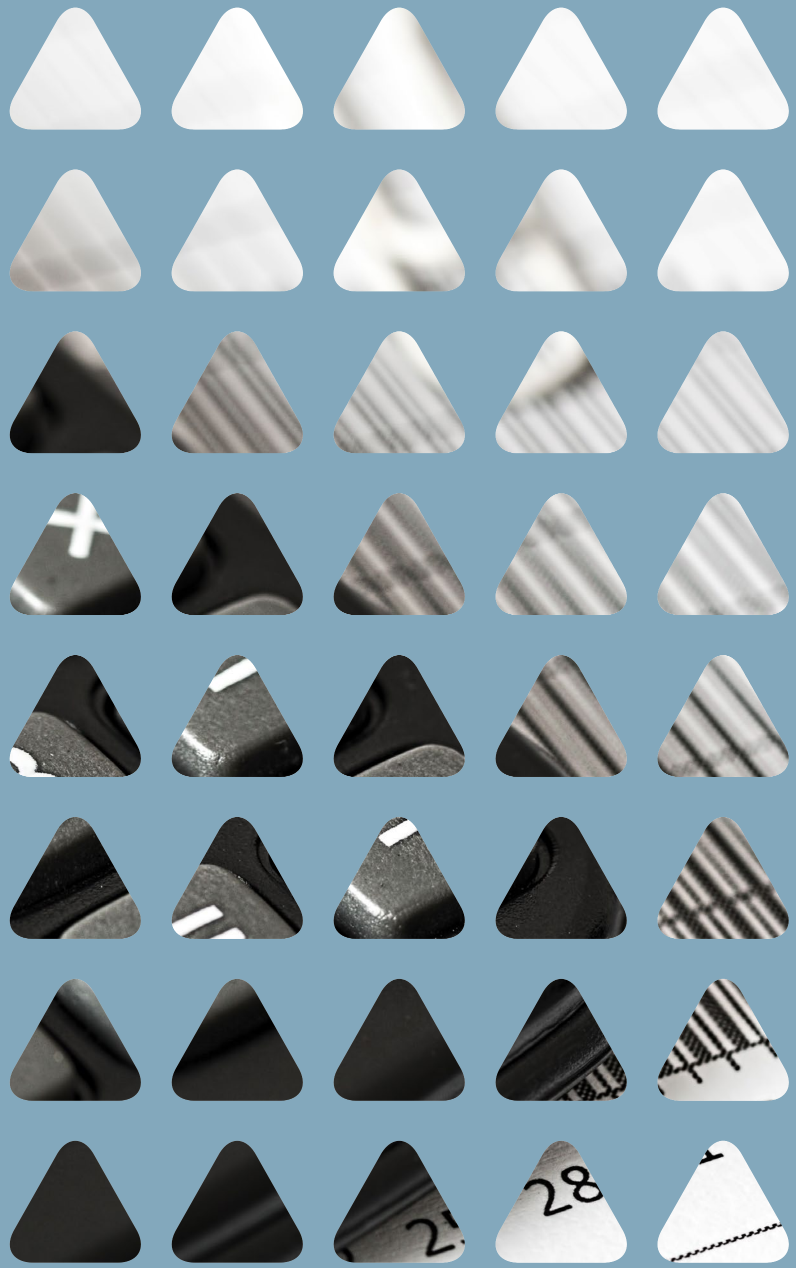

FINANCE AND ACCOUNTING

ENTER THE AUDITOR

THE VALUE OF AUDITOR ASSURANCE TO CREDIT INSTITUTIONS DURING THE COVID-19 CRISIS


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Among the many disruptions caused by the COVID-19 pandemic is an explosion of businesses seeking financial help. Credit institutions must sort out viable applicants from risky ones, often with limited information and no ability to perform detailed background research. In this situation, input from auditors can be very valuable. How can credit institutions make the best use of the input they get from auditors? Here are some practical tips.

Challenges to credit risk assessment procedures amidst the COVID-19 crisis

COVID-19 has hit the global economy hard. In their efforts to mitigate the negative impacts of this crisis, many countries are providing ambitious support packages intended to keep the economy afloat. In Sweden, along with offering various compensation mechanisms, the state is aiming to expand corporate financing opportunities via a multitude of sources, such as state loan credit guarantees provided by commercial banks, direct lending to exporting companies via the Swedish Export Credit Corporation, and direct lending through Almi, a state-owned financier and advisor to fast-growing companies. The Swedish central bank has also provided banks with up to SEK 500 billion of interest-free loans to improve financing conditions for companies in need.

To be eligible for state-supported financing, firms must have suffered from the COVID-19 crisis but must be otherwise financially stable. Even though the state is typically guaranteeing 70 percent (in some cases, up to 80 percent) of the loan, the remaining, non-guaranteed portion still represents a significant risk to financing institutions, in view of the enormous wave of bankruptcies that have occurred, or appear to be imminent, since the pandemic's outbreak.

In such a setting, auditor assurance can become more important than ever in banks' loan assessment process. Bank loan officers' ability to perform a reliable risk assessment and credit check during the COVID-19 crisis may be limited due to the highly turbulent economic

environment, travel restrictions, and social distancing requirements. On the other hand, auditors, especially those with longer client tenure and industry specialization, may have intimate knowledge of clients' activities, past performance, current situation, and future plans. Insights from auditors in the form of audit assurance, especially auditors' comment on the going concern basis of accounting, may allow credit institutions to make more reliable risk assessments within an existing financing framework. Likewise, auditors in this situation have the opportunity to create additional value for their clients by providing, within their audit reports, information that may facilitate a smoother credit application process.

