

FINANCIAL REPORTING: CONCERN OVER 'Going Concern'?

THIS IS THE SECOND OF TWO ARTICLES BY THE FINANCIAL STATEMENTS REVIEW COMMITTEE OF THE MALAYSIAN INSTITUTE OF ACCOUNTANTS, WHICH SHARES COMMON FINANCIAL REPORTING ISSUES NOTED DURING THE REVIEW OF PLCs' FINANCIAL STATEMENTS.

Can your business continue as a 'going concern'? Probably 99% of the management would (promptly) answer 'yes' to the question, and skip this during the Board's agenda whilst discussing financial reporting issues.

One of the issues commonly raised by the Financial Statements Review Committee (FSRC) of the Malaysian Institute of Accountants (MIA) revolves around 'going concern' and the adequacy of related disclosures in the financial statements.

As shared by the Chairman of FSRC, Stephen Oong: "The going concern assumption is a fundamental principle in the preparation of financial statements. Under both Financial Reporting Standards (FRS) and Private Entity Reporting Standards (PERS), management and directors are required to satisfy themselves that the going concern assumption used as the basis in the preparation of the financial statements is appropriate. The management of an entity therefore has a responsibility to assess the entity's ability to continue as a going concern."

Under the going concern assumption, an entity is normally viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seek-



ing protection from creditors pursuant to laws or regulations. Fundamental to the going concern assumption is the ability of the entity to continue as a going concern.

ECONOMIC CONDITIONS AND GOING CONCERN

Consumer and business confidence seems to have improved in the second and third quarter of 2009. It was also reported that there are glimmer signs that the global downturn has stabilised somewhat. But how soon does it take for the economy to revive, and how certain is the road to global recovery?

The current economic conditions are likely to increase the risk in a number of issues in connection with the preparation of financial statements, for example, impairment of goodwill and other assets, classification of liabilities, measurement of recoverable amount, and estimation of future profits for the purpose of determining whether deferred tax assets should be recognised, etc. The current economic conditions also place some companies under financial stress, which may in turn affect the ability of an entity to continue as going concern. However, it should not be assumed that the current general economic situation in itself means that a material uncertainty exists about an entity's ability to continue as a going concern or justifies that the auditor's reports be modified with an emphasis of matter on the existence of material uncertainties on the entity's ability to continue as a going concern.

EARLY PLANNING BY DIRECTORS/ MANAGEMENT AND TAKING REMEDIAL ACTION

PLCs with a 31 December year-end are required to announce their fourth quarter results to Bursa Malaysia by the end of February 2010. FRS 101* requires management to make an assessment of an entity's ability to continue as a going concern when preparing financial statements, taking into account all available information about the future, which is at least, but not limited to 12 months from the balance sheet date. It is advisable

TABLE 1: Examples of events or conditions, which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

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.
- 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.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

(source: Paragraph 8 of ISA 570 "Going Concern")

for management to start assessing the financial position of the entity before the end of the financial year and take remedial action to avoid being trapped in an irreversible unfavourable situation, for example, breaching loan covenants as of the financial year end. Therefore, early planning by management is highly recommended.

What should management look out for? In many cases, the assessment of the status of going concern is straightforward. An entity that has a history of profitable operations and ready access to financial resources will almost certainly be a going concern without detailed analysis. In other cases, the FRS 101 states that the 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 themselves that the going concern basis is appropriate. Management may also refer to the examples of indicators provided in the International Standard of Auditing (ISA) 570 "Going Concern" as a guide (see **Table 1**).

It is crucial to note that what constitutes a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern is a judgment involving:

- the nature and materiality of the events or conditions giving rise to the uncertainty, and
- the ability of the entity to adopt strategies that mitigate that uncertainty.

POSSIBLE OUTCOME AND IMPLICATIONS ON THE FINANCIAL STATEMENTS

The FSRC summarised the possible outcome arising from the management’s assessment of going concern and the implications on the financial statements in a flowchart (see **Table 2**).

It is hoped that members of the Institute will find the succinct flowchart useful.

