

GOING CONCERN

It is essential that candidates preparing for the Paper F8 exam understand the respective responsibilities of auditors and management regarding going concern. This article discusses these responsibilities, as well as the indicators that could highlight where an entity may not be a going concern, and the reporting aspects relating to going concern

Candidates attempting Paper F8, *Audit and Assurance* will need to have a sound understanding of the concept of going concern. Among other syllabus requirements, candidates must ensure they are aware of the respective responsibilities of auditors and management regarding going concern. The provisions in ISA 570, Going Concern deal with the auditor's responsibilities in relation to management's use of the going concern assumption in the preparation of the financial statements.

THE CONCEPT OF GOING CONCERN

An entity prepares financial statements on a going concern basis when, under the going concern assumption, the entity is viewed as continuing in business for the foreseeable future. The term 'foreseeable future' is not defined within ISA 570, but IAS 1, *Presentation of Financial Statements* deems the foreseeable future to be a period of 12 months from the entity's reporting date.

The concept of going concern is an underlying assumption in the preparation of financial statements, hence it is assumed that the entity has neither the intention, nor the need, to liquidate or curtail materially the scale of its operations. If management conclude that the entity has no alternative but to liquidate or curtail materially the scale of its operations, the going concern basis cannot be used and the financial statements must be prepared on a different basis (such as the 'break-up' basis).

MANAGEMENT'S RESPONSIBILITY

The concept of going concern is particularly relevant in times of economic difficulties and in some situations management may determine that a profitable company may not be a going concern, for example because of significant cash flow difficulties. It is important that candidates understand that it is the responsibility of management to make an assessment of whether the going concern presumption is appropriate, or not, when they are preparing the financial statements. In order to conclude as to whether, or not, an entity is able to continue in business for the foreseeable future, management will have to make judgments on various uncertain future outcomes of events or conditions. ISA 570 outlines three factors that are relevant and which management must take into consideration when determining whether, or not, an entity can prepare the financial statements on the going concern basis:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require

an explicit management assessment specify the period for which management is required to take into account all available information.

- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made. (1)

Question 5(b) in the June 2010 exam (Medimade Co), for eight marks, required candidates to: 'Identify any potential indicators that the company is not a going concern and describe why these could impact upon the ability of the company to continue trading on a going concern basis.'

The scenario presented to candidates gave an abundance of warning signals that management's assessment of going concern may not be appropriate in the circumstances. These warnings signals were:

- a growth in the level of competition Medimade Co faces
- a significant decline in demand for its products
- failing to re-invest in new product development
- difficulties in recruiting suitably trained scientific staff
- an inability to agree suitable financing terms with the bank
- investing \$2m in new plant and machinery using an overdraft (a short-term borrowing facility which carries higher rates of interest)
- delayed payments to suppliers with some suppliers withdrawing credit and insisting on cash on delivery, which further impacts the overdrawn balance at the bank
- cash flow forecast showing a significantly worsening position within the next 12 months.

In the Paper F8 exam, candidates must be able to identify factors that may have an impact on an entity's ability to continue as a going concern. The factors present in Question 5 of the June 2010 exam are not exhaustive and there are many other indicators that an entity may not be a going concern, such as:

- inability to pay dividends to shareholders
- major losses or cash flow difficulties that have arisen since the reporting date
- adverse key financial ratios
- indications of withdrawal of financial support from the bank or other financial institutions
- negative operating cash flows
- major debt repayments falling due which the entity will not be able to meet
- pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied

If there are any material uncertainties relating to the going concern assumption, then management must make adequate going concern disclosures in the financial statements.

AUDITOR'S RESPONSIBILITIES

As mentioned earlier, it is not the auditor's responsibility to determine whether, or not, an entity can prepare its financial statements under the going concern presumption; this is the responsibility of management. The auditor's responsibility under ISA 570 is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

In the June 2010 exam, question 5(c) required candidates to: 'Explain the audit procedures that the auditor of Medimade should perform in assessing whether or not the company is a going concern.'

When faced with such a requirement, candidates must be careful not to produce a list of generic audit procedures, but instead identify and highlight the factors from the scenario that may call into question the entity's ability to continue as a going concern. Once these factors have been identified, candidates should then be able to think about the procedures the auditor may adopt to establish whether the factors mean the going concern presumption is appropriate in the circumstances, or not.

In Question 5(c) of the June 2010 exam, if candidates simply wrote 'Obtain confirmation from the bank that the overdraft facility will be renewed' this will generate no marks for two reasons:

- The scenario clearly says that Medimade's bankers will not make a decision on the overdraft facility until AFTER the audit report is completed.
- A bank, or other financial institution, is not going to give this sort of information directly to the auditor.

Candidates should generate the audit procedures specifically from information contained in the scenario to demonstrate application skills, and candidates should refer to the model answer in the June 2010 exam to make sure the procedures they have generated are specific to the scenario.

