

Going Concern Why Auditors Must Be Specific

By Ronan Nolan, FCA



Recent guidance from the Auditing Practices Board contains useful pointers for auditors faced with analysing the difficult issues raised by the current economic crisis. Ronan Nolan takes a look at the new guidance.

Auditors, like everyone else, are conscious of the very difficult current economic conditions and must consider the potential implications arising for their reports. They should not take ‘the easy way out’, however, by referring to going concern uncertainties in every audit report; rather, they must consider in each case whether there are circumstances specific to the particular entity that indicate significant uncertainties such as to warrant an ‘emphasis of matter’ paragraph in their audit report. This is the key message in *Going Concern Issues during the Current Economic Conditions*, issued by the Auditing Practices Board (APB) in December 2008.

Background

In the difficult economic conditions we are experiencing at present, all involved in the preparation and audit of financial statements must pay careful attention to whether the going concern assumption continues to be appropriate, and what disclosures may be required.

Directors have the onerous responsibility for preparing financial statements that show a true and fair view of the result and financial position of their companies, and the basis for adopting the going concern assumption is a critical element of this exercise.

Auditors must form a view on the financial statements, including the disclosures made by the directors in relation to the going concern assumption.

In a helpful document, *An Update for Directors of Listed Companies: Going Concern and Liquidity Risk* (November 2008) the Financial Reporting Council (FRC) identifies matters which directors need to consider in this regard. It recommends:

- ▶ Management should undertake an assessment of an entity’s ability to continue as a going concern when preparing financial statements;
- ▶ When management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity must disclose those uncertainties;
- ▶ Directors should have in place processes and procedures which ensure a rigorous approach to this assessment, as set out in guidance issued by the FRC in 1994¹, and now under review. Some of the areas upon which such procedures should focus are:
 - forecasts and budgets;
 - borrowing requirements;
 - liability management;
 - contingent liabilities;
 - products and markets;
 - financial risk management; and
 - financial adaptability.

- ▶ A particular area for focus is bank and other facilities, and the 1994 guidance offers the following pointers:

30. *The facilities available to the company should be reviewed and compared to the detailed cash flow forecasts for the period to the next balance sheet date, as a minimum. Sensitivity analyses on the critical assumptions should also be used in the comparison. The directors should seek to ensure that there are no anticipated shortfalls in facilities against requirements; arrears of interest; or breaches of covenants.*

31. *The directors have responsibility to manage borrowing requirements actively. Any potential deficits, arrears or breaches should be discussed with the company’s bankers in order to determine whether any action is appropriate. This may prevent potential problems crystallising. The onus is on the directors to be satisfied that there are likely to be appropriate and committed financing arrangements in place.*

32. *The directors may seek confirmation from their bankers regarding the existence and status of any finance arrangements which the company has entered into.*

As a result of their assessment, directors will come to one of three potential conclusions:

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

Appropriate disclosures are required in respect of each of these three conclusions, but it is the second outcome which is the main focus for the APB guidance, and which raises significant considerations in relation to the form of the auditors' report.

Accounting standards provide no definition of 'material uncertainties' or 'significant doubt'. Directors must exercise judgement in assessing the probability of an event occurring and the impact it will have if it does occur.

Audit Reports

As noted at the outset of this article, a key message from the APB guidance is that 'emphasis of matter' paragraphs should not become ubiquitous. If such modifications to the auditor's report become commonplace there is a real risk of 'devaluing the currency'. General economic circumstances should not give rise to modified audit reports. Such reports should only arise out of circumstances particular to an individual entity. Having said that, one can readily foresee that many entities, such as those with significant asset valuation uncertainties, will in fact be subject to specific circumstances so we may expect to see an increase in modified audit reports. Professional judgment must be exercised by auditors as to whether in their view such specific circumstances exist in relation to the entity being audited.

Audit Considerations

ISA (UK and Ireland) 570 requires the auditor to consider the appropriateness of the directors' use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about

the entity's ability to continue as a going concern that need to be disclosed in the financial statements.

To do this the auditors will evaluate the directors' process, decide whether they agree with the conclusion the directors have reached, assess the adequacy of related disclosures and consider the implications for the auditor's report.

It is particularly important that the auditor documents this work.

The auditor should meet the directors as early as feasible in order to help plan his audit procedures and also to minimise the risk of qualifying his opinion on the grounds of a scope limitation or of a disagreement due to inadequate disclosure. This early meeting may encourage the directors to develop a realistic remedial action plan where one is needed.

Appendix 3 of the APB guidance provides a useful list of risk areas to consider arising from current economic conditions, including:

- fair values;
- impairments;
- current versus non-current classification;
- revenue recognition;
- pensions;
- hedging;
- insurance;
- deferred income taxes.

The APB guidance notes the significance of banking arrangements, and suggests the following procedures for the auditor:

- ▶ review the terms of loan agreements and determine whether any may have been breached.
- ▶ obtain confirmations of the existence and terms of bank facilities and assess the intentions of the bankers thereto.

This latter assessment could involve the auditor examining written evidence or making notes of meetings held with the directors and, where appropriate, with the directors and the entity's bankers.

In the present economic environment, bankers may be reluctant to provide positive confirmations to the directors that facilities will continue to be available. The absence of bank confirmation of

bank facilities does not, of itself, necessarily cast significant doubt upon the ability of an entity to continue as a going concern. Auditors must differentiate between circumstances where the lack of a confirmation reflects the existence of a material matter regarding going concern (which, therefore, falls to be emphasised in the auditor's report) and increased caution on the part of bankers that is not indicative of a material matter regarding going concern (and which, therefore, does not fall to be emphasised in the auditor's report).

Ethical considerations

The APB considers it appropriate to remind auditors to be careful not to fall foul of ethical standards in their efforts to work with clients facing difficulties. The main risk identified is that auditors might be drawn into an advocacy role in assisting clients in dealing with funding requirements. Appropriate safeguards are recommended to ensure that audit independence is not impaired.

Going Concern Review

Finally, a key aspect of the going concern review, both for directors and auditors, is the period covered. IAS 1.26 provides that management should take into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period. A fundamental point here is that account must be taken of any event or circumstance which can be foreseen, without any limit on the time horizon. Auditors have an explicit obligation to include an extra paragraph in their audit report if the period covered by the directors' review is less than twelve months from the date of approval of the annual report and accounts and this fact is not disclosed by the directors.

¹ Going concern and Financial Reporting; guidance for directors of listed companies registered in the United Kingdom, 1994. This guidance is reproduced as part of the Update for Directors described in this article.

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