

1 Going concern (Lecture A815 – 17.46 minutes)

The current economic climate, high inflation and rises in interest rates are likely to impact on businesses up and down the country. The high cost of energy, fuel and other materials means many businesses (particularly those in the hospitality sector) are struggling and the issue of going concern continues to be a very important issue when it comes to financial reporting.

Going concern issues are frequently cited as being deficient during audit file reviews and when reviewing sets of financial statements. In today's climate it's crucial that practitioners have a sound understanding of the rules around going concern in UK and Ireland GAAP to ensure that they can not only advise the client appropriately, but that they can also ensure the financial statements are prepared on the correct basis and contain appropriate disclosures.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, para 3.8 states:

*When preparing financial statements, the management of an entity using this FRS shall make an assessment of the entity's ability to continue as a **going concern**. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue.* FRS 102, para 3.8

The approach taken by FRS 102 (and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*) is to use the going concern basis as a 'default'. In other words, even if the company is experiencing significant cash flow difficulties, the entity prepares the financial statements on a going concern basis. FRS 102 would only require a basis other than the going concern basis to be used when management intend to liquidate the entity, or cease trading, or have no realistic alternative but to do so.

As noted above, FRS 102 only refers to circumstances of liquidation or cessation of trade as a reason not to use the going concern basis of accounting. In the absence of such intentions, management continues to prepare the financial statements on a going concern basis and will disclose any material uncertainties in the notes to the financial statements.

When management is undertaking its assessment (see **3.1** below), it may conclude that there are material uncertainties relating to the entity's ability to continue as a going concern. Even with those material uncertainties, the directors may conclude that the going concern basis of preparing the financial statements is appropriate and, in such situations, disclosure of the material uncertainties will be required. This ensures that the users of the entity's financial statements are clear that the going concern basis is subject to material uncertainties.

1.1 Management's assessment

FRS 102, para 3.8 requires management to carry out an assessment of going concern using information at its disposal concerning the future which is **at least but not limited to 12 months from the date when the financial statements are authorised for issue**.

The requirements of UK and Ireland GAAP are more onerous than their international equivalent which some accountants may also be familiar with. IAS 1 *Presentation of Financial Statements* requires management to conduct a going concern assessment for a period of at least 12 months from the balance sheet date which is not the same as UK and Ireland GAAP. It is important, therefore, that accountants ensure they know the correct period that management should be assessing going concern for. This is also particularly important for auditors as any incorrect assessment may have an impact on the auditor's opinion.

The wording '... not limited to' means that even if the directors do not intend to cease trading until, say, 18 months after the date the financial statements are authorised for issue, the accounts should still not be prepared on a going concern basis. This is because going concern is a forward-looking concept and there is no limit as to how long management look forward in assessing going concern.

1.2 Small companies applying FRS 102, Section 1A *Small Entities*

Small companies choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A are encouraged to disclose material uncertainties related to going concern (FRS 102, para 1AE.1(c)). It should be noted that for small entities in the UK, the proposals in FRED 82 will mandate going concern disclosures.

This does not relieve the directors from their duties to carry out an assessment of whether the entity can adopt the going concern basis of accounting in preparing its financial statements – this must still be done.

Where a small company has identified material uncertainties related to going concern, it would be encouraged to disclose these uncertainties in order that the financial statements give a true and fair view. As going concern has such a material and pervasive impact on the financial statements, it would be difficult to justify a true and fair view is presented where any material uncertainties related to going concern are not disclosed. Where the small entity has an audit (e.g. a voluntary audit or because one is mandated by a shareholder or financier), any non-disclosure of material uncertainties related to going concern could (and is likely to) impact the auditor's opinion, which may be modified accordingly.

As discussed in the previous section, FRED 82 proposes to make such disclosures for UK-based small entities mandatory rather than encouraged.

ACCA's Technical Factsheet issued in October 2020 in respect of Covid-19 grants and reliefs states:

*Where there are material uncertainties relating to the small entity's ability to continue as a going concern, it is ACCA's view that if such disclosures are **not** made, it would be extremely difficult to justify that the financial statements give a true and fair view and hence are misleading. For ACCA member firms, this creates an ethical threat as member firms cannot have their names associated with financial statements that are misleading.*

While the citation above is from ACCA's Technical Factsheet on accounting for Covid-19 grants and reliefs, this paragraph should be applied across the board.