We will suggest a few tips to assist credit institutions' decision making process by emphasizing the importance of auditor assurance and highlighting specific circumstances where the value of auditing might be greater in this unusual time.

Lessons from the research frontier

The main reason for auditing is to add credibility to a company's financial statements and thereby reduce information risk. Auditor assurance also reduces lenders' monitoring costs and is thus a very important component of loan decisions. We know from prior research that bank loan officers are more likely to grant loans to companies that provide audited financial reports and that auditor assurance is associated with lower interest rates. This positive effect of auditing on lending costs seems to be prevalent among both private and public companies, and the magnitude of the effect increases with the quality of auditing. Therefore, we highlight in the next paragraph some characteristics of high-quality audits that may be especially useful for banks amidst the COVID-19 crisis.

High audit quality implies that the auditor has the ability to discover material misstatements and also to report them to external investors. A large body of literature suggests that audit quality increases with the size of the audit firm (DeFond and Zhang, 2014). Larger firms such as EY, Deloitte, KPMG, and PwC (the so-called Big 4 firms) are expected to deliver higher audit quality due to their higher litigation and reputational risks, but also as a result of their superior competencies, as reflected in factors such as in-house training and informal knowledge transfer. Auditing firms can improve audit quality by specializing in certain industries so as to acquire greater knowledge of industry-specific issues and accounting practices.

In relation to the COVID-19 crisis and its potential effect on audit outcomes, two additional factors may affect audit quality. First, research has shown that geographic proximity to a client tends to increase the auditor's knowledge of the client and thus improves audit quality (Choi et al., 2013). This benefit may be more evident during the COVID-19 crisis due to travel restrictions and social distancing rules. Second, a longer auditor tenure may improve audit quality. This is because an auditor that works for a long time with the same client will gradually build a better understanding of the client's business and financial reporting practices, and will therefore provide a better service.

Importantly, past literature also informs us that the harsh economic environment that prevails during recession periods may weaken auditor independence and impair audit quality (Ettredge et al., 2017). Just a few months into the current pandemic, global auditing firms have already started slashing staff salaries and scaling back their operations. Travel bans and social distancing policies also limit the scope of audit tests. Such threats to audit quality, combined with the high level of uncertainty that audit clients are currently facing, pose enormous challenges to auditors' work. Thus, although auditor insights are essential in lending decisions, credit institutions must make well-informed judgements about the quality of the audits that companies seeking financing have received.

Our recommendations for the use of audit information in credit risk assessments

Based on previous research, we suggest credit institutions to put

more weight on audit assurance in credit risk assessment procedures, particularly when information in audit reports may yield unique insights about a firm's situation. More specifically, we suggest two perspectives on how audit reports could be used to differentiate between firms in financing decisions.

First, we highlight the importance of the going concern opinions in credit risk assessment. As per the International Standards on Auditing (ISA 570), the going concern opinion reflects an auditor's view of any material uncertainties that may impair the firm's ability to continue as a going concern within the next 12 months from the end of the last financial year. However, the audit report must take into consideration not only factors pertaining to the audited fiscal year but also material events that occurred after the books were closed. In view of the timing of the COVID-19 crisis in Sweden, auditors have a unique opportunity to convey useful information to credit institutions by highlighting the reasons for their going concern opinion, especially if those reasons emerged after the previous fiscal year's books were closed and are related to the COVID-19 crisis. Such communication could enhance the distinction between viable firms that have suffered temporary economic damage from the COVID-19 crisis and those whose business model was unstable even during normal circumstances.

Second, more attention should be paid to modified audit opinions that concern internal control weaknesses (ICWs). The COVID-19 pandemic has presented many firms with unprecedented risk management challenges. Firms with more robust risk management processes and fewer ICWs are likely to weather the economic turbulence better, whereas firms that are not strong in these areas may be unable to obtain relevant internal information to help them make timely, prudent decisions in a crisis situation. Economic consequences may be particularly pronounced for firms with pervasive deficiencies, i.e. ones that auditors have identified repeatedly over extended periods of time.[1]

[1] Due to the nature of audit assurance requirements, we caution against an automatic use of ICW opinions in credit risk assessment. The auditors may be obliged to report certain deficiencies that the firm has already addressed before or shortly after the end of the fiscal year.

Looking forward, financial institutions and government agencies may want to consider instituting a mandatory financial audit requirement for firms that receive government-guaranteed loans. In Sweden, about 70 percent of all registered firms are not subject to a mandatory financial audit requirement. Although their prior choice not to receive audits should not be held against them in credit risk assessment processes, instituting an audit requirement during the financing period would enhance these firms' reporting quality and accountability and would reduce the risks of inaccurate reporting, rent extraction, and, in the most extreme cases, economic crime, all of which are more likely during an economic downturn.[2]

In the current situation, delivering high-quality audits may be a challenging task due to the high levels of uncertainty, contact restrictions, and reduced staffing experienced by many firms. In view of these difficulties, we expect larger audit firms and those with longer tenure, closer proximity to their clients, and industry-specific specializations to deliver higher-quality audits. Although these insights are not unique to the COVID-19 pandemic, they become particularly important when traditional audit processes are interrupted and audit outcomes depend highly on auditors' intimate knowledge of their clients and the industries in which those clients operate. Overall, as COVID-19 has changed the business landscape for many years to come, the auditing profession should leverage its position and expertise to create new value as an intermediary between a firm and its capital providers.

[2] However, it should be noted that mandatory audits would constitute another burden on companies that are already financially distressed.

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