

Accounting Changes the World, the World Changes Accounting!

(Relevant to Paper I – PBE Financial accounting)

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We have witnessed serious financial turmoil over the last year. No one can say when the economy will reach its worst. We cannot predict it, but we need to face it. We are accountants living in a vibrant economy and we need to adjust and indeed respond to the rapidly changing environment.

The fast-changing economic situation means things change quickly; accounting records have to reflect concerns about assets such as impairments to the value of property, plant and equipment; financial assets; investment property; intangible assets; biological assets; inventories; and trade and other receivables.

As we witness banking bankruptcies in the United States, so we need to assess liquidity issues. Here in Hong Kong, we experienced this back in 1991 with the forced world-wide closure of Bank of Credit and Commerce International, in which many depositors had to write down the value of their bank deposits. Bank facility terms may also affect the classification of assets and liabilities; therefore, these need to be carefully examined before the financial statements are finalized.

Deposits may be used as a charge against such liabilities or bank facilities. Under normal circumstances, these deposits are classified as non-current assets; however, if there are breaches of certain terms in the contract, they

may be used to settle liabilities first. Therefore, judgment on the proper classification cannot be made unless the terms are carefully considered.

Do not leave the other side of the Statement of the Financial Position unattended. A study of provisions in asset impairment should be carried out to assess the impact of the current economic situation in order to ensure proper provisions are recorded according to the business environment.

The current economic environment may mean companies consider disposing of certain group assets. HKFRS5 “Non-current Assets Held for Sale and Discontinued Operations” will need to be studied here.

We present a more detailed discussion of these areas in a series of articles, concentrating on recent and updated points in areas of interest and giving timely and relevant information to assist fellow accountants in making their daily decisions by reference to current practice. We start here by considering one of the fundamental accounting bases: going concern.

Liquidity and going concern

The going concern assumption is one of the generally accepted accounting principles in the preparation of the financial statements. Before proceeding further, let us have some basics from HKAS 1:

“Paragraph 23. When preparing financial statements, management should make an assessment of an enterprise’s ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise’s ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reasons why the enterprise is not considered to be a going concern.

Paragraph 24. In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate can be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.”

Under normal circumstances, we should prepare the financial statements of an enterprise on a

going concern basis; the exception is when we intend to liquidate the enterprise or to cease its operations. However, during the financial crisis, an enterprise may face great challenges and also be unable to continue realizing its assets and discharging its liabilities in the normal course of business. The ability of the enterprise to continue as a going concern is doubtful and need to be carefully analyzed.

As accountants, we need to get familiar with the financial risk management of the enterprise and take instant and appropriate action to minimize its credit risk and liquidity risk. HKFRS 7 “Financial Instruments: Disclosure” paragraphs 36 to 39 set out the disclosure requirements for the financial risk management of these financial risks.

The financial crisis has adversely affected the financial and operating activities of enterprises in the US and other overseas countries. Sales to these countries may be significantly reduced and these overseas customers may ask for more favourable credit terms than before. An enterprise should exercise due care when selecting overseas customers and then regularly monitor the recoverability of receivables. At the same time, it may apply for credit protection from the Export Credit Insurance Corporation or enter into non-recourse financial factoring arrangements on the receivables with banks or other factoring providers. This kind of credit protection or factoring will increase the enterprise’s operating costs but can safeguard its assets and minimize losses if overseas customers go into liquidation.

If the factoring arrangement is with recourse, and the accounts receivable, should still be recognized in the statement of financial position as assets, in question is doubtful to be recovered, an enterprise then will need to

honour the contractual obligation to compensate any default payment by any accounts receivable to the financial institutions involved. Accordingly, accountants and auditors may also need to consider making provision on the accounts receivable being sold to the financial institutions.

As accountants, we should not only focus on the enterprise's financial performance and position, which are historical in nature, but also monitor the undrawn banking facilities, compliance with financial or non-financial covenants and other market factors surrounding the current or expected profitability which may expose the enterprise to liquidity risks. For example, any non-compliance with covenants (e.g. timely submission of the audited financial statements to the bank) stipulated in a loan agreement may trigger the cancellation or freezing of bank facilities. A significant revaluation deficit on pledged properties may mean there is inadequate collateral against the loan and the bank may require the enterprise to pay or discharge the excess of the loan amount over the fair value of the pledged properties according to the terms of the loan agreement.

The financial turmoil has led to banks being more conservative with their loan approvals; this can mean enterprises may face severe liquidity problems. In addition they can face asset impairments, e.g. non-recovery of receivables due to the liquidation of their customers. If this is the case and significant provisions need to be made on the financial statements, care should be taken to see whether the enterprise is breaching its financial covenants as stipulated in loan agreements due to the changes of ratios such as current ratio, gearing ratio, and etc below or higher than the one stipulated in the banking facilities.

If we become aware of a breach of financial or non-financial covenants stipulated in loan agreements, we should take immediate action to liaise with the bank requesting a waiver of strict compliance of the covenants, negotiation and revision of the terms of the loan agreement and/or seeking alternative financing arrangements, for example, by increasing the capital base of the enterprise by issuing of new shares to existing or new shareholders for cash.

If there has been a breach of financial covenant, we should assess whether a non-current bank loan is subject to immediate repayment. If so, the non-current bank loan should be reclassified as a current liability. Then the ratios mentioned may become even worse and the bank may cast serious doubt on the business of the enterprise.

In order to avoid the ripple effect mentioned above, accountants are advisable to keep a monthly calculation of the ratios as stipulated in the banking facilities letter in order to monitor the company's activities and negotiate with the banks when ratios stipulated in financial covenants are with red lights. Early discussion with the existing banks in order to renegotiate the financial covenants for the current financial sentiment would be a good process to avoid any last minute panics.

Certainly, to formulate a back-up plan is also important to get more financial funding to support the operation and settlements of any loans due to the breaches of the financial covenants are also critical for the accountants.

In the next article, focus will be given from the auditors' perspective in relation to the audit procedures and the consideration for issuing auditors' report on the going concern issues.

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