Going Concern

Kalina Sukarova, Senior Financial Management Specialist, CFRR, the World Bank

3 October 2017, Vienna

Audit Training of Trainers

CFRR

Centre for Financial Reporting Reform

WORLD BANK GROUP
Governance

EU REPARIS

Road to Europe: Program of Accounting Reform and Institutional Strengthening

EU-REPARIS is funded by the European Union and is a part of **WB EDIF.**

Key Concepts

» **ISA 570 (Revised), *Going Concern*** deals with the (i) auditors responsibility relating to going concern and (ii) implications for the audit report

» The **going concern basis of accounting** assumes that:

  » assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business;

  » the entity will continue in the foreseeable future.

» A **material uncertainty** exists when events or conditions may cast significant doubt on the entity's ability to continue as a going concern.

Judgement

- While assessing the entity ability to continue as a going concern, **management makes judgement** at a particular point in time, about uncertain future outcomes of events or conditions
- Factors relevant to that judgement include:
  - Uncertainty increases as further in the future the outcome takes place;
  - Size and complexity of the entity;
  - Occurrence of subsequent events.
- The **audit covers the same period** as management's assessment to evaluate the entity's ability to continue as a going concern.
- This period should be at least, but not limited to, **twelve (12) months** from the end of the reporting period.

Considerations for Smaller Entities

- Smaller entities are **affected by their size** when it comes to their ability to withstand adverse conditions, for example:
  - have insufficient reserves to withstand the loss of a major customer, supplier, or key employee;
  - may encounter issues in their right to operate under a license or franchise;
  - greater risk present that banks and lenders may cease support of the entity should difficulties in operations be encountered.
- **Continued support from the owner – manager** is very important to the ability of smaller entities to continue as a going concern and often in financial difficulties a personal guarantee of the owner-manager with his personal assets as collateral is an important factor.
- Management of smaller entities often **rely on in-depth knowledge of the business** and anticipated future prospects rather than preparing a detailed assessment of the company's ability to continue as a going concern.

Going Concern Indicators

» The auditor considers conditions, events, and indicators, to determine if a potential going concern issue is present.

» These may be financial (e.g. withdrawal of financial support by creditors), operating (loss of key management without replacement), or other (e.g. uninsured or underinsured catastrophes).

» The existence of one or more of these indicators may not always signal that a material uncertainty exists and the significance of these events can be mitigated by other factors.

» Consideration of these indicators at the planning stage helps the auditor determine whether going concern is likely and is an important issue. It also allows for more timely discussions with management, and resolution of any identified going concern issues.

Illustrative Indicators

Current financial issues

- Net liability, or particularly a net current liability position;
- Recorded operating losses or reoccurring operating losses over several years;
- Deterioration in the value of assets used to generate cash flows;
- Dividends in arrears or discontinuance of dividend payments;
- Unfavorable or adverse key financial ratios (for example working capital ratio, gross profit ratio, inventory turnover, times interest earned, debt to equity ratio).

Cash flow and liquidity issues

- History of operating cash flows being significantly less than operating profits
- Negative operating cash flows, indicated by historic or prospective financials
- Increases in debtors and inventory without matching increases in cash flow
- Evidence of slowing in payments to creditors on due dates
- Evidence of slowing in collections from debtors
- Cash revenues insufficient to cover interest outgoings
- Growing expenditure on research without corresponding increases in cash flow
- Lack of sustainable cash flows from core business activities
- Significant growth of the entity making large cash drains on the organization

Financing arrangements

- Borrowings and bank overdraft facilities approaching maturity with uncertainty as to prospects of renewal or repayment
- Borrowings excessively based on non-cash generating revaluations of assets
- Excessive reliance on short-term borrowings to finance long-term assets
- Difficulty in complying with the terms of loan agreements or the need to restructure debt
- Inability to obtain financing for necessary new product development or other investments
- Disposing of substantial assets to generate funds
- Indications of withdrawal of financial support by creditors

Illustrative Indicators

Business risks

- Concentration of risk in a limited number of products or projects
- Rapid or unplanned development of business or expansion into non-core areas
- Declining industry or pressure on the industry from a declining economy
- Failures of other entities in the same industry
- Technical developments which render a key product obsolete
- Undue influence from a market dominant competitor
- Adverse changes or likely changes in legislation or government policy
- Pending legal or regulatory proceedings against the entity
- Loss or likely loss of a major market, franchise, or license
- Shortages of important supplies or loss of principal supplier
- Uninsured or underinsured disasters such as drought, flood, fire, fraud, or sabotage

Operational and management issues

- Excessive reliance on transactions with related parties
- Lack of budgets and cash flow forecasts
- Deficiencies in management information systems
- Lack of adequate back-up and recovery procedures
- Lack of management response to information received
- Loss of key management without replacement
- Instances of non-compliance with capital or other statutory or legal requirements

Audit Procedures

» The audit procedures for going concern do not need to be elaborate in all cases, however they must be documented.

