Going Concern – Reporting in Audit

A key principle in preparation of financial statements is the assumption that the reporting entity will remain in business for the foreseeable future, that is, it is a going concern. To uphold and enhance the integrity of financial markets, financial statements must be prepared to reflect the most accurate value of entities and their assets. As financial statements are used to make decisions (investors, employees, analysts, lenders, etc.), rules have to be in place to ensure that, to the greatest extent possible, financial information is presented in a fair and useful way. Recent years have seen a wave of highly visible corporate failures that have greatly reduced investors' confidence. Many cases have been filed under the Insolvency and Bankruptcy Code (IBC) since its implementation, before the National Company Law Tribunal (NCLT). Further, there have been cases of downgrading of credit ratings of various entities even up to 'default grade'. In these scenarios, the assumption of going concern in preparation of financial statements and reporting thereon by auditors has become more critical and vital. The article summarises various aspects of going concern. Read on to know more…

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The going concern concept

The going concern concept or assumption is a fundamental principle in the preparation of financial statements. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.

In case an entity has the intention to liquidate or cease operations or has no realistic alternative but to do so, then in such cases the entity should not prepare financial statements on a going concern basis.

Indications of Material uncertainty about going concern

Some examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern:

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 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.

Operating

- Management intentions to liquidate the entity or to cease operations
- Loss of key management personnel without replacement
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s)
- Continued labour difficulties.
- Shortages of important supplies
- Emergence of a highly successful competitor

Others

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.

> The absence of any reference to the material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.
- Public sector entities where Government support may be reduced or withdrawn, or in the case of privatisation, lack of funding for its continued existence

Responsibilities of the Auditor

The auditor of the entity has responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The auditor is required to obtain and evaluate sufficient appropriate audit evidence, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and based on the audit evidence obtained conclude whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

The auditor is not responsible for predicting future conditions or events due to inherent limitations. Accordingly, the absence of any reference to the material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern. The opinion of the auditor therefore can never provide absolute assurance.

Risk Assessment Procedures and Related Activities

The auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In doing so, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern based on the Indicators (events or conditions) mentioned above. Further, the auditors are also required to remain alert throughout the Audit for Audit Evidence about events or conditions. Further,

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(b) If such an assessment has not yet been performed, the auditor shall discuss

with management the basis for the intended use of the going concern basis of accounting, and inquire from management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

Evaluating Management's Assessment and Plans

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. While evaluating, the auditor would cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. The period of assessment would be of at least twelve months from the date of the financial statements. In case the period of assessment is less than that the auditor would request the management to cover at least a 12 months period. The procedure shall include:

- Evaluation of the process management followed, to make its assessment.
- The assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.
- Ensuring management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

The auditor also needs to inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. The auditor should document the auditing procedures performed and evidences obtained to evaluate the management plans.

Additional Audit Procedures When Events or Conditions are Identified

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence by performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

- Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Analysing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.
- Evaluating management's plans for future actions for example, such as to liquidate assets, borrow money or restructure debt or increase capital.
- Requesting written representations from management regarding their plans for future action and the feasibility of these plans.

Communication with those Charged with Governance

Auditor should communicate with those charged with governance including Audit Committee and shall include the following:

- Whether the events or conditions constitute a material uncertainty;
- Whether management's use of the going concern basis of accounting is appropriate;
- The adequacy of related disclosures in the financial statements; and
- Where applicable, the implications for the auditor's report.

> The auditor should document the auditing procedures performed and evidences obtained to evaluate the management plans.

Reporting on Going Concern

SA 570 (Revised) identifies the following situations in terms of use of going - concern basis of accounting that **impacts an auditor's opinion** and illustrative paragraphs in different situations are given in the SA 570 (Revised):

- **Use of going concern basis of accounting is inappropriate:** If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgement, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor would express an adverse opinion.
- **Use of the going concern basis of accounting is appropriate but a material uncertainty exists:**
  - **a) Adequate disclosure of a material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern"**

    SA 570 (Revised) has enhanced the auditor's reporting requirements when a material uncertainty related to going concern exists and disclosure in the financial statements in this regard are adequate. Instead of the earlier requirement to report material uncertainty within an 'Emphasis of Matter paragraph', material uncertainty is now required to be reported by a separate section of audit report titled "Material Uncertainty related to Going Concern". Further, this section should be placed immediately after the opinion paragraph and before the Emphasis of Matter (EOM)/Other Matter (OM) paragraph.
  - **b) If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion, as appropriate in accordance with SA 705(Revised).**
- **Management unwilling to make or extend its assessment:** In situations where an auditor has requested management to make an assessment, or extend their original assessment of going concern, however, management has refused to make, or extend such an assessment then the auditor would consider the implications for the Auditor's report.

