Polish Agency for Audit Oversight

PREPARATION FOR THE 2022 AUDIT

WARSAW 2023

In connection with the ongoing preparations for the audit of financial statements for 2022, the Polish Audit Supervision Agency wishes to draw your attention to selected material issues that may affect the audit of financial statements in 2023.

Issues that are worth paying attention to when planning audit tasks:

<u>I. Companies' response to disrupted supply chains, purchase bubbles, inflation and other changes to economic conditions.</u>

In 2022, in addition to further extraordinary events related to economic unpredictability resulting from the COVID-19 pandemic and the war in Ukraine, many entities also adapted to the changing economic situation. There was a reaction to previously identified risks, i.e. preventing disruption to supply chains, unloading traffic jams in seaports and finding substitutes for raw materials. Therefore, there were far-reaching changes to both procurement and sales processes adopted by enterprises.

One of the effects of global economic interactions is increased inflation. According to the Announcement of the Central Statistical Office of 13 January 2023, the increase in consumer prices in 2022, compared to the previous year, amounted to 14.4%. At the same time, there was a change in the law - tax acts (e.g. Article 15 paragraph 5 of the Corporate Income Tax Act) - significantly changing the rules of mandatory revaluation of fixed assets. Due to the amendment of this provision, there will be no revaluation of fixed assets, which will result in the effect of inflation on the assessment of short-term and long-term positions being ignored.

Increased inflation may have a significant impact on the following issues during the course of the audit:

a) Analytical procedures at the beginning and end of the audit – the degree of comparability has been distorted as fixed assets (and capital) are not subject to inflation-related revaluation. Therefore, analytical procedures may lead to overly optimistic conclusions from analyses of ratios.
b) As a result, it will be difficult to **draw conclusions about the continuation of operations on the basis of existing models.** These models - due to the optimistic nature of financial ratios in relation to non-current assets or equity - will not be able to correctly refer to anomalies in this area.
c) Another issue that the auditor should pay particular attention to will be the **valuation of debt instruments secured on assets** (especially those not measured at a fair value); the valuation of assets will be burdened with high risk.
d) **In the case of assessing credit exposures in banks, there may also be a problem with the assessment of creditworthiness** (both in plus and in minus).
e) Due to the analytical problems identified, there may also be **pressure to manipulate assets in order to change the true picture**; fraudulent reporting may increase, which, in turn, could trigger an increase in professional scepticism amongst statutory auditors.

The above-mentioned examples of risks may be reflected in the following elements of financial statements:

a) Inventories (especially risks related to inventory overvaluation, overdue and demand changes as well as risks related to contractual penalties, significant effects changing the production valuation due to energy problems or the occurrence of significant events after the balance sheet date),

b) Valuation of credit exposures (valuation of expected losses resulting from credit holidays, problems with the assessment of creditworthiness – excessive optimism or lack of provisions for the return of commissions in accordance with the judgments of the CJEU),
c) Future contracts (problems with assessing whether a profit will be made on the contract due to the fact that budgets and financial plans were defined in non-inflationary values, and revenues are probably shown in sales prices with inflation; problems with recognising a potential loss as the costs of the contract were budgeted earlier; risks related to contractual penalties for prolonging enforcement; withdrawal of suppliers contracted in public procurement from contracts despite high contractual penalties, which may result in the lack of implementation of subsidised projects),
d) Financial instruments (risk of insolvency, lack of collateral coverage and risk of misuse of funds),
e) Provisions (lack of adequate provisions for contractual penalties; incorrect valuation of provisions for employee benefits due to inappropriate inflation rate or measurement of provisions for employee benefits impeded by anomalies (COVID-19),
f) Liabilities (incorrect valuation of liabilities or lack of proper presentation of collateral),
g) Costs (increased wage costs, increased storage costs, increased downtime, resulting in an increase in unused production capacity; significant exchange rate differences),
h) Financial assets related to shares in subsidiaries located in Ukraine (the need to conduct critical impairment tests).

The above-mentioned catalogue is only an example of risks and their potential impact on the financial statements. For each company, a separate approach to auditing the financial statements is required from the auditor.

II. Customer Familiarisation

As can be seen from the above brief analysis, during the audit of the financial statements for 2022, audit teams should again conduct a thorough analysis of the client and what changes have occurred in the way it operates. The auditor should not rely solely on his previous knowledge, but should thoroughly re-examine the socioeconomic environment of the entity and changes in the entity's operation. In this respect, the guidelines of ISA 315 (Revised) should be followed, with particular emphasis on paragraphs 11, 12 and 13.

III. Risk of fraud

When approaching the analysis from the element of the fraud risk triangle,[1] it is essential to consider:

Pressure – employees and managers may experience increased fraud pressure, as a result of a possible deterioration in the financial situation of the business entity and increased inventory.

