

ASSESSING GOING CONCERN

(Lecture A619 – 1.17 minutes)

The collapse of the building firm, Carillion, will undoubtedly reverberate for several months while investigations continue into the company's collapse. As is usually the case in these matters, questions are being asked as to how the auditors signed off accounts and corroborated management's assessment that the entity was a going concern for the foreseeable future.

Of course, issues arise during the course of business which cannot be foreseen, but it seems a sensible time to recap on the auditor's responsibilities where going concern is concerned and the signs to watch out for when corroborating management's assertion that the going concern basis of accounting is appropriate.

Auditors must apply ISA (UK) 570 *Going Concern* when undertaking procedures on an entity's ability to continue as a going concern. ISA (UK) 570 uses the term 'going concern' as follows:

'The term "going concern" applies to any entity unless its management intends to liquidate the entity or to cease trading, or has no realistic alternative to liquidation or cessation of operations.'

ISA (UK) 570

ISA (UK) 570 uses the term 'ability to continue as a going concern' as follows:

'The term "ability to continue as a going concern" is equivalent to the term "ability to continue to adopt the going concern basis of accounting" in the future.'

1.1 **Significance of going concern**

Whether or not a company can be regarded as a going concern affects how its financial statements are prepared. Ordinarily, financial statements are prepared on the basis that the entity is a going concern. Accounting standards (FRS 102 and IAS 1 *Presentation of Financial Statements*) states that an entity should prepare its financial statements using the going concern basis of accounting, unless:

- management intends to liquidate the entity, or to cease trading; or
- the directors have no realistic alternative but to do so.

When circumstances are such that the directors have no realistic alternative but to cease trading, or they intend to liquidate the entity, the going concern basis of accounting must not be used. UK GAAP does not specify which basis should be used when the going concern basis of accounting is not applied, but usually the financial statements will be prepared on a 'break-up' basis under which:

- the basis of preparation and the reason why the entity is not regarded as a going concern is disclosed;
- fixed assets are restated to their recoverable amount;
- stock, work in progress and trade debtors often need to be written down as stock will be sold for a lower price or may be scrapped and some trade debtors may be irrecoverable; and
- additional liabilities may need recognition (e.g. redundancy costs and the costs of closing the business down).

1.2 *Management's responsibility*

It is the responsibility of management to assess whether the going concern basis is appropriate in the company's circumstances when the financial statements are being prepared. In order to do this, a business may often use forecasts to help assess whether they are likely to be able to continue trading for the foreseeable future.

In the UK, the directors must carry out an assessment of the entity's ability to continue as a going concern for a period of at least 12 months from the date of approval of the financial statements. It is important to emphasise that this requirement is for **at least** 12 months and could be longer in certain situations.

Paragraph 26 of IAS 1 is not as arduous in its requirements as this only requires management to take into account all available information about the future, which is at least, but not limited to, 12 months from the end of the reporting period. However, this should be extended for the purposes of the UK as footnote 4a to paragraph 13 of ISA (UK) 570 confirms that in the UK, the period used by those charged with governance in making their assessment is usually at least one year from the date of approval of the financial statements. Periods less than this will have reporting implications for the auditor.

If management become aware during their assessment of the entity's going concern of any material uncertainties which may affect the entity's ability to continue as a going concern, they should disclose those uncertainties in the financial statements.

Example – Going concern uncertainty

A company has a large contract with the government which generates around 90% of its income. The financial statements for the year-ended 31 March 2018 are being prepared and the contract has to go out to tender on 30 June 2018. There is no guarantee that the company will be awarded the contract and the decision as to who will be awarded the contract will be made in August 2018, by which time the financial statements will have been audited and approved.

This is an indicator of a material uncertainty related to the entity's ability to continue as a going concern. If the company is not awarded the contract, they stand to lose around 90% of its income, which will clearly have a material impact. Therefore, such material uncertainties need to be disclosed in the financial statements.

There are a number of factors which the directors must take into consideration when carrying out a going concern assessment, such as:

- current and expected levels of profitability;
- the ability to repay debt on time; and
- sources of financing.