If management is unwilling to do so, **a qualified opinion or a disclaimer of opinion** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

Reporting as per SA 701-Communicating Key Audit Matters in the Independent Auditor's Report

A matter giving rise to a modified opinion in accordance with SA 705(Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570(Revised), are by their nature key audit matters. However, in such circumstances, these

> If in the auditor's judgement, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor would express an adverse opinion.

matters shall not be described in the Key Audit Matters section of the auditor's report. Rather, the auditor shall include a reference to the Basis for Qualified (Adverse) Opinion or the

Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section.

Key Reference Material on 'Going Concern' issued by the Institute of Chartered Accountants of India [ICAI]

- SA 570(Revised) Going Concern
- Implementation Guide to SA 570(Revised), "Going Concern" issued by Auditing and Assurance Standards Board (AASB). It provides a very practical and easy to follow approach to going concern assessment in the forms of questionnaire, checklists, templates and case studies, etc.
- Frequently Asked Questions on SA 570(Revised), 'Going Concern' issued by AASB.

Practical examples

Example-1

XYZ Limited, a Public sector company has incurred a net loss during the year ended March 31, XXXX and, as of that date, the Company's current liabilities exceeded its Current assets by significant amount, huge borrowings and it has accumulated losses which has resulted in complete erosion of the net worth of the company. These events or conditions cast a doubt on the ability of the company to continue as a going concern. However, the management is of the opinion that going concern basis of accounting is appropriate in view of written communication by Government for support by way of equity infusion, various steps taken by the Government/ promoter towards improving the operational and financial efficiencies of the company, various revenue enhancing measures and cost control measures undertaken by the management, Government guarantee to lenders, etc. and the same has been appropriately disclosed in the notes to Financial Statements.

In such circumstances, after obtaining the sufficient appropriate audit evidence in support of management's above disclosures in financial statements, the auditor may conclude that the management's use of going concern basis of accounting is appropriate and include a section in audit report on **'Material Uncertainty related to Going Concern'**.

Example-2

ABC Limited has accumulated losses of XXX as at March 31, XXXX and company has negative net worth of YYY as at March 31, XXXX. The Company is incurring losses, it has cash flow issues, low levels of business, fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment and inability to pay creditors on due dates.

Management has prepared accounts on going concern basis as management is hopeful of turnaround in future however there are no concrete business plans, no evidence by promoters for equity infusion, no extension /sanction letters from banks/ lenders.

In such circumstances, use of going concern basis of accounting is inappropriate and the auditor shall express an '**adverse opinion**'.

Example-3

ABC Limited has incurred significant losses during the year and its current liabilities have exceeded current assets by a significant value as at March 31, XXXX. Further, due to significant default made by the company in repayment of borrowings, its credit rating has been downgraded to 'default grade' subsequent to the year-end which may substantially impair its ability to raise or generate funds to repay its obligations. All these developments raise a significant doubt on the ability of the said Company to continue as a going concern.

The Management has prepared these financial statements using going concern basis of accounting based on their assessment of the successful outcome of monetising its assets, draft resolution plan to the consortium of bankers for restructuring its borrowings and discussions for stake sale by the promoters to a strategic partner with further equity infusion.

Since, the ability of the Company to continue as a going concern *inter alia* is dependent upon its ability to monetise its assets, secure funding from the bankers or investors, restructure its liabilities and recommence its operations, are not wholly within control of the Company, in these circumstances, Auditor is unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Auditor in such circumstances may give a **'Disclaimer of Opinion'**.

Conclusion

In view of, certain corporate failures, implementation of Insolvency and Bankruptcy Code (IBC), involvement of the National Company Law Tribunal (NCLT), downgrading of credit ratings, auditor needs to identify the conditions and events, evaluate the management's plans, plan and perform auditing procedures to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements and its implications while issuing auditor's report and should remain alert throughout the Audit. ■