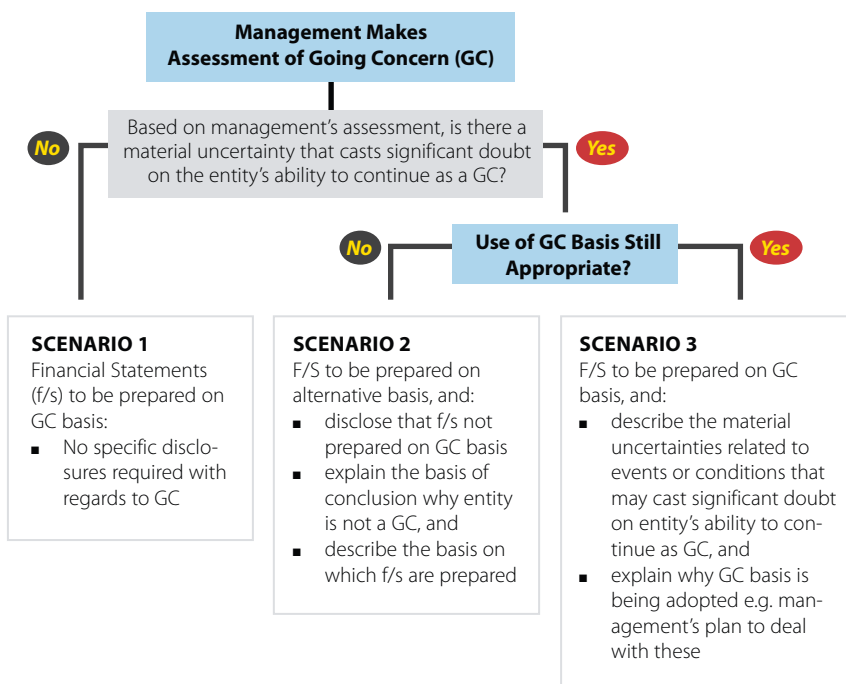
“WHERE WERE THE AUDITORS?”

The responsibility of performing an assessment of an entity’s ability to continue as a going concern lies with the directors. Auditors however play an important role in safeguarding the integrity of the financial reports prepared by the directors of companies. Therefore, it is important for the auditors to carry out their roles effectively.

It was said that the most worrying misstatement that could occur at the financial statements level is that the going concern basis used in the preparation of the financial statements is not appropriate.

When the financial statements of the audit client are subjected to increased risk of material misstatement, the audit engagement executive will have to consider:

TABLE 2: Possible outcome from management’s assessment of going concern and the implications on the financial statements



NOTE:

Management also needs to consider other disclosure requirements about liquidity risk and other risks that may have a bearing on the going concern assessment, including:

- sources of estimation uncertainty about the carrying amount of assets and liabilities (FRS 101.116-124, or FRS 101(2009).125-133 effective 1 January 2010)
- defaults and covenant breaches (FRS 132.94(m), or FRS 7.18-19 effective 1 January 2010)
- risks arising from financial instruments, including liquidity risk where it is material (FRS 132.52, or FRS 7.31-42 effective 1 January 2010)

