Credit squeeze made even tighter

Pressure on auditors is flowing through to banks and borrowers, writes **Andrew Cornell.**

Finding funding is tough enough, but the Australian Securities and Investment Commission's heightened scrutiny of auditors is compounding the credit squeeze.

Legal, accounting and banking figures have told *The Australian Financial Review* that warnings from the corporate regulator last year and again this year have made auditors "hyper-sensitive" to signing off on accounts.

That feeds through to financing decisions by banks, which are reluctant to guarantee finance without a clean sheet from auditors.

"It's obviously not a bad thing that everyone is more vigilant but it is also pro-cyclical in the sense it makes it harder to get finance at the very time when we want companies to invest and grow," Minter Ellison banking and finance partner David Eterovic said.

Although the impact of the audit crackdown is tougher access to finance – a common theme of business surveys and a Senate economics committee inquiry – it is also a reaction to looser auditing and lending standards in the good times before the crisis.

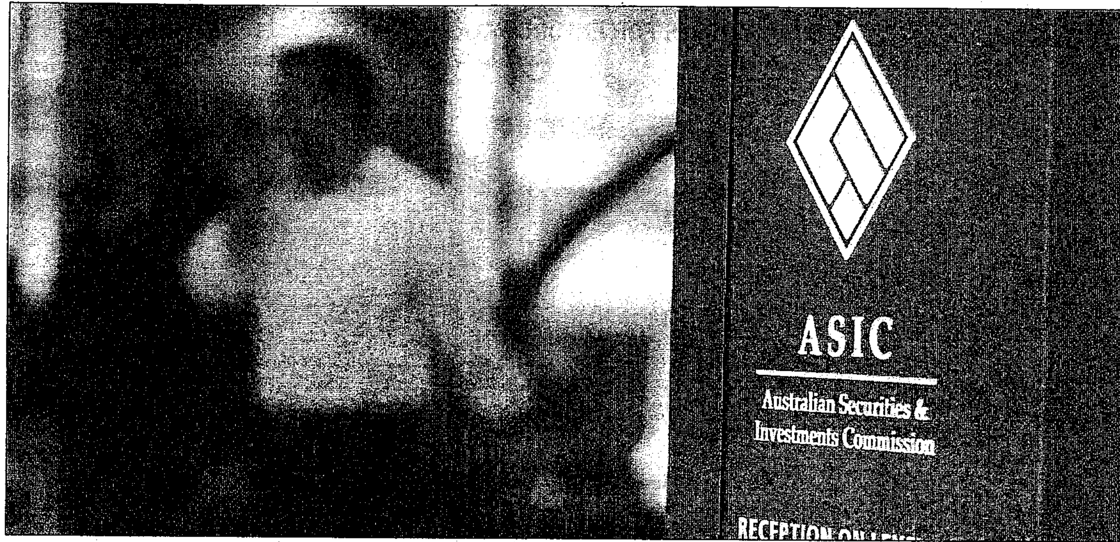
"There is no doubt the ASIC releases have put the business community on notice regarding debt classification and breaches of banking covenants," RSM Bird Cameron partner Robert Miano said.

"(While) these matters have always been at the forefront of auditors' going-concern assessments, the economic environment has resulted in greater scrutiny of the subjective elements of the impairment assessments."

Although the credit squeeze on SMEs and smaller listed companies is not directly the result of ASIC's colder eye on auditors, the regulator concedes it has made a difference to funding decisions.

"We have heard, from early on in this cycle – and others – that [the booking of impairment losses and the focus of directors and auditors on these areas] makes financing more difficult, but I think that is a case of shooting the messenger," ASIC's senior executive leader, accountants and auditors, Doug Niven, said

"And generally I think the banks are sensible about how they use this information. As a securities regulator, we look at the matter differently [to some others]. For us, transparency, the accuracy of accounts, is the most important thing. People have to know where they stand if they are going to invest or lend."



ASIC says transparency is important and that people have to know where they stand if they are going to invest or lend. Photo: ROB HOMER

A senior business banking executive at one of the major banks said that although the issue was manageable in the majority of cases, it became a factor when the bank and a company were working through complex refinancing decisions, particularly when the company had breached lending covenants but both it and the bank were confident about the future.

