Seven Myths of the Audit on Going Concern
(Relevant to Paper 8 – Principles of Auditing and Management Information Systems)

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Hong Kong Standard on Auditing (HKSA) 570 (Clarified) – Going Concern deals with the auditor's responsibilities in the audit of financial statements relating to the audited company's management's use of the going concern assumption in the preparation of its financial statements. Seven myths concerning the audit on going concern will be addressed below. This will provide some clarification on the audit approach and procedures adopted by auditors in collecting sufficient appropriate audit evidence to determine the appropriateness of management's use of the going concern basis.

Myth No. 1: Auditors perform going concern evaluation only at the final stage of an audit.

During the planning stage of an audit, auditors are required to perform risk assessment procedures. At that point in time auditors shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In doing so, auditors shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern. These risk assessment procedures help auditors to determine whether the management's use of the going concern assumption is likely to be an important issue, as well as its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and the resolution of any identified going concern issues.

Throughout the audit, auditors shall remain alert for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. When additional audit evidence that affects the auditors' assessment of risk is obtained during the course of the audit, auditors are required to revise their risk assessment and modify the further planned audit procedures accordingly.

If events and conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, auditors shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty[1] exists through performing additional audit procedures, including consideration of mitigating factors. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for the fair presentation of the financial statements.

[1] The phrase "material uncertainty" is used in HKAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements.

At the final stage of an audit, based on the audit evidence obtained, auditors shall conclude whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

Myth No. 2: In the event that the management has not completed an assessment of going concern, auditors are responsible for rectifying this lack of analysis by producing their own detailed analysis.

HKSA 570 (Clarified) states that auditors' responsibilities in respect of the use of the going concern basis in the financial statements prepared by the management are:

(a) 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; and

(b) 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.

Management's assessment of the entity's ability to continue as a going concern is a key part of the auditors' consideration of management's use of the going concern assumption.

It is not the auditors' responsibility to rectify the lack of analysis conducted by management. However, in some circumstances, the lack of detailed analysis conducted by management to support its assessment of the going concern assumption may not prevent the auditors from concluding whether management's use of the going concern assumption is appropriate under the circumstances. For instance, when the entity has a history of profitable operations and a ready access to financial resources, management may make its assessment without conducting a detailed analysis. In this case, the auditors' evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditors' other audit procedures are sufficient to enable them to conclude whether management's use of the going concern assumption in the preparation of the financial statements is appropriate under the circumstances.

In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern may include an evaluation of:

(a) The process that management followed to make its assessment;
(b) The assumptions on which the assessment is based;
(c) Management's plans for future action; and
(d) Whether management's plans are feasible under the circumstances.

Myth No. 3: Auditors are only responsible for expressing an opinion on the financial statements, and thus there is no need to review the client's cash flow forecast.

In order to determine whether or not a material uncertainty exists, auditors shall obtain sufficient appropriate audit evidence. The analysis of the cash flow forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action. Review procedures of the cash flow forecast include:

(a) Evaluating the reliability of the underlying data used in preparing the forecast; and

(b) Determining whether there is adequate support for the assumptions underlying the forecast.

Myth No. 4: For the audit of small entities, auditors can automatically assume that the owner-managers intend and are able to continually support the entity in the foreseeable future.

Continued support by owner-managers is often important to smaller entities' ability to continue as a going concern. Where a small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn.

For example, the continuance of a small entity experiencing financial difficulties may be dependent on the owner-manager subordinating a loan to the entity in favour of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances, auditors may obtain appropriate documentary evidence of the subordination of the owner-manager's loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, auditors may evaluate the owner-manager's ability to meet the obligation under the support arrangement. In addition, auditors may request a <u>written letter of support</u> confirming the terms and conditions attaching to such support, as well as the owner-manager's intention or understanding.

Myth No. 5: If risk assessment procedures have identified events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, auditors could conclude that a qualified opinion should be expressed.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

(a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment;

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances;

(c) Evaluating the reliability of the underlying data generated to prepare the cash flow forecast and determining whether there is adequate support for the assumptions underlying the forecast;

