Testing and Reporting of Going Concern assumption

Case Study 2

Panel Members: Jesal, Saurabh, Parth, Raghav

Moderator: Sanjay

Case Study 2 - Question

M/s KBC Pvt. Ltd. is in the business of manufacturing of Jewellery having unit in SEZ. During the year, the Company has sold its unit located in SEZ to Big-B Company Ltd. under slump sale. The Company does not have any other activity after slump sale.

As an Auditor of KBC Pvt. Ltd., How testing and reporting will be done on going concern assumption in FS and audit report)

Disclosure of Accounting Policies – AS 1 (Going Concern)

Para 10:

- The enterprise is normally viewed as a GC ie as continuing in operation for the foreseeable future.
- It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Para 27:

- If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required.
- If a fundamental accounting assumption is not followed, the fact should be disclosed .

Disclosure of Accounting Policies – Ind AS 1 (Going Concern)

Para 25:

- When preparing FS, management shall assess an entity's ability to continue as a GC.
- An entity shall prepare FS on a GC basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.
- When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a GC, the entity shall disclose those uncertainties.
- When an entity does not prepare FS on a GC basis, it shall disclose the fact, together with the basis on which it prepared the FS and the reason why the entity is not regarded as a GC.

Disclosure of Accounting Policies – Ind AS 1 (Going Concern)

Para 26:

- In assessing whether the GC assumption is appropriate, management considers all available information about the future, which is at least, but is not limited to, 12 months from the end of the reporting period.
- The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the GC basis of accounting is appropriate without detailed analysis.
- In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the GC basis is appropriate

Concept of Going Concern

- 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**.
- General purpose financial statements are prepared using the going concern basis of accounting, unless **management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so**.
- Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis).
- When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objective of SA 570

The objectives of the auditor 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 SA.

Who is responsible to assess the GC assumption? What factors to be considered?

As per SA, it is management's responsibility to assess the entity's ability to continue as GC. This responsibility arises either through

- Financial reporting frameworks which contain an **explicit requirement for management** to make a specific assessment of the entity's ability to continue as a going concern and matters to be considered and disclosures to be made in connection with going concern.
- Where the law or regulation governing the entity has specified such assessment
- Where the going concern basis of accounting is a fundamental principle in the preparation of financial statements**, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern** even if there is no explicit requirement for management to make specific assessment of the entity's ability to continue as GC

What factors to be considered ?

Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. **The following factors are relevant to that judgment:**

- The **degree of uncertainty** associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.

- The **size and complexity** of the entity, the **nature and condition** of its business and **the degree** to which it is affected by **external factors** affect the judgment regarding the outcome of events or conditions.

- Any judgment about the future is based on information available at the time at which the judgment is made. **Subsequent events** may result in outcomes that are **inconsistent** with **judgments** that were reasonable at the time they were made.

What are the responsibilities of the auditors relating to GC ?

- To obtain sufficient appropriate audit evidence regarding the appropriateness of managements use of the going concern assumption in the preparation of the financial statements
- To conclude, whether there is a material uncertainty about the entity's ability to continue as a going concern
- This responsibility exists 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

Examples of events / conditions auditors need to consider for arriving at a conclusion on GC

Financial

- Net current liability position
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment
- Excessive reliance on short term borrowings to finance long term assets
- Denial of usual trade credit from suppliers
- Negative operating cash flows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Inability to obtain finance for essential new product development

Examples of events / conditions auditors need to consider for arriving at a conclusion on GC

Operating

- Directions from the court / management to liquidate the firm
- Work stoppages or other labour difficulties
- Legal proceedings against the entity
- Loss of key management without replacement
- Shortage of important supplies
- Loss of a key franchise, license, or patent
- Emergence of highly successful competitors
- Unsold finished inventory in its books of accounts from a long period
- Sale of business

Examples of events / conditions auditors need to consider for arriving at a conclusion on GC

Others

- Non compliance with capital or other statutory or regulatory requirements (capital adequacy for banks, NBFC)
- Uninsured or underinsured catastrophe such as a drought, earthquake, or flood, *pandemic*
- Changes in major law having implications on the business (AGR ruling of SC)
- A major debtor has been declared insolvent or the firm has a single buyer who has closed its business

How management can mitigate consequences of adverse events ?

