increase in closing stocks tends to signal slow moving items whose valuation may need to be questioned. The risk of material misstatement of the accounts is that some stock lines may be past seasons' collections and their realisable value could have fallen below their cost.

In this case the auditor should discuss with Mrs A the assumptions underlying the estimates of the net realisable value of slow moving stock lines and should obtain appropriate evidence of such value by examining the sales of the specific stock lines after the year end. Low selling prices after the year end may result in the net realisable value being less than cost and would require a write down of the closing stocks balance.

Valuation of tangible fixed assets to maintain loan covenants

Scenario
Your client is a media company that operates from directly owned premises located in central London. The company satisfies its medium term capital requirements via a loan secured on the property. The loan was extended on the basis of a revaluation of the property carried out last year and reflected in last year's financial statements.

The loan features the following covenants:

- Maximum loan to value at the end of each year 50% of the net book value of the property, any excess becoming immediately repayable on demand;

- Maximum debt to equity ratio 60% at the end of each year; if the ratio is exceeded the lender can demand repayment of part of the loan that would realign the ratio to the maximum 60%.

Currently the company has been extended a loan of 45% of the property value and the accounts show a debt to equity ratio of 55%.

You are aware that during the accounting period in question commercial property prices have gone down by an average 10% in the area but the carrying value of the property in the accounts is still derived from last year's revaluation.

Although the lender relies on the carrying value of the property included in the audited financial statements, it insists on an annual valuation. Performing a new valuation of the property may reveal a breach of the loan covenants. The directors of the company strongly oppose any change in valuation, arguing that the reduction in local property prices does not have a material effect on the value of the company's property.

Impact on audit risk
Although the property was revalued only last year both the FRSSE and FRS 15 require an interim valuation to be carried out in each year where it is likely that there has been a material change in value.

There is therefore a significant risk of material misstatement of the financial statements if a material change in the value of the property is not reflected in the accounts. In addition, if a breach of the loan covenants would result from a reduction in the property value, a provision for a liability would probably be needed in the accounts.

Possible responses to assessed risks
The auditor has already obtained information about property prices in the specific area that suggests that the value of the company's property is likely to have materially reduced. The auditor should therefore discuss the issue with the directors and request that the property valuation is updated by an experienced valuer, if the FRSEE is applied, or a qualified valuer, if FRS 15 is applied, who will have regard to transactions in similar properties and identification of market trends to determine the value of the property. Material changes in value would need to be reflected in the accounts or the auditor should consider qualifying the auditor's report accordingly.

Debt factoring

Scenario

Your audit client resorts to trade debtors recourse factoring to finance its working capital requirements. The arrangements with the factor allow your client to draw up to 90% of the face value of trade debts assigned to the factor, which in turn administers your client's sales ledger and takes care of debts collection. The money advanced to your client and the money collected from debtors is recorded in a factoring account operated by the factor. The factor charges interest and administration fees to the account and pays over to your client the net amount of any debts after 90 days of their assignment. On the other hand debtors assigned to the factor that are not settled within 90 days of assignment are transferred back to the company, which pays the full face value of the debts to the factor.

As a consequence of an increase in the number of debtors not settled within 90 days and of the generally more difficult credit situation, the factor has informed your client that the terms of the arrangements have been changed. For any new trade debt assigned to the factor the client will only be able to draw 70% of the face value and the balance will be charged a higher interest rate. The reduction in the financing facility will put a strain on the company's cashflows and could have an impact on the going concern assumption in the accounts.

The way in which the recourse debt factoring is accounted for in the financial statements is in agreement with applicable accounting principles. The full recourse to the client, granted to the factor in respect of each debt assigned, requires the factored debtors to be kept as receivables in the balance sheet of the client. On the other hand the cash advanced to the client, the interests accrued and the administration fees are recorded as a creditor towards the factor.

Impact on audit risk

The post balance sheet events of reduced advances granted by the factor due to an increase in aged debtors reveal that there is a risk of material misstatement of the accounts. The risk is of an overstated valuation of trade debtors that could be effectively unrecoverable.

Possible responses to assessed risks

In this case the auditor should obtain information about factored debtors that have been transferred back from the factor and carry out procedures to confirm the recoverability of such amounts. Some of the most effective procedures could be that of debtors' circularisation and of verifying post-balance sheet payments. Doubtful balances would require an appropriate bad debts provision and some unrecoverable balances could need to be written off in the accounts.