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment; and

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

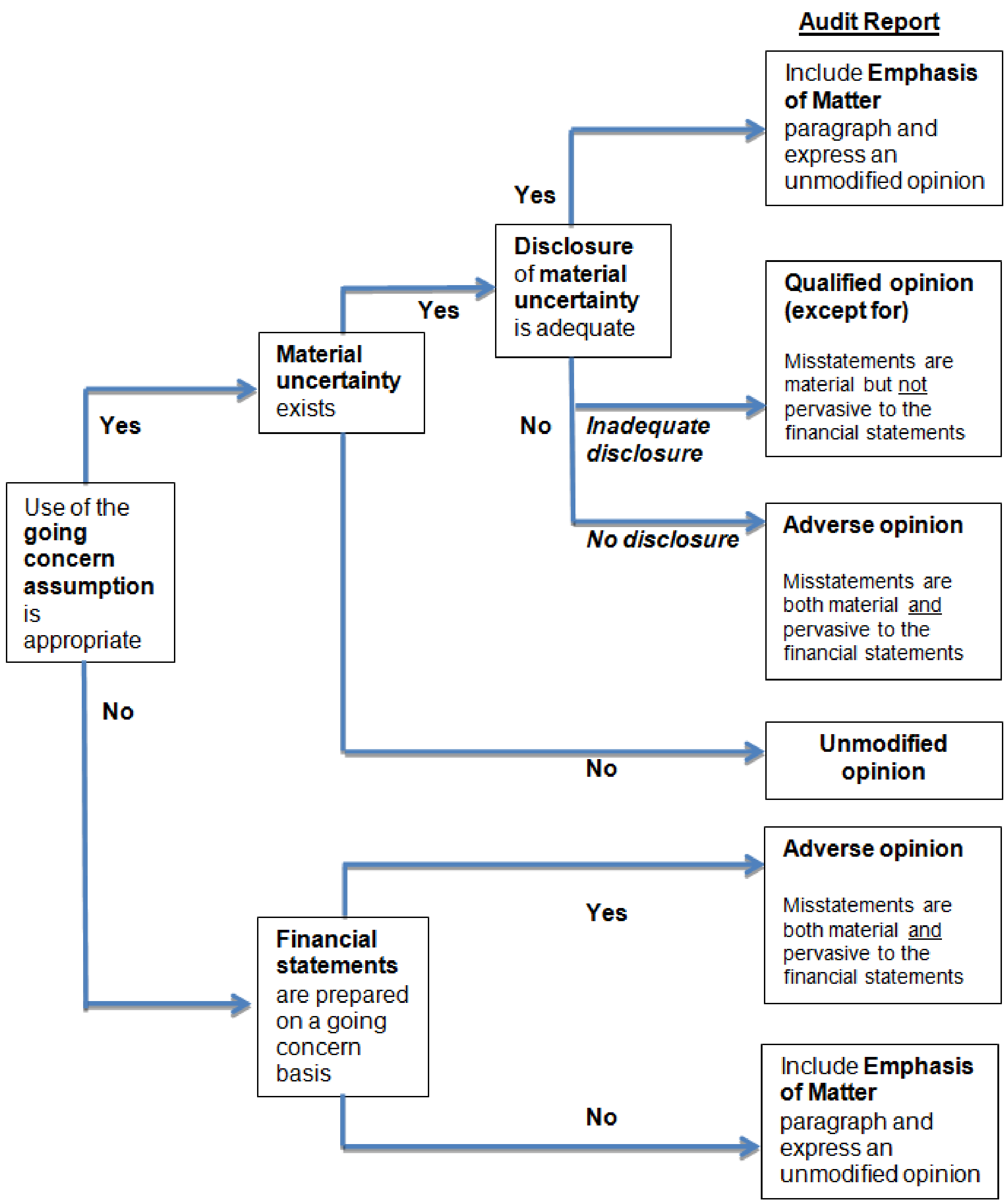
Based on the audit evidence obtained, auditors shall then conclude whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Myth No. 6: The existence of material uncertainty will justify the auditors' expressing an adverse opinion.

The following diagram summarizes the factors considered by auditors before drawing conclusions on their audit opinion. Auditors shall express an adverse opinion only if:

(a) No disclosure is made in the financial statements about the existence of material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern; and

(b) Misstatements are both material and pervasive to the financial statements.



Myth No. 7: The going concern assessment undertaken for financial reporting purposes is intended to provide to the users of the financial statements a guarantee that the entity will remain a going concern until the next accounts are issued.

HKSAs require auditors to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditors have obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditors draw conclusions and base their auditors' opinion being persuasive rather than conclusive.

The potential effects of inherent limitations on the auditors' ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Auditors cannot predict such future events or conditions. Accordingly, the absence of any reference to going concern uncertainty in the auditors' report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

References

HKSA 570 (Clarified) "Going Concern", revised July 2010 by the Hong Kong Institute of Certified Public Accountants

HKSA 200 (Clarified) "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing", revised February 2015 by the Hong Kong Institute of Certified Public Accountants