"The issue you get is a bit Catch 22 – the company wants the finance locked in so the auditor will sign off but we might have some more work to do. So we will have an understanding that we will roll the finance for, say, 45 days but the auditor needs something more definite," he said.

"Then if the auditor puts in a note, say an emphasis of matter, then the whole process is kicked up a level and that makes it more difficult."

An emphasis of matter paragraph draws attention to uncertainties about the ability of a company to continue as a going concern.

ASIC, in its latest list of accounting standards it will be monitoring, noted yesterday that uncertainty remained about the economic climate.

"There are indications that credit may still be tight for some entities, and entities should continue to focus on the ability to refinance debt within the next 12 months and beyond," the regulator said. "Entities should also review compliance with lending covenants."

The banker said there were multiple factors behind the tougher environment for business credit and this was one. Although higher risk premiums to reflect the greater chance of default and more selective lending were the main factors, the more onerous processes in the audit did affect access to finance.

National Australia Bank executive general manager business banking Geoff Greer said ASIC's position was understandable as diverse parties relied on the transparency of accounts. He said NAB made lending decisions based on the relationship with the client rather than a particular audit opinion.

"We are not seeing any problems with supply (of funding) but demand (from business) has softened if you look at system figures – NAB is growing above system," he said.

It makes it harder to get finance at the very time we want companies to invest.
Minter Ellison's David Eterovic

Minters' Mr Eterovic said the flow-on from ASIC's warning to auditors became evident late last year but the firm had seen a growing impact this year.

ASIC issued a warning to auditors – and boards of listed entities – in June 2009 to be particularly watchful on a number of items for annual and interim reports. These included going-concern assumptions; asset impairment/valuation of assets; borrowings and the current/non-current classification of liabilities; and whether the availability and terms of financing were subject to unfinished negotiations with lenders.

"The auditors were therefore on notice that ASIC would be checking their performance in relation to a number of important items," he said.

In its submission to the Senate inquiry into access of small business to finance, the Reserve Bank noted that lending to small business levelled off in 2009 after growing steadily in previous years. "The slowdown reflects both reduced demand from small businesses and a general tightening in banks' lending standards," the RBA said.

"Small businesses in most industries have been able to access funding throughout the financial crisis, albeit on less favourable terms than previously. Since late 2008, the interest rates on small-business lending have been below their averages over the past decade, as the large net reduction in the cash rate has more than offset the increases in banks' lending spreads.

"Fees have risen, but for most businesses they are only a small part of the overall cost of a loan. Competition in the small-business lending market has eased from the strong levels just prior to the onset of the financial crisis, but should recover as the economy continues to strengthen."

Similar tightening of funding conditions for smaller public companies has also been widely noted as these companies typically have not had access to either new equity or offshore debt funding available to larger corporates.

Ferrier Hodgson partner Brendan Richards said the tougher funding conditions were clearly visible but he considered that a cyclical phenomenon. "There have been examples where auditors won't sign off on accounts until they have comfort the banks will provide ongoing financial facilities," he said.

"This is not a new phenomenon but a natural extension of diligence as it relates to the review of debt in the context of an audit in a challenging economic environment."

Mr Richards said that regardless of the approach of ASIC and auditors, finance in this stage of the cycle would remain tight.

"What this has done is focus new lending towards security-based rather than cash-flow-based lending and that is a very normal defensive reaction when you've got a deterioration in international markets," he said. "Some businesses are not suited to debt funding, or additional debt funding, in these circumstances, and this is driving a pervading view that credit is tight."

Nor will ASIC be lightening up.

"Throughout the financial crisis we were asking a lot of questions in the audit inspection process, about training, review of second partners, areas of focus, reporting standards," Mr Niven said. "Our actions range from this to legal action, the pointy end of the stick."

The chairman of the Auditing and Assurance Standards Board, Merran Kelsall, said ASIC's stance was necessarily conservative at this point but she did not believe it had changed auditors' attitudes unduly.

"At this point in a cycle cash is king, it is so important to analyse cash flows and, in the case of going-concern issues, the audit has to project out 12 months," she said.

"The critical point is the capacity to pay debts when they fall due."