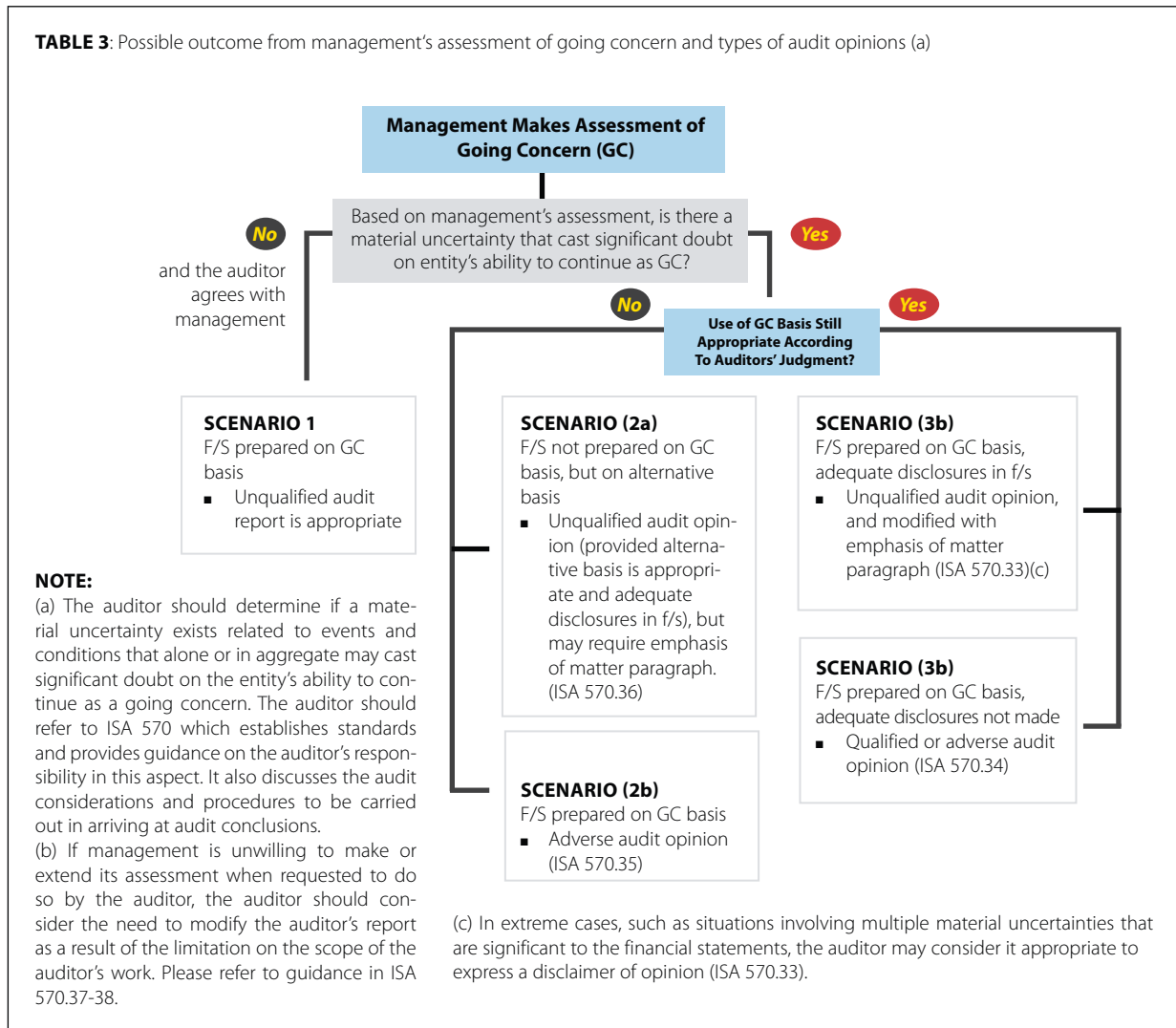
Disclosure of undrawn borrowing facilities and any restrictions on the use of those facilities such as covenant requirements is encouraged (FRS 107.50(a)).

- his/her own involvement in the direction, supervision and performance of the audit when complying with the requirements of the ISA 220, paragraph 21;
- the capabilities and competence of the engagement team when complying with the requirements of ISA 220, paragraph 19; and
- consultations with other professionals on difficult and contentious matters when complying with the requirements of ISA 220, paragraph 30.

ISA 570 laid out the procedures that the auditors will have to carry out in considering the appropriateness of



TABLE 3: Possible outcome from management's assessment of going concern and types of audit opinions (a)



the directors' use of the going concern assumption, and to 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.

Auditors are reminded to gather sufficient audit evidence to confirm or dispel whether or not a material uncertainty exists, including considering the effect of any plans of management and other mitigating factors. **Table 3** lays out the possible outcome from management's assessment of going concern and the types of audit opinions.

As indicated by paragraph 11 of ISA 260, the auditor should consider communicating with those charged with gov-

ernance on audit matters of governance interest, including when he identified material uncertainties relating to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern, and expected modifications to audit report, etc.

And, needless to say, it is important that the auditor document his findings in accordance with ISA 230 at the date of the auditor's report and his basis of arriving at his conclusion, as going concern is most likely a significant matter affecting the financial statements.

Earlier in 2009, the Institute launched a set of guidance titled "Facing The Financial Global Crisis: Guide For The Preparation Of Upcoming Financial

Reports" to assist preparers, members of the board, audit committees as well as auditors in carrying out their respective roles in the financial reporting process. The guidance contains existing guidelines on key areas of concern that need to be considered in light of the current economic conditions. Members of the Institute are encouraged to download a copy from <http://www.mia.org.my/frguide>. ■

* Reference is made to paragraphs 23 and 24 of FRS 101 "Presentation of Financial Statements". Similar requirements are found in paragraphs 23 and 24 of MASB 1 "Presentation of Financial Statements"

The first article titled "Lessons from Deficient Disclosure" (appeared in Accountants Today - November 2009 - Vol.22 No.11)