Going concern: Don't take it for granted

Ben Higgin gives advice on how to deal with issues arising from preparing financial statements on a going concern basis

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Going concern is a fundamental accounting concept that has been engrained in financial reporting principles for years and underlies the preparation of financial statements.

Recent high-profile liquidity problems at brand name banks, insurance companies, retailers and carmakers have demonstrated that remaining a going concern (and thus having enough cash to meet liabilities as they fall due for at least 12 months from the balance sheet date) is now a real issue for many companies. Addressing these challenges well before the preparation of annual reports and accounts is important to help avoid last minute problems or surprises that may unnecessarily unsettle investors, analysts and other users of the financial statements.

It is important to note that the preparation of financial statements on a going concern basis is not intended to, and does not, guarantee that a company will remain a going concern until the next annual report and accounts is issued. Recent market developments have shown that while an assessment can be made in good faith, any judgment is only valid at the time and can be overturned by subsequent events.

Here is some additional guidance to help management be well informed and prepared to make the necessary and possibly difficult judgments when they try to meet their responsibilities in this area.

Making an assessment

For companies preparing their financial statements in accordance with HKFRS, management must assess an entity's ability to continue as a going concern. Preparation of the financial statements should be on this basis unless management intends to liquidate the entity or cease trading. When making this assessment, if management is aware of material uncertainties related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern, then management will need to disclose such uncertainties in the financial statements (HKAS 1 para. 25).

The planning of the assessment should be done as early as practicable because a significant amount of information needs to be produced (such as board papers that consider the areas listed below) and processes

and procedures to be followed, including coordinating all the relevant parties, such as executive and non-executive directors.

In making their assessment, management should consider all available information about the future, which is at least, but not limited to, 12 months from the end of the reporting period (HKAS 1 para. 26). In practice, detailed projections are often prepared to cover the period to when the next financial statements are approved, with future periods being covered by medium- or long-term plans, which give an indication in more general terms of how the directors expect the company to fare.

Areas of focus

When making an assessment, management should place emphasis on the importance of the processes and procedures that they carry out, and focus on areas where procedures are likely to be appropriate. Some key areas that are often subject to procedures as part of the assessment include:

- forecasts and budgets
- borrowing requirements
- liability management including covenant compliance
- contingent liabilities
- products and markets
- financial risk management
- financial adaptability

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Management's liquidity risk disclosures

By Steve Ong

HKFRS 7 *Financial Instruments: Disclosures* defines liquidity risk as one where an entity will encounter difficulty in meeting obligations associated with financial liabilities. Liquidity risk arises when an entity is required to pay its liabilities earlier than expected.

HKFRS 7.39 requires an entity to disclose a maturity analysis for all financial liabilities at the balance sheet date, showing the remaining contractual maturities at the balance sheet date together with a description of how it manages its liquidity risk.

Illustrative financial statements provided by the larger accounting firms provide some guidance for companies to tailor-make the disclosures appropriate to the circumstances of their companies. In recent years, there have been significant changes to specific HKFRSs relevant to disclosures about liquidity risk and other risks and uncertainties, including:

Requirement

Disclosures relating to risks arising from financial instruments – nature and extent of qualitative and quantitative disclosures including liquidity risk	HKFRS 7.31 to HKFRS 7.42
Disclosures of the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities	HKAS 7.50(a)
Disclosures of defaults and covenant breaches and potential reclassification of loans in default as current liabilities	HKAS 1.74 to HKAS 1.76
Disclosures of key sources of estimation uncertainty about the carrying amounts of assets and liabilities	HKAS 1.125 to HKAS 1.133

Directors should ensure that appropriate disclosures are made, where applicable to the circumstances of the company.

What auditors need to know now

By Steve Ong

The effects of the global financial crisis require careful evaluation and the current economic situation necessitates auditors to be extra vigilant about a company's ability to continue as a going concern. It is important that annual financial statements contain appropriate disclosures to give a true and fair view.

Auditors are required under HKSA 570 *Going Concern*, when planning and performing audit procedures and in evaluating the results thereof, to consider whether it is appropriate for management to use the going concern assumption in preparing financial statements.

