# GOING

RELEVANT TO ACCA QUALIFICATION PAPER P7

DURING THE RECENT GLOBAL ECONOMIC CRISIS, ISA 570, *GOING CONCERN* HAS BEEN A WELL-ESTABLISHED SOURCE OF GUIDANCE FOR AUDITORS. ADDITIONAL DIRECTION HAS BEEN PROVIDED BY THE IAASB'S PRACTICE ALERT *AUDIT CONSIDERATIONS IN RESPECT OF GOING CONCERN IN THE CURRENT ECONOMIC ENVIRONMENT*, ISSUED IN JANUARY 2009.

**The recent global economic crisis, commonly referred to as the credit crunch, has provided many challenges for both the preparers and the auditors of published financial statements.**

For auditors, ISA 570, *Going Concern* is a well-established source of guidance, and additional direction has been provided by the IAASB's Practice Alert *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, issued in January 2009. In the UK, the APB issued the Bulletin *Going Concern Issues During the Current Economic Conditions* in December 2008. Both of these are examinable documents for the Paper P7 exams in 2010.

### The auditor's objectives in relation to going concern

ISA 570 contains well-established guidance on going concern, including the following objectives for the auditor:

- to obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements
- 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
- to determine the implications for the auditor's report.

All audits should involve an assessment of the appropriateness of the going concern assumption, and it is obvious to say that the auditor may well have to perform additional procedures when there are heightened risks relating to going concern, caused by difficult economic and market conditions. But going concern should be considered at all stages of the audit, not just in terms of specific procedures.

It is important to remember that going concern is not just something considered at a particular stage in the audit cycle, but should be an issue that permeates the whole performance and review of an audit.

Auditors should consider the current economic circumstances and their impact on a particular audit when:

- assessing risk at the planning stage of the audit, and when re-assessing risk as the audit progresses
- designing and performing audit procedures to respond to the assessed risks
- evaluating and concluding on the results of audit procedure, and
- forming an audit opinion.

### Assessing risk at the planning stage of the audit

Auditors are required by ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, to gain an understanding of the audit client's business and the economic environment in which it operates. This understanding should then lead to the identification of business risks, which are then evaluated in terms of any risks of material misstatement in the financial statements.

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# CONCERN

Business risks include risks that could reduce the company's profit and/or cash inflows, and could ultimately mean that either a company is not a going concern, or that there are significant doubts over its ability to continue as a going concern. Identification of this heightened risk at this initial stage in the audit cycle means that additional audit procedures can be planned as a response to the specific risks identified.

All of this means that the auditor must gain a detailed understanding of the economic environment in which a company is operating, and more specifically, an understanding of the particular market conditions affecting its operations. Risks can arise from many factors, including reduced demand for goods and services, customers' inability to pay for goods and services already provided, and an inability to raise necessary finance. Such factors must be assessed for their specific impact on a company's operations. It is important to remember that difficult economic or market conditions do not necessarily mean that a material uncertainty exists about a company's ability to continue as a going concern.

IT IS IMPORTANT TO REMEMBER THAT GOING CONCERN IS NOT JUST SOMETHING CONSIDERED AT A PARTICULAR STAGE IN THE AUDIT CYCLE, BUT SHOULD BE AN ISSUE THAT PERMEATES THE WHOLE PERFORMANCE AND REVIEW OF AN AUDIT.

The evaluation of business risks should lead to the assessment of specific financial statement risks. For a company facing going concern difficulties, the fundamental financial statement risk is whether the financial statements have been prepared under the correct assumption, or whether any significant uncertainties have been disclosed in the financial statements. However, there are more specific financial statement risks including:

- potential overstatement of non-current assets if impairments caused by reduced market value or value in use have not been recognised
- potential overstatement of inventory if net realisable value has fallen due to reduced demand
- potential overstatement of receivables if bad debts not provided for
- incorrect measurement and recognition of gains or losses on financial instruments due to inactive markets
- incorrect measurement and disclosure of assets held for sale or discontinued operations
- incorrect measurement or disclosure of provisions or contingent liabilities caused by restructuring of operations.

### Designing, performing and evaluating audit procedures

Where risks, such as the ones mentioned above, have been identified, the auditor must respond to the risks by designing and performing appropriate audit procedures. Clearly the procedures should address the specific risks identified, and so extra procedures may be needed on many balances and transactions such as the ones outlined above.

More generally, audit procedures are necessary in order to evaluate how the key management personnel have satisfied themselves that it is appropriate to adopt the going concern basis in preparing the financial statements. Procedures should include:

- analysing and discussing cash flow, profit and other relevant forecasts with management
- reviewing the terms of loan agreements and determining whether they have been breached
- reading minutes of board meetings and relevant committees for any discussion of financing difficulties

- reviewing events after the year end to identify factors relevant to the going concern assumption as a basis for the preparation of the financial statements.