EXAMPLES OF CIRCUMSTANCES AFFECTING THE GOING CONCERN ASSUMPTION

In a general situation of difficulties for the financial markets and restrictions on access to credit facilities, particular circumstances may emerge that can definitely affect or cast doubt on the ability of a company to continue as a going concern. The magnitude of the risk posed would depend on the degree of the company's financial position exposure in respect of each circumstance.

A few instances of financing risk factors associated with a credit squeeze situation that can call the going concern assumption into question are outlined below together with possible auditor's responses.

Mismatching of long term capital requirements and short term financing

Scenario

You have been the auditor of a professional services company for a number of years. The company was founded by two directors, who are currently also the majority shareholders, about 15 years ago and in recent years has experienced a rapid rate of growth.

A peculiarity about the accounts is that the company's largest asset in the balance sheet is constituted by the work in progress amount that before the implementation of UITF 40 reached £ 1.5m, almost 25% of the turnover. The application of UITF 40 has resulted in a reduction in absolute terms of the work in progress balance in the accounts and in a corresponding more than proportional increase in trade receivables.

The increase in the level of work in progress and trade receivables is effectively a consequence of the recent rapid growth and is considered by the management as psychological. In fact, although the company has an efficient credit control function that routinely meets its collection targets, it is not possible to invoice the clients before the provision of the professional services has been completed. This leads to a substantial level of current assets that needs to be maintained to carry on in business, irrespective of whether the assets are classified as work in progress or receivables, which in practice represent a long term working capital requirement. At the other end the company cannot increase the level of its creditors given that its main suppliers are merely its employees.

The funding of the company is mainly provided via a shareholders' loan that the two founders have conferred after securing their personal properties with a mortgage. As the shareholders did not have any further assets to offer as security to their lenders, further growth has been financed via an overdraft facility, repayable on demand, conceded by a local bank. At the end of the year the amount overdrawn was almost £500,000 against an amount originally agreed with the bank of £350,000.

In this case it is quite clear that a large part of the working capital outlay for the company that is a long term requirement has been financed by a short term facility which is by definition unsuitable for the purpose. There is also an indication that the company might be overtrading.

In view of the credit crunch you are aware that the bank might not be willing to renew the existing overdraft facility, as the balance exceeds the original level agreed and as in general lenders have become more cautious in conceding unsecured finance. The prospects are that reasonably the overdraft could be reduced to below the original £350,000 agreed for the prior period and that the interest costs will increase.

Impact on audit risk

The impact of the reduced credit on the company could be far reaching and affect its ability to continue as a going concern. If the company cannot finance the required level of working capital it will possibly not be able to pay its employees' salaries and could not accept new clients as it would not be able to advance the cost of the engagement. It might be forced to refocus its activities on a smaller number of clients and services and to make people redundant. If the management is not able to handle the situation competently the company may also struggle to repay the shareholders' loan and interests, which may trigger a really delicate situation by forcing the proprietors to put the company in liquidation.

Possible responses to assessed risks

The auditor should therefore ascertain the bank's intentions in respect of the renewal of the current facility and if no evidence is obtained about the continued support of the bank for the required level of capital, the auditor should discuss with the entity's management the appropriateness of the going concern basis in the accounts. The auditor should check whether the management have plans for alternative finance arrangements, if the current facility is not renewed, to cover for any credit shortfall. If the management does have such plans then the existence of the new facility and the intentions of the potential new lender should be tested. If the management does not indicate any possible alternative financing arrangements then any plans to overcome the impending financial difficulties, for instance restructuring of the business, should be examined and tested by the auditor.

The auditor may conclude that the going concern basis is not appropriate, if for instance the management intends or has no alternative but to liquidate the company, or that there is a fundamental uncertainty about the ability of the company to continue as a going concern for the foreseeable future.

If the going concern basis is not appropriate then the accounts should be prepared on a break up basis or the auditor should consider issuing an adverse opinion in the auditor's report.

If a fundamental uncertainty in respect of the going concern exists then a discussion of the matter should be included in the notes to the accounts and highlighted in an emphasis of matter paragraph in the auditor's report. If the matter is omitted in the accounts then the auditor should consider issuing a qualified opinion or disclaiming an opinion in the auditor's report.

