Going Concern

ICAEW calls for greater understanding of the going concern uncertainty expected in 2008 audited financial statements

1. The ‘going concern’ basis:

‘That the business entity is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.’

Financial reporting is at the heart of modern markets and the going concern basis is a fundamental concept in financial reporting. Normally, assets and liabilities are reported on a going concern basis – i.e. that the company will continue for the foreseeable future.

Company directors must prepare financial statements on a going concern basis unless they intend to liquidate the business or to cease trading, or have no realistic alternative but to do so. In deciding whether the going concern basis is appropriate, directors examine existing budgets and forecasts, assess borrowing requirements, and review other information as needed. Directors are required to take into account all available information about the foreseeable future which is at least, but not limited to, one year from the date of approval of the financial statements. This is an exceptionally difficult task in the current market climate.

The auditor evaluates the directors’ assessment and considers whether there are events or conditions which may cast significant doubt on the company’s ability to continue as a going concern. As a result, the auditor may seek further audit evidence.

If, after obtaining further audit evidence, a material uncertainty remains which may cast significant doubt on the company’s ability to continue as a going concern and this uncertainty has been adequately disclosed in the financial statements, the auditor will modify the audit opinion by including an ‘emphasis of matter’ explanatory paragraph highlighting those disclosures. Such a paragraph does not affect the auditor’s opinion, that the financial statement’s give a ‘true and fair’ view, which is modified but ‘clean’ or unqualified. Alternatively, where disclosures are deemed not to be adequate, the auditor will issue a qualified opinion and provide the required additional disclosures.

2. What is the issue?

Given the current economic environment, the ICAEW anticipates that a significantly higher proportion of 2008 year end annual reports are likely to contain disclosures relating to going concern and liquidity, together with an increase in the number of modified audit reports, as compared to previous years.

The nature of the market reaction, and the full market implications of a rise in these disclosures and modified audit opinions, will be heavily affected by the levels of understanding and awareness regarding the cause of this likely rise.

1 Paragraph 3 of International Auditing Standard (UK and Ireland) 570 Going Concern
If investors and others do not respond proportionately to emphasis of matter paragraphs explaining going concern uncertainty, and do not take into account the current exceptional economic circumstances, the issue has the potential to undermine wider business confidence.

3. Why are modified audits expected to rise?

The economic environment is currently challenging, with low levels of business and consumer confidence. The ICAEW 2008 Q4 Business Confidence Monitor found that UK business confidence had fallen for a sixth consecutive quarter to reach the lowest level since the Monitor began. Commercial and domestic property values, which underpin a large proportion of credit facilities, have been falling. In addition, adverse trading conditions have negatively impacted profitability and cashflow. These factors all reduce the likelihood that lending institutions, already inclined to be more risk averse, will renew existing credit lines.

This may well result in directors concluding that there is a need to disclose that a material uncertainty exists that leads to significant doubt about the company’s ability to continue as a going concern. In addition, the auditor will need to refer to the directors’ disclosure of a material uncertainty in the audit opinion.

4. How might businesses and investors react to modified audit reports?

If the wider market is insufficiently prepared and readers of audit opinions do not understand why a company is including going concern or liquidity risk disclosures or why an audit opinion has been modified, there is the potential for a number of damaging effects:

- A funder/lender may react by withdrawing or declining to renew credit facilities, damaging an otherwise viable business that may be reliant on those credit arrangements;
- In some cases, a modified audit opinion could be interpreted as meaning that businesses will have breached loan covenants;
- Suppliers may stop or interrupt providing credit facilities to a business, disrupting its trading activities;
- Landlords may seek to enforce break clauses in property lease arrangements;
- General business confidence and investor sentiment may be damaged.

5. The importance of wider market understanding of going concern uncertainty

Market participants need to be fully aware of what emphasis of matter paragraphs mean in the current business environment.

Investors and other users of financial statements need to be aware that, even in those cases where the directors have concluded that there are material uncertainties, it does not mean that the company concerned will cease to continue. Going concern uncertainty is less important in many ways than the nature of the uncertainties and the proposed management response. Conversely, where the directors have concluded that there are no material uncertainties, and the auditor concurs, it does not mean that the company is guaranteed to continue in business until the date of the next financial statements.

The ICAEW believes that, in many cases, the damaging potential reactions to modified audit opinions, summarised above, may be caused by misinterpretations of the ‘emphasis of matter’ in those modified audit opinions – and as such may be avoidable given sufficient market understanding and awareness.