Paragraph A15 of ISA 570 contains examples of additional procedures that may be used.

Analysis of cash flow is usually a key feature of any going concern evaluation. In this evaluation the auditor should pay particular attention to the reliability of the company's systems for generating the cash flow information, and whether the assumptions underlying the cash flow appear reasonable.

In evaluating going concern, the auditor will consider whether necessary borrowing facilities are in place and in doing so will attempt to obtain confirmations from the company's bankers. However, the bankers may be reluctant to confirm whether the borrowing facilities will be available, in which case the auditor should consider the significance of this to the entity's ability to continue as a going concern, and also consider, through discussion with management, whether there are other strategies or sources of finance available.

### Forming an audit opinion

In forming the audit opinion, the auditor should consider two issues: have the financial statements been prepared using the appropriate going concern assumption, and is there adequate disclosure of any material uncertainty regarding the going concern status.

First, the auditor may conclude that management's use of the going concern assumption is inappropriate. This means that the financial statements are effectively rendered meaningless, and ISA 570 requires the auditor to express an adverse opinion on the financial statements.

IN EVALUATING GOING CONCERN, THE AUDITOR WILL CONSIDER WHETHER NECESSARY BORROWING FACILITIES ARE IN PLACE AND IN DOING SO WILL ATTEMPT TO OBTAIN CONFIRMATIONS FROM THE COMPANY'S BANKERS.

In rare circumstances, where the financial statements have not been prepared under the going concern assumption (for example, using a liquidation basis), and the auditor agrees with the use of this alternative basis for the preparation of the financial statements, the audit report will not be qualified, as there is no basis for a disagreement, but the auditor may consider it necessary to include an Emphasis of Matter paragraph in the audit report to highlight the unusual circumstances to the users of the financial statements.

It is much more likely that the auditor disagrees with the level of disclosure of material uncertainties, rather than disagreeing with the use of the going concern assumption. ISA 570 contains detailed guidance in this area, which is briefly summarised below:

- Where the disclosure of material uncertainty is considered adequate, the auditor includes an Emphasis of Matter paragraph within the audit report to highlight the uncertainty to the users of the financial statements.

- Where there are multiple significant uncertainties that relate to the financial statements as a whole, a disclaimer of opinion may be considered more appropriate than an Emphasis of Matter paragraph. ISA 570 comments that this is in extremely rare cases only.
- Where the disclosure of material uncertainty is not considered adequate, the audit opinion should be either qualified due to disagreement, or an adverse opinion should be given, depending on the level of significance of the lack of disclosure.

EVEN THOUGH THE GLOBAL ECONOMY MAY SHOW SIGNS OF RECOVERY, THE EFFECTS IN SOME MARKETS AND FOR MANY COMPANIES ARE NOT LIKELY TO BE SEEN FOR SOME TIME. AUDITORS SHOULD NOT APPROACH THE ASSESSMENT OF GOING CONCERN IN DIFFICULT TIMES AS A ONE-OFF EXERCISE, BUT AS AN ISSUE TO BE CONTINUALLY ADDRESSED.

### Ethical matters

In the current economic climate, with severe restrictions on borrowing facilities in many jurisdictions, auditors are likely to be asked by audit clients to perform non-audit services which may create self review, advocacy or management threats to objectivity and independence. For example, the audit firm may be asked to perform:

- a review of the business including advising on restructuring options
- a review of prospective financial information, possibly for presentation to potential providers of finance
- advising on corporate finance options, or negotiating such options.

The problem created is that the audit firm may not be able to objectively assess going concern factors when in addition becoming involved with non-audit services pertaining to the going concern status of the company. The audit firm should carefully consider the appropriateness of providing such non-audit services in these circumstances.

Safeguards may be able to reduce the threats to objectivity and independence to an acceptable level. Safeguards may include:

- a review of the going concern assessment and conclusion reached by a partner who is not a member of the audit team
- additional procedures as part of an Engagement Quality Control Review
- confirmation from the audit client that they remain responsible for any decisions or actions taken as a result of the non-audit service provided.

## CONCLUSION

In the current economic climate, auditors must be extra vigilant in relation to the audit of going concern matters, and should also remember the possible ethical implications of being involved in non-audit services relevant to going concern. Even though the global economy may now be showing signs of recovery, the effects in some markets and for many companies are likely to be seen for some time, so auditors should not approach the assessment of going concern in difficult times as a one-off exercise, but as an issue to be continually addressed.

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