Auditors should check whether there are events or conditions and related business risks that may cast significant doubt on the entity's ability to continue as a going concern. Such events and conditions include:

Financial

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets
- Indications of withdrawal of financial support by debtors and other creditors
- Negative operating cash flows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with the terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments

Operating

- Loss of key management without replacement
- Loss of a major market, franchise, license or principal supplier

This list is not exhaustive and the significance of these and other factors will vary from company to company, but, given the economic climate, management should consider them with greater vigour and formality.

Challenging assumptions

Management will also need to be comfortable that the assumptions in the budgets and forecasts are realistic, particularly in light of the global economic downturn. For example, in addition to the usual level of challenge to assumptions, management may want to ask themselves:

- Are gross profit projections still realistic and consistent with past practice, or perhaps more relevant than the anticipated pricing of future orders?
- Is the sales mix and yield going to change?
- Will the profile of debtor collections change?
- Will current stock balances and work in process be recovered?
- Will creditors squeeze their payment terms?

Management may also want to prepare stress-tested forecasts so they can better understand the effect of changes in the assumptions.

A rigorous review of assumptions related to borrowing requirements, liability management and contingent liabilities is important. Particular areas of focus often include:

- the certainty of the availability of bank facilities (Will the bank provide a positive confirmation of this?)
- the effect of covenants (existing and potential breaches)
- accrued interest on borrowings (Are there any which is actually in arrears?)
- projected inflows to satisfy liabilities and off balance sheet commitments, including operating leases
- whether contingent liabilities may arise, for example, through breach of guarantee conditions.

Management is advised to monitor their approach regularly to ensure their assumptions remain valid. Companies that have not had to negotiate or renegotiate borrowings and facilities with banks for some time might be surprised by the extent to which the world has changed. Management should therefore keep cash flow forecasts and budgets up to date and approach lenders as soon as any potential problem becomes apparent.

The role of non-executive directors is also important in undertaking a

- Labour difficulties or shortages of important supplies

Others

- Non-compliance with capital or other statutory requirements
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied
- Changes in legislation or government policy expected to adversely affect the entity

This list is not all-inclusive nor does the existence of one or more of the items signify that a material uncertainty exists.

HKSA 570 provides detailed guidance on the steps auditors should perform in evaluating management's assessment and further audit procedures when events or conditions are identified.

The auditor should consider the implication on the auditor's report in accordance with HKSA 570 as follows but the areas set out are not exhaustive:

Situation	Modification to auditor's report
Going concern assumption appropriate but a material uncertainty exists a. Adequate disclosure is made b. Adequate disclosure is not made	a. Add an emphasis of matter paragraph (HKSA 570.33) b. Express a qualified or adverse opinion (HKSA 570.34)
When there are multiple uncertainties that are significant to the financial statements	May consider a disclaimer of opinion instead of adding an emphasis of matter paragraph (HKSA 570.33)
Going concern assumption inappropriate and financial statements prepared on a going concern basis	Express an adverse opinion (HKSA 570.35)
Management is unwilling to make or extend its assessment	Modify the auditor's report as a result of the limitation of scope (HKSA 570.37)

robust review of the assessments and underlying assumptions. They should ensure that they are involved throughout the process.

Disclosures

Based on the above, management will need to determine whether it remains appropriate to prepare the financial statements on a going concern basis. The conclusions are likely to fall into one of the following three categories:

- There are no material uncertainties that lead to significant doubt about the entity's ability to continue as a going concern.
- There are material uncertainties that lead to significant doubt about the entity's ability to continue as a going concern.
- The use of the going concern basis is not appropriate.

A material uncertainty is not defined but will involve assessing both the probability of an event occurring and the impact it will have if it does occur. This is likely to involve a high degree of judgment.

The assessment's outcome will dictate whether additional disclosures are required in the financial statements, especially when management's conclusion is based on assumptions that are subject to significant uncertainty. Management should also carefully consider the liquidity disclosures required by HKFRS 7 and the critical judgment and estimate disclosures required by HKAS 1. If such disclosures are required, management should be well prepared to address questions that users are likely to have in the financial statements (*see table on p.49*).

Nasty surprises?

In the recent past, a positive going concern assumption has been a foregone conclusion for many companies. In today's business environment, with increased pressure on pricing, liquidity and asset valuations, more companies and their management will find that the amount of time required to make this assessment will significantly increase this year-end.

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