The ethical threat created by non-disclosure of material uncertainties related to going concern must be carefully considered by the practitioner. ACCA (like other professional bodies) do not allow members to have their names associated with accounts that are misleading and hence it may be that the practitioner has no option but to resign if the accounts would be misleading without going concern disclosures.

In such instances, advice should be sought by the practitioner to ensure they comply with ethical requirements and the relevant professional body's Code of Ethics [and Conduct].

1.3 Indicators of material uncertainties related to going concern

The current economic climate may mean that some businesses that have previously been profitable may now be sustaining losses and could find that they now have material uncertainties related to going concern. Keep in mind that uncertainties are considered to be material if their disclosure could reasonably be expected to affect the decision-making process of the users (including the shareholders) of the financial statements. This is a wholly judgemental issue and one that may need careful documentation.

The following is a non-comprehensive list of examples of indicators that an entity has material uncertainties related to going concern:

Indicator	Why it is an issue
The balance sheet shows a net current liabilities or net liabilities position	This indicates the entity may be unable to meet debts as they fall due
The bank does not renew borrowing facilities or expresses an unwillingness to support the business	A lack of cash makes it difficult for a company to pay suppliers, employees and other liabilities
Loan agreements have been breached	Breaches of a loan agreement may trigger immediate repayment of the loan hence placing additional pressure on cash flow
Staff are not paid on time	This indicates a lack of working capital and potential loss of employee goodwill
Legal claims have been brought against the entity	If successful, these claims may result in significant cash outflows thus placing additional pressure on

	working capital
Loss of key staff	This may make it difficult for the entity to trade
Changes in law and regulation	Such changes may make it costlier for the business to comply and the costs of compliance may be more than the company can realistically afford
Withdrawal of credit facilities by suppliers or a failure to obtain credit	This indicates a bad credit-rating which usually arises from a failure to pay liabilities
Missing payments to HMRC	Payments to HMRC should be prioritised and any missed payments may indicate the company has a lack of working capital
Negative cash flows	This indicates overtrading
Significant bad debts	Significant bad debts will also place pressure on the company's cash flow resulting in an inability to meet its liabilities
Successful competitors	These will have a detrimental impact on revenue if customers decide to buy from the competitor
Uninsured catastrophes	A fire or a flood or other disaster which is uninsured may mean the company cannot survive
Major technological change	An inability to keep up with major technological changes or an inability to afford to keep up with such changes may result in a loss of customers and inventory obsolescence

1.4 Reporting on material uncertainties related to going concern

FRS 102, para 3.9 states:

*When management is aware, in making its assessment, of **material** uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.*

FRS 102, para 3.9

Example – Going concern uncertainty

The financial statements of Currie Ltd for the year ended 31 December 2022 are going to be authorised for issue on 2 April 2023. During the year the company lost a number of contracts that are unlikely to return. The company's overdraft facility (on which the company is currently reliant) is due for renewal in three months' time and the bank has not yet given any indication as to whether, or not, the overdraft facility will be renewed.

If the company had received indications that the overdraft facility was going to be renewed, the directors may conclude that there is no material uncertainty related to going concern. However, the fact that the bank has not given any indications of continued support (which the company is currently reliant on), disclosure of a material uncertainty related to going concern will be needed.

If Currie Ltd is a small company reporting under FRS 102, Section 1A, then it would be encouraged to make such disclosures (FRS 102, para 1AE.1(c)).

Example – Material uncertainty related to going concern

Ratchford Ltd operates from four outlets in the UK but has warehouses located in Spain and Italy. The company is preparing its financial statements for the year ended 31 December 2022 and the impact of high inflation and global economic challenges has had an adverse effect on operations. In addition, on 27 December 2022, a large contract to supply goods was cancelled indefinitely.

The company's overdraft was nearing its limit and the balance sheet as at 31 December 2022 is showing a large level of net current liabilities.

The company reports under full FRS 102.

An example disclosure is as follows:

Note 20: Going concern

The company has been materially and adversely affected by the effects of high inflation and global economic challenges. This has resulted in demand for the company's products and services becoming reduced. Operating results have been negatively impacted.

