

Getting to grips with going concern



Addressing going concern

By K C Cheng

Despite going through the financial crisis in 1990s and the impact of SARS in the early 2000s, we have not seen such extensive professional, public and regulatory discussion coverage on going concern issues in the past two decades as we have in the first five months in 2009. The message is very clear: accountants and auditors need to sit up and take note of tight cash flows and the dynamic changing world. In this article, we focus on how today's accountants in business should address going concern issues.

Hong Kong case

Here's an example of a recent case from Hong Kong. A Hong Kong listed company Kong had a good profit last year and good interim results in the current period (3.5 times the previous interim profit), and had raised additional funds through a placement of shares within two months of the interim results announcement. Then, suddenly, the company faced a petition for winding up for non-payment for certain debts three months after its interim results announcement.

On review of the financial statements, it was found that the high level of accounts receivable was recorded at the interim period end, with most of them falling due within 30 days to 60

days and representing approximately 45% and 81.5% of total assets and net assets respectively.

Going concern issues

We do not attempt to find out the reasons for the company's failure. The financial crisis probably meant the company faced a shortage of cash, possibly due to the non-recovery of accounts receivable.

The going concern assumption is a fundamental principle in the preparation of financial statements. HKSA 570 "Going Concern" requires the auditors to consider if there are events and conditions and related business risks (ECR) which may cast significant doubt on the company's ability to continue as a going concern. Nonetheless, it is the company's management's primary responsibility to assess and conclude whether the company has the ability to continue as a going concern.

Imagine if you were the auditors of the above listed company. What would you do now to face the challenges if an unqualified review report had been issued? What could the auditors have done to prevent an unqualified report being issued?

However, the most important cue is to

understand your clients' business and their industries. Unique and systematic risks (possibly similar to the ECR mentioned in HKSA 570) are commonly referred to in portfolio and security analysis. It is not easy for auditors to collect this information as dramatic changes in the economy make it more difficult to access updated data.

Practical concerns for accountants and auditors

External (Systematic) risks

Counterparty Risk: Accountants and auditors may need to use their eyes, ears, professional research reports on their customers and even on suppliers to assess the status of their business partners' activities to assess if anything may interrupt the business momentum, therefore affecting the going concern assumption. This is explained in the example quoted in relation to the listed company earlier.

The new FASB Statement No. 165 "Subsequent Events" also requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date.

Government policy: may also impact the going concern assumption. For example, General Motors filed for Chapter 11 protection under the US law to protect the company's restructuring. These days auditors are required to perform more work on the subsequent events as those events may affect the presentation and disclosure of the financial statements. In-house accountants should also assess the impact of any significant subsequent events which may affect the financial statement presentation as well. Again, the above case may give some hints on the importance in reviewing subsequent events.

Banking environment: Late 2008 saw drastic

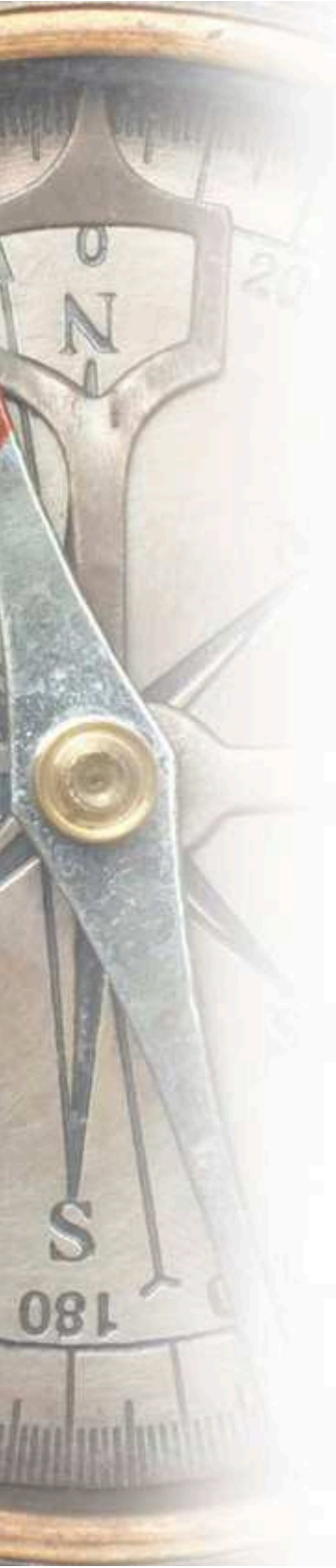
measures by banks reducing the money supply by controlling bank borrowings and not releasing funding for undrawn banking facilities. This is a major problem that borrowers need to address. Paragraph 50 of HKAS 7 "Cash Flow Statements" requires an entity to disclose additional information relevant to users in understanding the financial position and liquidity; this may include the disclosure of any amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions of the use of these facilities. We seldom see comments relating to the above restriction in mainland Chinese loan agreements; maybe, it is not a written national policy. However, these banking policies and austerity measures may also affect an entity's ability to continue as a going concern.