Many candidates fall into the trap of relying on 'discussions with management/directors' and 'obtaining a written representation'. Candidates must appreciate that while discussion/inquiry is a valid audit procedure under ISA 500, *Audit Evidence*, such a procedure is always used in addition to other procedures – in other words, inquiry on its own will not generate sufficient appropriate audit evidence. Similarly ISA 580, *Written Representations* recognises that while written representations

do provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

Other procedures that the auditor may adopt to establish whether the use of the going concern presumption is appropriate in an entity's particular circumstances could be:

- Reading minutes of shareholders' meetings to identify any current, or potential, cash flow difficulties.
- Liaising with the entity's legal advisers concerning any ongoing litigation or future litigation and assessing the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Evaluating the entity's plans to deal with unfulfilled customer orders.
- Obtaining and reviewing reports of regulatory actions.

REPORTING

An important point to emphasise at the outset is that candidates are strongly advised not to use the 'scattergun' approach when it comes to deciding on the audit opinion to be expressed within the auditor's report. The scattergun approach is when a candidate will say that the auditor may express more than one opinion depending on a varying degree of situations. For example, where candidates write 'an unmodified opinion should be expressed, but the auditor may include an emphasis of matter paragraph if X is disclosed, or the opinion could be qualified "except for" if Y has happened or maybe an adverse or disclaimer should be expressed if Z occurs'. This is not going to earn many (if any) marks because Paper F8 candidates are expected to be able to come to a conclusion as to the auditor's opinion, depending on the circumstances presented in the question.

There are three situations that ISA 570 identifies in terms of the going concern assumption:

- use of the going concern assumption is appropriate but a material uncertainty exists
- use of the going concern assumption is inappropriate
- management unwilling to make or extend its assessment.

USE OF THE GOING CONCERN ASSUMPTION IS APPROPRIATE BUT A MATERIAL UNCERTAINTY EXISTS

A reporting entity that considers the going concern assumption to be appropriate, but still has a material uncertainty present will have to make disclosure of the fact in the financial statements that there are uncertain future transactions/events that may result in the entity being unable to continue in business in the foreseeable future.

The auditor will consider the adequacy of the disclosures made in the financial statements by management. If the auditor considers the disclosures to be adequate, then the audit report will be modified by the inclusion of an Emphasis of Matter paragraph. The Emphasis of Matter paragraph will follow immediately after the

opinion paragraph and will always cross-reference the reader's attention to the relevant disclosure in the financial statements, and the opinion will be unmodified.

If the auditor concludes that the disclosures are inadequate, or if management have not made any disclosure at all and management refuse to remedy the situation, the opinion will be qualified or adverse.

In both cases a paragraph explaining the basis for the qualified or adverse opinion will be included before the opinion paragraph and the opinion paragraph will be qualified 'except for' or express an adverse opinion.

USE OF THE GOING CONCERN ASSUMPTION IS INAPPROPRIATE

Consider the following example:

An entity has borrowings of \$10m which became immediately repayable in full on 31 March 2012. The entity is already in breach of its agreed overdraft and the bank has refused to renew the borrowings. The entity has also been unsuccessful in applying to other financial institutions for re-financing. It is highly unlikely that the entity will be successful in renewing or re-financing the \$10m borrowings and, in such an event, the directors will have no alternative but to cease to trade. The bank have already indicated that they are shortly going to commence legal proceedings to force the company to cease trading and sell off its assets to generate funds to pay off some of the borrowings. In order to avoid the entity's credit rating suffering any further decline, the directors have refused to make disclosures in the financial statements and have prepared the financial statements for the year ended 31 March 2012 on the going concern basis.

In this example it is clear that the going concern basis is inappropriate in the entity's circumstances. The directors have no realistic alternative but to liquidate in order to raise funds to pay back the bank and the bank have already confirmed that they will commence legal proceedings to force the entity into selling off assets to raise finance to repay their borrowings.

If the directors do not make adequate disclosure of the material uncertainty, the auditor must express an adverse opinion. An adverse opinion states that the financial statements do not present fairly (or give a true and fair view). This opinion will be expressed regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

MANAGEMENT UNWILLING TO MAKE OR EXTEND ITS ASSESSMENT

There are situations that may arise when the auditor may request management to make an assessment, or extend their original assessment of going concern. If management refuse to make, or extend, an assessment of going concern the auditor will consider the implications for the report.

CONCLUSION

Going concern is an important syllabus area for Paper F8 and candidates attempting the exam must ensure they are familiar with the requirements of the syllabus. This article has covered management's responsibility, the auditor's responsibility, indicators that an entity may not be a going concern and the reporting aspects relating to going concern. Candidates need to be aware that the syllabus also requires them to:

- define and discuss the significance of the concept of going concern
- explain the importance of, and the need for, going concern reviews, and
- discuss the disclosure requirements in relation to going concern issues.

Candidates are therefore encouraged to practise as many exam standard questions as possible as the syllabus offers a variety of ways in which the concept of going concern can be examined.

Written by a member of the Paper F8 examining team

Reference

(1) ISA 570, paragraph 5