1.3 *Indicators that an entity may have going concern problems*

Carillion collapsed with around £900m worth of debt and a huge pension deficit of some £587m (although recent press reports indicate the buy-out value of this pension deficit is more like £2bn). Notwithstanding these issues, the board claimed the firm had substantial liquidity and a large amount of available funding (approximately £1.5bn).

Between July and November, the company issued three profit warnings resulting in its shares crashing by around 90%. Fast forward to 2018, and the company failed to secure financing to secure a rescue plan with the government refusing to use taxpayers' money to rescue the firm. This saw Carillion file for compulsory liquidation.

When a corporate disaster like this strikes, the auditors are always questioned and Carillion is no exception. The auditor's report on the financial statements for the year-ended 31 December 2016 confirm that KPMG had nothing to report in respect of the entity's use of the going concern basis, nor on the directors' viability statement.

At the present time, there is nothing to suggest that the auditors were at fault; nor whether the audit work was deficient. On 29 January 2018, the FRC confirmed that they will be reviewing the audit work performed by KPMG on Carillion for the year-ends 31 December 2014, 2015 and 2016.

Auditors are not able to see into the future, but during the audit of management's assessment of going concern, professional scepticism must be applied which will enable the auditor to challenge management's assertions and enable the auditor to have a questioning mind. Merely accepting management's assessment that '*of course the company is a going concern*' and obtaining a representation from the client confirming this is not enough.

Indicators that a problem has going concern problems are as follows (note, the list below is not exhaustive):

- net current liabilities, or an overall net liability position on the balance sheet indicates that the company may not be able to meet debts as they fall due;
- borrowing facilities are not renewed or they are nearing their renewal date which may mean that a lack of cash is available which will make it difficult for a company to manage its cash operating cycle;
- the company has defaulted on loan agreements which could result in the bank or financier 'calling-in' the debt which will place pressure on the cash operating cycle;
- tax payments are being missed or arrangements to pay are frequently put in place which would indicate a lack of working capital;
- staff are paid late which is also due to a lack of working capital;
- negative cash flows in the cash flow statement which indicates overtrading;
- suppliers credit is being withdrawn which indicates a failure to pay suppliers on time indicating a lack of working capital;
- successful legal claims are brought against the company which will place pressure on cash and may result in the company going into liquidation;

- over-reliance on a small number of key customers, staff or suppliers, the loss of which may result in an inability to trade;
- customers ceasing to trade (particularly large customers) which will result in bad debts and hence an inability to recover payment;
- uninsured/under-insured catastrophes which may mean the company will not have enough money to survive;
- changes in laws and regulations which may mean the costs of compliance may be more than the company can afford; and
- emergence of successful competitors which will impact revenue if customers switch.

1.4 Auditor's responsibilities

ISA (UK) 570 sets out the auditor's objectives at paragraph 9 which are:

- (a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;*
- (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and*
- (c) To report in accordance with this ISA (UK).'*

ISA (UK) 570
paragraph 9

The auditor is not responsible for assessing the entity's going concern ability as this is a management responsibility. The auditors are responsible for obtaining sufficient appropriate audit evidence about management's assessment of going concern and to conclude on whether, or not, a material uncertainty related to going concern exists.

1.5 Audit procedures

The audit procedures which can be applied to assess management's evaluation of going concern are set out below. The list below is not exhaustive, and other entity-specific procedures may be applied:

- evaluate management's assessment of going concern;
- assess the same period that management have used in their assessment and if this is less than 12 months from the date of issuance of the financial statements (i.e. approval), ask management to extend their assessment; and
- consider whether management's assessment includes all relevant information.