Internal

Operation risk: Timothy Flynn, chairman of KPMG International, recently advised major international corporations to do a thorough and comprehensive review of their business models, operations, compensation incentive packages, and, more importantly, risk management status. This is the best way to address the issues facing business today, especially listed companies, which owe a public duty to stakeholders. The non-sustainable business model may cause the auditors to cast significant doubt about the ECR of an entity. Therefore, the above recommendation should be seriously considered. Management should prepare cash flow forecast and calculation of various financial ratios as tools to assess the going concern assumption.

Debt covenant: If there has been a breach of financial covenant, auditors 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. The change may put the company into a net current liability position and this should draw immediate attention to the appropriateness in applying the going concern assumption in the preparation of the financial statements and the relevant disclosures. In-house accountants should implement a system to identify such breaches and fix them immediately. HKFRS 7 paras 18 and 19 require disclosures in financial statements in event of any defaults and breaches unless such a breach is remedied before the reporting period end.

In fact, during the negotiation of new debt covenant, flexibility should be built in to fix such breaches in maintaining certain levels of the financial ratios. For example, when there is case of breach of any debt covenant terms in relation to the financial ratios, the company should immediately inform the bank(s) and fix it within 30 days. The bank(s) should not take any action after the fixing of the ratios within the grace period. Again, it depends on the bargaining power with the lenders and it is worthwhile trying to include such terms to protect the borrower.

Refinancing issue: If existing banks will not grant a waiver for a breach of financial ratios, the borrower has to refinance the loan immediately. If no new loan can be secured to replace the current loan, the borrower may face a petition for winding up and thus the going concern assumption is likely to be challenged.

Valuation of non-financial assets and liabilities: An economic downturn has a negative impact on the valuation of land, equipment, intangible assets (customer lists,

goodwill, etc). This may make a company's financial position and performance even worse and contribute to more challenges to the appropriateness of the going concern assumption.

The above is not an exhaustive list for readers to use in considering the going concern assumption, but these highlights do give some practical considerations for accountants and auditors. The continuing evaluation of the going concern assumption is necessary. It is definitely not a year-end exercise only as, from practical point of view, the going concern disclosure and/or a modified auditors' report will affect the continuation of borrowing and the cost of future borrowing. Therefore, it is a very serious topic.

New development

In 2009, the US Financial Accounting Standard Board discusses to make an accounting standard: Going Concern which is currently set forth in auditing literature. Most notably, the draft requirement to assess going concern for a 12 month period is being changed to align it more closely with international standards, which do not have a 12 month bright line.

The implication is that auditors and accountants should be responsible for assessing the going concern assumption when preparing the financial statements.

In order to use its resources better, an entity may look into selling some non-current assets or discontinuing certain operations. In the next issue we will look into the classification of these assets and some interesting discussions in relation to the HKFRS5: Non-current Assets Held for Sale and Discontinued Operations.