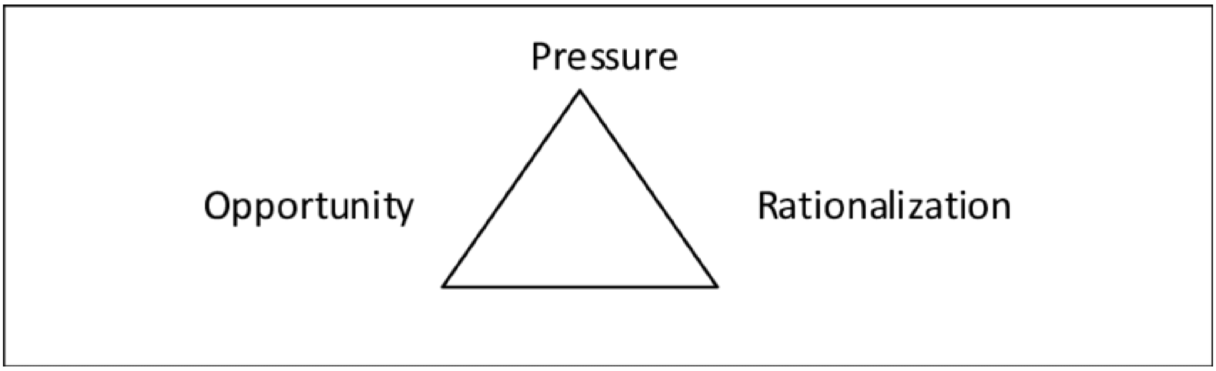
Opportunity – strong buying pressure may cause improper securing of inventory, overvaluation and thus temptation to destroy assets to recover insurance funds; in addition, managers may improve the financial result using several provisions (e. g. no creation of reserves or lack of entry in the costs of unrealised production capacity).

Particular attention should be paid to entities (e. g. investment funds) that have invested funds in shares and other financial instruments. It is worth ensuring that a risk-free rate is not used as a potential manipulation tool.

1 Based on D. R. Cressey's Theory of Deception

It is also worth looking at changes in the scope of people employed in accounting, which may cause changes in internal control (e. g. in terms of accounting estimates) and may cause its circumvention.

Rationalisation – employees and managers may rationalize fraudulent actions by thinking "this is necessary to help the company survive and nothing will happen to anyone."



When planning an audit, audit teams should consider any potential fraud risks that could have a material impact on the financial statements. It is therefore important to understand the actions taken by management to mitigate these risks and then assess whether the audit procedures that have been planned need to change. In this respect, the guidelines of ISA 240 should be followed. PANA encourages you to read the IAASB summary on the relationship between ISA 240 and other standards.

IV. Examination of estimates

Given the high volatility of the way the economy operates, this area of audit will pose a significant challenge for auditors. In the current year, the 540 (Revised) standard applies to the examination of estimated values, which places particular emphasis on risk analysis. In the light of the above analyses, special areas of risk include impairment losses, provisions, valuation of goodwill and valuation of intangible assets.

Due to the global volatility of the economic and geopolitical environment, the auditor cannot currently rely on assumptions from previous years. Instead, the auditor should make a critical analysis of the behaviour of the industry and the conditions in which the entity (including both suppliers and recipients) operates. It is worth noting changes in demand due to the lower purchasing power of consumers (retail sales are currently at the level of 2018-2019, and there are more consumers in Poland, due to migration from Ukraine etc.) On the other hand, business forecasts in the context of revenues usually assume optimistic models. Due to the unpredictability of the functioning of the economy, it may be worth assuming a decrease in revenues, rather than growth. On the purchasing side, it is also worth noting the unpredictability of purchase prices of certain raw materials, which is more difficult to forecast than a constant increase in prices (coal or steel prices, for example, were affected by this unpredictability affected). Due to the high volatility of the economic situation, it is particularly important to verify events after the balance sheet date; the latest information from the market may affect valuation assumptions.

Auditors should pay attention to the possibility of the head of the entity putting forceful pressure on financial engineering in DCF models by manipulating discount rates.

Once again, it should be emphasised that it is currently difficult to use analyses prepared on the basis of historical values. As part of research performed in the near future, it may be necessary to involve specialists in the process of valuing individual assets. At the same time, PANA encourages you to read a summary of the results of inspections performed by PANA before the end of June with regard to fair value estimates.2

V. Usefulness of consultation

As the current period of ongoing economic volatility may have unexpectedly affected the design of the financial statements, key auditors may have problems interpreting the financial statements. In such cases, consultation with other auditors or experts becomes indispensable. PANA encourages you to consult them as often as possible in order to be able to comprehensively consider the audit risks and, on this basis, design appropriate audit procedures.

VI. Changes in ESEF taxonomy

When reporting for periods beginning on or after 1 January 2022, issuers are required to apply the revised ESEF taxonomy and mandatory block tagging. It is mandatory to mark the disclosure of accounting policies and notes using tags from Table II of Annex 2 to the RTS Regulation.

PANA would like to point out that changes to operating conditions can lead to exceptionally unfavourable situations resulting from fraudulent reporting. PANA recalls that the purpose of the audit is to express a reasonable opinion with a high level of certainty that the audited financial statements are free from material misstatements, regardless of whether this is due to fraud or errors. PANA encourages you to read the commentary following the conference "Corporate Governance 2021: how to increase confidence in the economy".

PANA also recommends reading the recommendations of the Accounting Standards Committee entitled "Financial statements and activity report for 2022 in the face of an uncertain economic environment" as well as the IESBA alert entitled "Conflict in Ukraine: Key considerations regarding ethics and independence".