» For example, the procedures do not need to extend to detailed examination of budgets and forecasts **should the entity operate in uncomplicated circumstances**.

» Also, many of the going concern audit procedures are **already performed in the context of the audit** but these should be modified and extended in circumstances when a potential going concern issue is identified.

Mandatory Procedures

- **Performed on all audits at planning and updated at year end:**
  - While gaining an understanding of the entity and its related business risks, analyze if there are one or more indicators that individually or in combination may cast significant doubt on the company's ability to continue as a going concern;
  - Consider if there is evidence from other procedures, such as work performed on accounts receivable, inventory, or long term liabilities, that may cast significant doubt on the company's ability to continue as a going concern;
  - When the entity is dependent on financial support from a parent company (by means of borrowings, extended intercompany balances, or access to goods and services) consider if the parent company has the ability to continue to provide the support in the future;
  - Ask management / those charged with governance how they have satisfied themselves that the going concern is appropriate and whether they have any knowledge of business risks, events, or conditions that may cast significant doubt on the company's ability to continue as a going concern.

Investigative Procedures

- **Procedures to investigate potential going concern issues:**
  - Investigate events after the balance sheet date and identify issues that may affect the ability of the company to continue as a going concern;
  - Review recent financial information for evidence of improvement or deterioration of financial position;
  - Review minutes of meetings of shareholders, board of directors, and other sources of information and investigate if there have been discussions related to financial difficulties;
  - Ask lawyers about litigations and claims,
  - Review terms of borrowing agreements and facilities to determine if any covenants have been breached;
  - Review management cash flows, forecasts, and budgets and consider if these are reliable, including underlining data.

Evaluating a Going Concern Issue

- **Procedures to evaluate a going concern issue (gathering evidence to determine whether a material uncertainty exists):**
  - Review management’s plans for future actions based on the going concern assessment;
  - Obtain written representations from management concerning plans for the future to improve the financial situation;
  - Analyze and discuss with management cash flows, forecasts, and other relevant financial information just prior to the signing of the financial statements;
  - Review financing facilities, related party balances and other commitments and evaluate any consequences should there be no possibility to extended these beyond their due dates;
  - Evaluate the reliability of third party support letters;
  - Determine if the disclosures of the going concern is required /adequate.

Reporting Guidelines

Going Concern

 # 1

Going concern basis of accounting is appropriate and no material uncertainty exists

 # 2

Going concern basis of accounting is appropriate but material uncertainty exists

 # 3

Going concern basis of accounting is not appropriate

1: Going concern basis of accounting is appropriate and no material uncertainty exists

- Even when no material uncertainty exists, the auditor needs to **evaluate** whether in the view of the requirements of the applicable financial reporting framework **there is adequate disclosure**.
- When ISA 701 applies, the auditor may consider certain events or conditions related to going concern to be determined as **Key Audit Matters**.

2: Going concern basis of accounting is appropriate but material uncertainty exists

- An **unmodified opinion** is issued when adequate disclosure is made in the financial statements. The auditors' report includes a separate section in the audit report **"Material Uncertainty Related to Going Concern" when adequate disclosure is made**. No emphasis of matter, unless required by law or national regulation / standards.
- **Qualified or Adverse opinion if adequate disclosure is not made** in the financial statements or in cases when management is unwilling to extend its assessment when requested to do so by the auditor.
- **Disclaimer of opinion is considered in rare situations involving multiple uncertainties** that are significant to the financial statements as a whole.

3: Going concern basis of accounting is not appropriate

- **Adverse opinion** if management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate.
- In these circumstances, another basis (e.g. liquidation basis) is deemed appropriate and it is irrelevant if appropriate disclosures are made regarding the inappropriateness of management's use of the going concern basis of accounting.

Group Exercise

Approach and Format

- This group exercise further builds on the facts presented in the simulated audit client case study “PejaSko Cheese Ltd.”, that is used throughout the Audit Training of Trainers series.
- Participants should read through the Scenario (part A) and apply the Audit Firm Methodology (part B) to complete the assignments.
- Assignments are divided around two stages of the audit: (i) Assignments based on circumstances at the planning stage; and (ii) Assignments based on circumstances at year end.
- Participants use the Template: Going Concern Working Paper (part C) to record their work at both stages of the audit.
- Approximately 40 minutes are provided for the group work and table discussions, followed by a 20 minute group discussion.

Expected Outcomes

- Develop and enhance participants' analytical and intellectual skills while engaging in a practical case study involving going concern judgments;
- Obtain evidence, document, and conclude on the appropriateness of the going concern assumption in a small client context; and
- Build awareness that SMPs face specific challenges when auditing the going concern in their SME clients caused by the size of the entity; it is critical for these practitioners to develop a wide range of analytical and intellectual skills including abilities to apply sound professional judgement to reach well-reasoned conclusions based on facts.

Thank You