STATEMENT 3.251

AUDITING GUIDELINE

THE AUDITOR'S CONSIDERATIONS IN RESPECT OF GOING CONCERN

Introduction

1. This Guideline gives guidance on the auditor's considerations as to whether or not it is appropriate for an entity to prepare financial statements on a going concern basis, i.e. on a basis which assumes that the entity is able to continue in operational existence for the foreseeable future. It is supplementary to, and should be read in conjunction with, Auditing Standards 3.101 "Audit Approach" and 3.102 "Reporting" and with the related Auditing Guidelines.

2. This Guideline is written in the context of the auditor of companies incorporated under the Companies Ordinance. However, in the absence of specific provisions to the contrary, the principles embodied in this Guideline apply also to the audit of other entities.

3. The directors of a company have a statutory responsibility to prepare financial statements which give a true and fair view and comply with the Companies Ordinance. This means that the directors are responsible for the appropriateness of the basic assumptions underlying the financial statements.

4. Statement of Standard Accounting Practice No. 2.101 (SSAP 1) "Disclosure of accounting policies" identifies going concern as one of the fundamental accounting concepts and provides that if financial statements are prepared on the basis of assumptions which differ materially from that concept the facts should be explained in the financial statements.

5. The going concern concept identified in SSAP 1 is that the entity will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and the balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation.

6. Where the going concern basis is no longer appropriate, adjustments may have to be made to the values at which balance sheet assets and liabilities are recorded, to the headings under which they are classified and for possible new liabilities.

7. The auditor of a company has a statutory responsibility to express an opinion as to whether the financial statements give a true and fair view and comply with the Companies Ordinance. When forming his opinion, the auditor needs to consider whether there are reasonable grounds for accepting that the financial statements should have been prepared on a going concern basis. The auditor should therefore be satisfied when planning, performing and evaluating the results of his audit procedures that the going concern basis is appropriate. If, during the course of his audit, the auditor becomes aware of any indications that the going concern basis may no longer be valid, he should carry out the additional procedures outlined in this Guideline. If the auditor's procedures reveal no such indications, it will be reasonable for him to accept that the going concern assumption is appropriate.

8. It is implicit in assessing the foreseeable future that a judgement must be made about uncertain future events. No certainty exists that any entity will continue as a going concern. Hence the auditor's judgement will always involve an assessment, made at the time that the audit report is signed, of the risk that liquidation or enforced substantial curtailment of the scale of operations will occur.

9. While the foreseeable future must be judged in relation to specific circumstances, it should normally extend to a minimum of six months following the date of the audit report or one year after the balance sheet date, whichever period ends on the later date. It will also be necessary to take account of significant events which will or are likely to occur later.

Background

10. A company rarely ceases to carry on business without any prior indications either of inability to meet debts as they fall due or of other problems that raise questions about the continuation of business. The indications may vary in importance depending upon specific circumstances. They may be interdependent and some may only have significance as audit evidence when viewed in conjunction with others. Indeed, it is the cumulative effect of a number of different factors which is most indicative of a company's financial viability. Further, the significance of individual factors may diminish because they are mitigated by other audit evidence. Paragraphs 11 and 12 below list examples of such indications and paragraphs 13 and 14 list examples of mitigating evidence. The lists are not intended to be exhaustive.

11. Indications that a company may be unable to meet its debts as they fall due include recurring operating losses, financing to a considerable extent out of overdue suppliers and other creditors, heavy dependence on short-term finance for long-term needs, working capital deficiencies, low liquidity ratios, over-gearing in the form of high or increasing debt to equity ratios, and under-capitalisation, particularly if there is a deficiency of share capital and reserves. Other matters that could indicate difficulty would include borrowings in excess of limits imposed by debenture trust deeds, default on loan or similar agreements, dividends in arrears, restrictions placed on usual trade terms, excessive or obsolete stock, long overdue debtors, non-compliance with statutory capital requirements, deterioration of relationship with bankers, necessity of seeking new sources or methods of obtaining finance, the continuing use of old fixed assets because there are no funds available to replace them, the size and content of the order book and potential losses on long-term contracts.

12. Indications of problems that raise questions about the continuation of a business and which might lead to an inability to meet its debts might include internal matters, for example: loss of key management or staff, significantly increasing stock levels, work stoppages or other labour difficulties, substantial dependence on the success of a particular project or on a particular asset, excessive reliance on the success of a new product and uneconomic long-term commitments. Alternatively, indications may relate to external matters, for example: legal proceedings or similar matters that may jeopardize a company's ability to continue in business, loss of a key franchise or patent, loss of a principal supplier or customer, the undue influence of a market-dominant competitor, political risks, technical developments which render a key product obsolete, and frequent financial failures of enterprises in the same industry.

13. Indications that the company may be unable to meet its debts might be mitigated by factors relating to alternative means for maintaining adequate cash flows. Such factors include, for example: the ability to dispose of assets or to postpone the replacement of assets without adversely affecting operations, to lease assets rather than purchase them outright, to obtain new sources of finance, to renew or extend loans, to restructure debts, to raise additional share capital, and to obtain financial support from other group companies.

14. Similarly, indications of problems that raise questions about the continuation of business might be mitigated by factors relating to the company's capacity to adopt alternative courses of action, for example, the availability of suitable persons to fill key positions, the likelihood of finding alternative sales markets when a principal customer is lost, the ability to replace assets which have been destroyed, and the possibility of continuing the business by making limited reductions in the level of operations or by making use of alternative resources.

Audit procedures and reports

Procedures

15. In performing the preparatory procedures identified in the Auditing Guideline 3.210 "Planning, controlling and recording", the auditor should consider whether any of the indications of the nature described in paragraphs 11 and 12 above are present.