Renewal of finance facilities secured on assets

Scenario

Your audit client restructured its financing arrangements five years ago by negotiating with a bank a medium term loan secured on a commercial property owned outright by the company. In addition to the original amount borrowed, the company received a further advance from the bank based on a revaluation of the property carried out two years ago.

The loan is due for renewal this year and you are concerned about possible implications of the renewal in view of the credit crunch situation.

So far the bank has considered the property to be a reliable security and has advanced to the company 90% of its value based on the last revaluation. The covenants applicable to the loan have also been quite loose and have been easily met by the company. They were respectively an interest cover of 1.75 and a maximum debt to equity ratio of 75%.

You are aware that property prices are sliding and that before the renewal of the loan facility the bank will request a full revaluation of the property. In addition information emerging from the financial markets indicates that the proportion of the loan to the value of the property is likely to be reduced from the current 90% and that the covenants imposed would be more stringent together with higher interest rates payable.

Impact on audit risk

As a result of the reduction in the value of the property and of the lower loan to value proportion there could be a shortfall between the finance requirements of the company and the medium term credit available.

Furthermore the increased cost of interest could adversely affect the interest cover level and a downward correction in the value of the property, and revaluation reserves, may result in a higher debt to equity ratio that would render compliance with tighter loan covenants more difficult and could trigger an early repayment of the facility.

Possible responses to assessed risks
Such circumstances would constitute a fundamental uncertainty about the ability of the company to continue in business as a going concern for the foreseeable future.

The auditor will need to test the circumstances relating to the loan renewal including questioning the bank about its intentions to renew the facility and the terms that are likely to be enforced.

If a shortfall in the finance requirements is detected or if there is a material risk of breach of the loan covenants, the auditor should discuss with the management any alternative or contingent financing arrangements and test the existence and terms of such alternative arrangements.

If the auditor concludes, on the basis of the evidence gathered or of the inability to obtain sufficient evidence, that there is a fundamental uncertainty about the going concern assumption, the matter would need to be disclosed in the notes to the accounts and referred to in the auditor's report by way of an emphasis of matter paragraph. If the matter is not properly disclosed in the accounts the auditor should consider issuing a qualified audit report.

Delayed cash inflows from trade receivables

Scenario
You are in the process of finalising the audit of a small company and you are reviewing the assumption that the company can continue in business as a going concern for the foreseeable future.

The firm is a manufacturer of quality garden furniture and about 90% of its production is sold to two chains of national department stores.

Over the last few years the payment terms accepted by the national chains has been 30 days from receipt of the invoice and the corresponding trade debtors days figure has been 36 days overall with a short term working capital requirement to cover receivables of nearly £200,000 on average. The working capital requirement has been funded by a bank overdraft and the company has never exceeded the limit set by the lender.

Upon discussing the going concern basis with the directors of the company you learn that both the main customers have decided to arbitrarily extend their payment periods from 30 to 60 days. The directors of the company state that given the size and importance of the clients to their business they will not offer any resistance to the extension.

The inability to react to an undesirable move by customers is one of the side effects of over-dependence on a limited number of customers or markets. In this case the main clients are using their bargaining power to shift some of the weight of the credit squeeze difficulties onto their suppliers.

If the firm had not been so dependent on such a limited number of customers the attempt to extend the payment terms, whether explicit or not, could have been effectively tackled by an efficient credit control function. The credit control department could have chased late payers and refused further supplies to customers with aged outstanding balances.

Impact on audit risk
You are worried about the impact of the extended payment terms on the company's cashflows. Extending the terms will effectively double the debtors' days of the company and is likely to increase the working capital requirement to £400,000. There would be a shortfall in cashflows of £200,000 compared with current levels that would need to be funded.

Possible responses to assessed risks
The auditor should discuss the extra funding requirement with the management and verify whether there are arrangements in place or capable of being put in place to obtain the level of funding needed.

Under current credit crunch circumstances it could be difficult for the bank to extend the overdraft facility to cover the company's increased finance needs.

The auditor should test the existence, terms and intentions of lenders in respect of any possible arrangements indicated by the company's management. If the auditor does not obtain sufficient appropriate evidence about the availability of the further finance needed then he may conclude that a fundamental uncertainty exists in respect of the ability to continue in business as a going concern. Such uncertainty would need to be disclosed in the notes to the accounts and referred to in the auditor's report by way of an emphasis of matter paragraph. If the matter is not properly disclosed in the accounts the auditor should consider issuing a qualified audit report.