The ICAEW welcomes the guidance for directors recently issued by the Financial Reporting Council (FRC) regarding going concern and liquidity risk disclosures in the current difficult
economic climate. The guidance emphasised that many companies will be faced with increased uncertainties and that these need to be disclosed in an open and transparent fashion. The forthcoming Auditing Practices Board (APB) bulletin on emphasis of matter will also provide guidance for auditors when they consider these issues. The ICAEW has encouraged the APB to publish guidance as a matter of urgency, prior to the end of the year so that auditors are able to plan their audit work accordingly.

6. Background to audit reports and the role of company directors and auditors

Directors have a requirement to prepare financial statements on a going concern basis unless they intend to liquidate the business or to cease trading, or have no realistic alternative but to do so. In making these assessments, if management is aware of material uncertainties that may cast doubt on the entity’s ability to continue as a going concern, they need to disclose these uncertainties within the financial statements. They may however conclude that the financial statements cannot be prepared on a going concern basis. This also needs to be disclosed with details of why the business is not a going concern and of the basis on which the financial statements are prepared.

All publicly listed companies and companies that exceed a threshold of staff numbers, turnover, or assets are required to be audited. In addition, banks or lending institutions may require businesses to be subject to audit as a term of a loan agreement. Although publicly listed companies are generally large businesses, a proportion of companies that exceed the audit threshold and a significant number of audit-exempt companies that opted for an audit to fulfil the terms of loan agreements will be small and medium sized businesses. According to Companies House, 143,600 companies submitted full audited accounts during the 12 months to 31 March 2008.

The auditor reviews the information used by directors in drawing their conclusion that the going concern basis is appropriate. The auditor also considers disclosures about going concern and liquidity risk made in financial statements. If the auditor concludes that the disclosures are not adequate to meet the requirements of accounting standards, including the need for financial statements to give a true and fair view, they are required to qualify their opinion and to provide their reasons for doing so.

Where a material uncertainty exists that leads to significant doubt about a company’s ability to continue as a going concern, the auditor has the following choices:

Where the directors have concluded that the going concern basis is appropriate:

- Where the uncertainty has been adequately disclosed in the financial statements, the auditor will issue an unqualified opinion, modified by including an emphasis of matter paragraph. If there are significant multiple other material uncertainties, auditors may disclaim their opinion instead of adding an emphasis of matter paragraph
- Where the uncertainty has not been adequately disclosed in the financial statements, the auditor will issue a qualified opinion, stating the reasons why, or give an adverse opinion

Where the directors have concluded that the going concern basis is not appropriate:

- Where the directors have followed an alternative basis, with which the auditor agrees, and have provided adequate disclosure in the financial statements, the auditor can issue an unmodified report (in relation to going concern). Such situations are rare.

An audit opinion that does not refer to going concern is not a guarantee that a business is a going concern.
For further details on the processes for assessing going concern uncertainty for audit opinions, please see the Financial Reporting Council guidelines.²

The FRC, in its press statement of 27 November 2008, says that it ‘recognises that the global liquidity squeeze and its impact on the wider economy increases the challenges for directors in preparing corporate reports this year…. more time may need to be spent by directors and audit committees planning the year end activities, reviewing key assumptions and models used in financial reporting and in reviewing the significant accounting and disclosure judgements.’ The FRC has therefore published an Update for directors of listed companies on reporting on going concern and liquidity risk.

The ICAEW plays a key part in making sure that the responsibilities of all parties are clarified and understood whether they be directors, auditors or other third parties (such as investors and lenders).

7. Recommendations

The government, regulators, accountancy profession and banking industry should work together to help ensure that:

- where modified audit opinions are issued, investors and other businesses respond in a measured and considered manner; and
- media reporting of emphasis of matter paragraphs should avoid using misleading or emotive language that gives the impression that a qualified audit opinion has been issued.

The ICAEW encourages wide public dialogue and parliamentary scrutiny of the going concern uncertainty issue in order to advise and educate the wider market.

FURTHER INFORMATION

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² [http://www.frc.org.uk/apb/publications/pub1824.html](http://www.frc.org.uk/apb/publications/pub1824.html) and The Auditing Practice Board’s International Standard on Auditing (UK and Ireland) 570 (ISA (UK and Ireland) 570) Going Concern guidelines for auditors