- Fighting against the liquidation orders at a higher court, if it was a creditors liquidation
- Maintain adequate cash flow by:
  - disposing some of the assets or
  - arranging for some loans or
  - obtaining additional capital
- Finding way through which the company can follow the changes in statue governing them (eg 10 year period to pay AGR dues)
- Finding new markets or customers
- Changing or altering the present business or operation line to follow or adept the change in the market

Provided that management's contentions can be supported by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity

Additional procedure to be undertaken when events or conditions are identified which cast doubt on entity's ability to continue as GC

- Analyzing and discussing cash flow, profit and other relevant forecast with management
- Review of covenants of borrowing terms to determine whether there is any breach
- Review of minutes of the BoD and Shareholders and relevant committee for reference to financing difficulties
- Inquiring with legal counsel regarding existence of litigation, legal claim, estimate of their financial implication
- Assessing financing ability of third parties who have made commitments to provide funds
- Review of subsequent events
- Evaluate entity's plan to deal with unfulfilled customer orders
- Review of reports from regulatory authority
- Determining the adequacy of support for any planned disposal of assets

Considerations specific to small entities that the auditor should look at

Indication to assess GC

- Banks and lenders cease to support the entity
- Loss of principal supplier
- Loss of principal customer
- Loss of key employee
- Loss of the right to operate under a licence, franchise or other legal agreement

Mitigating Options for Mgt

- Arranging long term or medium term finance by the owners or from his relatives / friends
- Receipt of confirm orders
- Owners refrain from withdrawing their capital / profits

Provided that management's contentions can be supported by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity

How should Auditors evaluate management's assessment of the GC assumption ?

- The auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.
- They shall evaluate:
  - the process management followed to make its assessment
  - the assumptions on which the assessment is based
  - management's plans for future action and
  - whether management's plans are feasible in the circumstances.
- It is not the auditor's responsibility to rectify the lack of analysis by management.
- In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances

When does material uncertainty exist?

- Material uncertainty is said to exist, when events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are in existence.
- A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor’s judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for ensuring fair presentation and to prevent the financial statements from being misleading.

How should the auditors conclude on existence of material uncertainty ?

The auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by performing some the following procedures:

- Requesting management to perform an assessment of entity's ability to continue as a GC.
- Evaluating management's plans for future actions in relation to its going concern assessment.
- Where the entity has prepared a cash flow forecast to consider the future outcome of events or conditions in the evaluation of management's plans for future actions.
- Considering whether any additional facts or information have become available since the date on which management made its assessment.
- Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

How should auditors deal with adequacy of disclosure ?

The auditor shall determine whether the financial statements, adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions.

Disclosure may include management's evaluation of the significance of the events or conditions, significant judgment made by the management and magnitude of the potential impact of the principal event or condition and likelihood and timing of their occurrence

Concurs with Mgt use of GC but Material Uncertainty exists

- Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business

Events / Conditions identified but no Material Uncertainty exists

- The auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

How to issue audit report when use of GC basis of accounting is appropriate, but material uncertainty exists ?

If adequate disclosure about the 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" to:

a) Draw attention to the note in the financial statements that discloses the matters

b) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

If adequate disclosure about the material uncertainty is **not made** in the financial statements, the auditor shall:

a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised) and

b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that 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

Responsibility of the auditor relating to communicating events or conditions that may cast doubt on entity's ability to continue as GC

Communication should be made with TCWG and it should include the following:

- Whether the events or conditions constitute a material uncertainty
- Whether management's use of the GC basis of accounting is appropriate in the preparation of the FS
- The adequacy of related disclosures in the FS
- Where applicable, implications for the auditor's report

KBC Pvt Ltd and Going Concern

In case of Positive Networth

- Positive Net worth even post slump sale means that the entity can continue functioning; maybe:
  - with a new line of operations, new business
  - Investment activities
- Since company's existence and operation in future is not endangered because of the positive net worth, the company can maintain it's financials on a going concern basis

In cash of Negative Net Worth

- Negative Net worth is a major indicator for the Going concern assumption. Continued operating losses, negative working capital, adverse financial ratios indicate the entity's inability to continue the business in case of the slump sale
- Thus if the entity ends up with a negative net worth post slump sale, it will be difficult for it to continue functioning as a company, endangering it's going concern assumptions

THANK YOU