16. The auditor will not generally need to carry out any specific additional procedures, since he will normally become aware of the matters identified above in the ordinary course of his audit. However, in this context the auditor will be particularly concerned with interim accounts or management information, and consulting with the directors and staff of the company. Such consultations should address not only the current situation but also the future. Where formal forecast and budget systems exist, they should be considered. Where they are not formalised, discussions should be directed to the directors' outline plans, including a comparison of anticipated needs with borrowing facilities and limits. Particular areas of concern will include cash flow and profit forecasts together with a review of margins and the profitability of main activities.

17. Where as a result of these procedures, evidence comes to the auditor's attention that suggests that the company may be unable to continue in business, he should review any factors that may counterbalance that evidence. The review should include further discussions with the directors and may also embrace other work as described in the following four paragraphs. These paragraphs are only indicative of the matters to be considered and are not intended to be exhaustive.

18. Where the directors have developed plans to overcome the company's problems, the auditor should consider the bases on which they have been prepared, consider whether they conform with facts already known to him and compare them with such

independent evidence as is available. If such plans are to have value for audit purposes, they should be specific rather than general and above all be feasible courses of action. The auditor should be aware that the relevance of such plans generally decreases as the time period for planned actions and anticipated events increases. A company which does not provide adequate forecasts and budgets as a matter of course will need to develop such information if it is facing difficulties, although small companies need not be expected to provide the same amount and quality of evidence as large companies.

19. In certain circumstances (for example, where finance is to be provided by third parties or where there are detailed plans to dispose of assets, borrow, restructure debt or increase share capital) the auditor may need to obtain written confirmations from banks or other third parties in order to be able to assess the degree of their commitment.

20. The auditor should consider any professional advice obtained by the directors as to the extent of the company's difficulties and the practicalities of overcoming them. The directors are responsible for obtaining such professional advice and, in addition to advice which the auditor himself may be able to provide, may need to consult others such as bankers, insolvency practitioners and solicitors. In particular, it may be necessary for the directors to obtain legal advice on the consequences of the company continuing to trade while it is known by the directors to be insolvent.

21. Where the company is a member of a group, the auditor should consider the implications of any obligations, undertakings or guarantees which exist between the company and other group members. Consideration should be given both to undertakings or guarantees given by the company and to those received by it. There are many different ways of providing support within a group and a proper understanding of complex agreements may not be possible without legal advice. When considering whether to place reliance on such agreements the auditor has to judge the probability that, in the event that support becomes necessary, it will be forthcoming. He should consider whether the agreements are prima facie legally binding or merely expressions of intent, whether they have been formally approved and minuted, and whether the supporting company is in a position to provide support. He may need to examine the financial statements of other group companies, consult with the management of such companies and, where appropriate, liaise with their auditors. Similar considerations arise where a company is dependent upon the support of another entity, even if no group relationship exists.

22. Having carried out the procedures and review referred to in paragraphs 15 to 21, the auditor can then consider whether he has sufficient evidence on which to reach a decision as to whether it is appropriate that the financial statements should have been prepared on a going concern basis. The evidence considered and the decision reached should be fully documented.

Unqualified audit reports

23. Where the auditor is satisfied that it is proper that the financial statements have been prepared on a going concern basis, no mention of any matters relating to the application of that basis will normally be required in the audit report.

24. There may, however, be rare circumstances where the reader will obtain a better understanding of the financial statements, and of the appropriateness of the basis on which they are prepared, if his attention is drawn to important matters. Examples might include events or conditions, such as operating trends, borrowing facilities or financing arrangements, awareness of which is fundamental to an understanding of the financial statements. In such circumstances, the auditor may decide to refer to these matters in his report as an emphasis of matter in accordance with the Auditing Standard 3.102 "Reporting".

Qualified audit reports

25. Where there is uncertainty about the appropriateness of the going concern basis the auditor should consider the effect of that uncertainty upon the view given by the financial statements. In doing so, he should consider both the adequacy of the disclosure of the uncertainty in the financial statements and the extent of the adjustments that might need to be made to the financial statements in the event that they were not to be prepared on a going concern basis.

26. In particular, the auditor should consider the recoverability and classification of assets, the classification of liabilities and the possibility of new liabilities were the company to cease to be a going concern. For example, there may be a need for provisions or amounts to be written off in respect of stocks and debtors, reclassification of long-term liabilities which become due immediately, provisions in respect of redundancy payments and revaluations of assets at their market values. While it will not

normally be practicable to quantify precisely the extent of the adjustments that would be necessary were the financial statements not to be prepared on a going concern basis, the auditor should form an opinion as to their likely impact on the financial statements.

27. Where the auditor considers that the uncertainty as to the appropriateness of the going concern assumption materially affects the view given by the financial statements, he should qualify his audit report giving a 'subject to' opinion. Materiality should be judged in terms of the extent of the adjustments that would need to be made to the financial statements in the event that they were not to be prepared on a going concern basis. The audit report should refer to the going concern assumption upon which the financial statements have been based, the nature of the related uncertainty and the nature of the adjustments that may have to be made to the financial statements.

28. Where the extent of the adjustments resulting from the uncertainty about the appropriateness of the going concern assumption is so fundamental as to prevent the auditor from forming an opinion on the financial statements, he will need to disclaim an opinion.

29. In rare cases, the auditor may conclude that the evidence indicating that the company is unable to continue in business is so overwhelming that he will wish to qualify on grounds of disagreement. In such cases, he should give an 'except for' or 'adverse' opinion depending on the extent of the adjustments that would be necessary were the financial statements not to be prepared on a going concern basis.

30. The auditor should not refrain from qualifying his report if it is otherwise appropriate, merely on the grounds that it may lead to the appointment of a receiver or liquidator.