If there is any doubt over the entity's ability to continue as a going concern, the auditor may carry out the following procedures:

- analyse and discuss the entity's cash flow statement, profit and other relevant forecasts with management;
- analyse the latest available management accounts and compare these to the cash flow statement to see if there are any inconsistencies;

- review the terms of loans and debentures to assess if any have been breached;
- read minutes of board meetings and meetings with shareholders to establish if there is any reference to financing difficulties;
- review correspondence to identify if there are any legal claims that have been brought against the company;
- if there are legal claims that are ongoing at the balance sheet date, assess the reasonableness of management's assessments of their outcome and the estimate of financial implications (this may need to be done in conjunction with the client's lawyers);
- review correspondence with customers for evidence of any disputes;
- review correspondence with the bank for indications that a bank loan or overdraft may be recalled;
- review correspondence with suppliers for evidence of any issues regarding payments which may impact the entity's ability to continue as a going concern; and
- obtain written representations from management regarding its future plans and how it plans to address the going concern issues.

1.6 *Disclosures in the financial statements*

Where there are material uncertainties related to going concern, the directors should include adequate disclosures which explain:

- the principal events or conditions which cast significant doubt on the entity's ability to continue as a going concern together with the directors' plans to deal with them; and
- that the company may be unable to realise its assets and discharge its liabilities in the ordinary course of business.

Small companies are encouraged to make the going concern disclosures in order to achieve a true and fair view. If the directors do not make these disclosures, citing there is no legal requirement to make them, the financial statements will not give a true and fair view and hence the auditor will have to qualify their auditor's report. Even where the financial statements of a small entity are not subject to audit, the directors still have a legal duty to prepare financial statements that give a true and fair view and any non-disclosure of material uncertainties related to going concern will still render the financial statements as failing to give a true and fair view.

In April 2016, the Financial Reporting Council published updated guidance in the form of '*Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks* – Guidance for directors of companies that do not apply The UK Corporate Governance Code'. While this guidance is non-mandatory, it is viewed as best practice for unlisted entities.

1.7 Auditor reporting

Going concern basis is appropriate and there are no material uncertainties

Under ISA (UK) 570, auditors' reports will make reference to going concern, even when the auditor concludes that there is no material uncertainty related to going concern and management's use of the going concern basis of accounting is appropriate. In such cases, the auditor reports by exception in a separate paragraph of the auditor's report headed up 'Conclusions related to Going Concern' or other appropriate heading.

Example – Conclusions related to Going Concern

Conclusions related to Going Concern

We have nothing to report in respect of the following matters to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

Going concern basis is appropriate and there are material uncertainties

When the auditor concludes that management's use of the going concern basis is appropriate in the circumstances, but nonetheless a material uncertainty exists, the auditor must determine whether the financial statements adequately disclose the principal events or conditions which may cast significant doubt on the going concern ability of the entity and disclose clearly in the auditor's report that there is a material uncertainty related to going concern.

ISA (UK) 570 requires a separate paragraph in the auditor's report headed up 'Material Uncertainty Related to Going Concern' when the going concern basis is appropriate but there are material uncertainties. The auditor no longer uses an Emphasis of Matter paragraph to flag up going concern uncertainties as was the case under the previous ISA (UK and Ireland) 570 *Going Concern*.

Example – Disclosure of a material uncertainty related to going concern in the auditor's report

Material Uncertainty Related to Going Concern

We draw attention to Note 23 in the financial statements, which indicates that the company incurred a net loss of £X during the year to 31 December 2017 and, as of that date, the company's current liabilities exceeded its total assets by £X. As stated in Note 23, these events or conditions, along with other matters as set forth in Note 23, indicate that a material uncertainty exists which may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in this respect.

Going concern basis is not appropriate

When management have prepared the financial statements using the going concern basis of accounting but, in the auditor's judgement, management's use of the going concern basis is inappropriate, the auditor must express an adverse opinion.

The Basis for Adverse Opinion paragraph will explain that the financial statements have been prepared using the going concern basis inappropriately.

The Opinion paragraph will state that the financial statements do not give a true and fair view and have not been properly prepared in accordance with the financial reporting framework and legislative requirements.

Adequate disclosure of a material uncertainty is not made

Where management have not adequately disclosed a material uncertainty related to going concern, the auditor must express a qualified opinion or adverse opinion as appropriate.

The Basis for Qualified (Adverse) Opinion paragraph in the auditor's report will state that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.