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HIGHLIGHTS OF TECHNICAL CLINIC

Going Concern

BY
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The going concern assumption is a fundamental principle in the preparation of financial statements, and the appropriateness of its use is a matter for the auditor to consider on every audit engagement. Singapore Financial Reporting Standard (FRS) 1 requires that management assess the entity's ability to continue as a going concern, whereas Singapore Standard on Auditing (SSA) 570 requires the auditor to evaluate management's assessment and the adequacy of disclosures. Ng Kian Hui, Partner of BDO LLP, facilitated the topic "Going Concern" for a group of practitioners in one of ISCA's monthly Technical Clinics. The main highlights of the discussion are shared here.

Q1 WHAT IS THE POTENTIAL IMPLICATION FOR THE AUDITOR IN SINGAPORE, PARTICULARLY ON THE TOPIC OF GOING CONCERN, AS A RESULT OF THE PROPOSED CHANGES TO THE INTERNATIONAL STANDARDS ON AUDITING?

Singapore Standards on Auditing, which closely follow International Standards on Auditing issued by the International Auditing and Assurance Standards Board, are expected to be revised soon – to improve the auditor's report. And one of the proposed changes to the auditor's report is the requirement for a section on "Going Concern" where the auditor directly comments on the appropriateness of a company's use of the going concern assumption. The new requirement may incorrectly result in the auditor being perceived to be providing a "guarantee" on a company's financial health and viability. In fact, the auditor is forming an opinion on whether the company's financial statements give a true and fair view of its financial position and performance. Thus, in view of the proposed changes, more robust documentation and procedures would be expected from the auditor to support the conclusion in the revised auditor's report, particularly in the audit of a company that has events or conditions that, individually or collectively, may cast significant doubt on its ability to continue as a going concern.

Q2 WHAT IS MOST CHALLENGING FOR THE AUDITOR IN THE REVIEW OF A COMPANY'S USE OF THE GOING CONCERN ASSUMPTION, PARTICULARLY IN THE AUDIT OF SMALL AND MEDIUM-SIZED ENTERPRISES (SMES)?

Most SMEs do not have in place structured working capital management processes. Management of SMEs tends to focus only on

running their businesses and may neglect their companies' working capital positions. Many of them find the preparation of cash flow projections unnecessary and redundant. In a situation where a company is loss making and has been in the red for consecutive years, the auditor may have difficulty trying to evaluate management's assessment on the appropriateness of the going concern assumption. It is not uncommon that some SMEs' management relies on their "experience" to determine the ability of the company to continue as a going concern. In view of the limited information available to the auditors, their working papers may include comments like "The Company has no problem on going concern" or "The directors are also the owners of the company (and) will definitely provide the necessary funding to the company". To aggravate matters, such general assessments may have been accepted by some auditors in the past, and pose challenges for the current auditor to request for more robust evidence including cash flow projections etc.

Q3 IN VIEW OF THE CHALLENGES FACED BY THE AUDITOR IN THE REVIEW OF A COMPANY'S USE OF THE GOING CONCERN ASSUMPTION, PARTICULARLY IN THE AUDIT OF SMES, WHAT SHOULD THE AUDITOR DO AT THE PLANNING STAGE?

SSA 570 para 10 states that when performing risk assessment procedures as required by SSA 315, the auditor shall consider whether there are events or conditions that may cast doubt on the entity's ability to continue as a going concern. Such consideration should include inquiry of management at planning stage for potential indication of going concern issues arising from possible events or conditions that are highlighted in Q4.

Early discussion between management, directors, and those charged with governance (TCWG) would provide the auditor sufficient time to plan, design and implement responses to address the assessed risk(s). Furthermore, management is also informed at an early stage of the audit about the supporting documentation that the auditor requires to evaluate their assessment of the company's ability to continue as a going concern. This would allow management ample time to obtain further supporting documentation or implement a remedial action plan to address the going concern issue.

Q4 WHAT ARE SOME COMMON EVENTS OR CONDITIONS IN THE CURRENT ENVIRONMENT THAT MAY CAST DOUBT ON A COMPANY'S USE OF THE GOING CONCERN ASSUMPTION? AND WHAT FURTHER AUDIT PROCEDURES SHOULD THE AUDITOR PERFORM ON THOSE EVENTS OR CONDITIONS?

Some common events or conditions in the current environment that may cast doubt on the going concern assumption discussed during the Technical Clinic are:

a) Significant fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment;
b) Withdrawal of financial support by creditors;
c) Non-compliance with the terms of loan agreements, and
d) Loss of a major market, franchise, license or principal supplier.

The above is not an exhaustive list and there are other events or conditions that need to be considered

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which are included in SSA 570 para A2.

The existence of one or more events or conditions highlighted in SSA 570 para A2 encountered by auditors during the audit, including the examples earlier, does not necessarily signify that a material uncertainty exists. However, when identified, these events or conditions would prompt the auditor to perform further audit procedures to gather sufficient appropriate audit evidence to confirm or dispel the material uncertainty as well as to consider if there are any mitigating factors. Further audit procedures the auditor should perform where relevant include (but are not limited to) the following:

- Inquire management as to their future action plans. For example, plans to restructure debts, delay or reduce capital expenditure, increase capital or funding through shareholder loans;
- Evaluate management's future action plans and the outcome of these plans to determine if they are feasible and whether they are likely to improve the situation;
- Confirm the existence, legality and enforceability of arrangements with related and third parties to provide or maintain financial support and assess the financial ability of such parties to provide additional funds. For example, if a letter of financial support is obtained from the parent company, the letter must be addressed to the company and signed off by an authorised person who has the right to grant the financial support to the company. In addition, the auditor needs to document the work performed in assessing whether the parent company has the ability to provide the financial support;
- Inquire management as to whether failure to comply with the respective loan covenants will result in immediate demand by the lenders, or changes to the terms on which the finance is made available. Corroborate management representations by obtaining a confirmation from the lender to verify the existence, terms and availability of borrowing facilities;
- Request for cash flow projection from management. Evaluate the reliability of the data, obtain support for the assumptions and discuss the cash flow projection with management;
- Request for the latest management accounts from management and compare them with the financial results for the same period in the year under audit. Inquire management as to any significant increase or decrease in sales and profit/loss for the year and evaluate whether the variance is reasonable. ISCA

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