The company has incurred operating losses of (£X) in the year to 31 December 2022 (2021: Operating profit £X). In addition, the company has reported net current liabilities for the year ended 31 December 2022 amounting to (£X) (2021: net current assets £X).

Due to the current economic situation and unfavourable forecasts in the economy, the directors are uncertain when, and if, the company will return to profitability and positive cash flows from operations. These uncertainties cast significant doubt on the entity's ability to continue as a going concern for the foreseeable future. The company has applied for additional borrowings to provide working capital but the outcome of these applications is yet unknown.

1.5 Going concern basis is inappropriate

The economic uncertainties currently being experienced around the world will inevitably give rise to businesses ceasing to trade. This will mean that the going concern basis of preparing the financial statements is not appropriate.

When the going concern basis of accounting is inappropriate, UK and Ireland GAAP does not specify on which basis the financial statements should be prepared. The standards require a basis other than the going concern basis to be applied when management intend to liquidate, cease trading or have no realistic alternative but to do so.

Many accountants are nonetheless familiar with the concept of the 'break-up basis'. Under this basis, assets are restated to recoverable amount and long-term liabilities are restated as current, with provisions being made for unavoidable costs under onerous contracts and the costs of winding the business down. Hence, the accruals concept becomes secondary because under the break-up basis, the financial statements reflect a forecast of future realisation rather than how the business has performed up to, and its financial position as at, the balance sheet date.

In addition, fixed assets are not restated to current assets if their role within the ongoing business remains unchanged. It should also be borne in mind that there is no 'held for sale' classification under UK and Ireland GAAP as there is under IFRS Accounting Standards.

The break-up basis will generally only be used in very rare situations as it is not compliant with the normal recognition and measurement principles of FRS 102. However, FRS 102 states that the entity must not prepare its financial statements on a going concern basis if management intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

3.5.1 Going concern basis deemed inappropriate after the reporting date

FRS 102 and FRS 105 normally require the financial statements to reflect all transactions, events and conditions which have arisen up to, and exist as at, the reporting date. However, if an entity determines **after** the year end that it intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so, it shall not prepare its accounts on a going concern basis (FRS 102, para 32.7). In this way, what would normally be a non-adjusting event because it occurs after the balance sheet date, becomes an adjusting event if it means the entity is no longer a going concern. This is a necessary exception because, as explained earlier, going concern is a forward-looking concept.

Example – Going concern basis is inappropriate

Osbourne Ltd is preparing its financial statements for the year ended 31 December 2022. Due to the impact of high inflation, the loss of a number of significant contracts and an inability to secure additional financing, the directors have decided to cease trading on 30 April 2023. The following note illustrates the wording that may be used in the Basis of Preparation of the Financial Statements paragraph included within the accounting policies note:

As explained in note X to the financial statements, the company will cease trading on 30 April 2023 and the financial statements have been prepared on a basis other than that of the going concern basis. This basis includes, where applicable, writing the company's assets down to net realisable value. Provisions have also been made in respect of contracts which have become onerous at the reporting date. No provision has been made for the future costs of terminating the business unless such costs were committed at the reporting date.

1.6 Summary of reporting requirements

In 2016, the FRC published *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks*. This guidance is non-mandatory but is intended to serve as best practice for directors in assessing the going concern ability of an entity. Companies which are required, or choose to voluntarily apply, *The UK Corporate Governance Code* are excluded from the scope of this guidance.

The 2016 guidance states that there are three scenarios which can be identified when concluding on the entity's ability to continue as a going concern for the foreseeable future as follows:

Situation	Basis of accounting	Disclosure requirements
The going concern basis of accounting is appropriate and there are no material uncertainties	The directors should use the going concern basis of accounting when preparing the financial statements	No specific disclosure requirements for the financial statements
The going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to adopt the going concern basis of accounting in the future	The directors should use the going concern basis of accounting when preparing the financial statements	When the directors are aware, in making their assessment, of material uncertainties related to events or conditions that cast significant doubt upon the company's ability to continue to adopt the going concern basis of accounting, the entity shall disclose those uncertainties
The going concern basis of accounting is not appropriate	The directors should use a basis other than that of the going concern basis of accounting when preparing the financial statements	When a company does not prepare financial statements on a going concern basis of accounting, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the going concern basis of accounting is inappropriate