

Evaluating Going Concern

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Quote

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Caryn is CA(SA and RA, who lectured extensively at UKZN (and other institutes) specialising in Advanced Financial Accounting. Subsequently, Caryn specialised in facilitating Ethics conversations, keeping assurance practitioners updated and unpacking legislation for the financial sector.

Caryn has conducted training for accountants since 2006 on various topics and has consulted on a number of technical issues. Since January 2011, Caryn has focussed on being a technical freelance consultant and trainer to the accounting profession.

Caryn has worked extensively with analysts, directors and other users of financials to interpret, prepare, analyse and forecast information based on these financials.



Course Outline

During this course we will look at:

- Going concern defined.
- The Conceptual Framework for financial reporting.
- The Companies Act - Solvency and liquidity.
- Disclosure of going concern.
- International Standards on Auditing relating to auditor reporting.

Module 1: Defining Going Concern




Defining Going Concern

The going concern principle is that a business will continue to operate for the foreseeable future

The rule of thumb test is normally 12 months after sign off date.


Question: What is I am signing off financials from 2020, in 2023?



Going Concern

[ˈgō-ɪŋ kən-ˈsɜrn]

An accounting term for a company that has the resources needed to continue operating indefinitely until it provides evidence to the contrary.

 Investopedia

Why is it important?

Going concern is important because it is a signal of trust about the longevity and future of a company.

Users are relying on the financials to make decisions that affect the future

Consider who are the users/stakeholders of the business?

- Each user has a reason why the business' going concern is important

It is a fundamental concept in preparing financial statements

Module 2: What are the risks to the businesses Going Concern



Understanding the General Environment

Knowing the environment that the business operates in, is critical

- Political
- Economic
- Regulatory
- Trends
- Impact of Climate Change
- International affairs
- Industry challenges
- Technology and Innovation
- Customer base

Mitigating Factors

Possible mitigating factors to consider include, but are not limited to:

- Capital infusion from new and existing investors
- Modification to debt obligations requirements
- Rent abatements negotiated
- Cost saving strategies
- Re-engineering of procedures
- Negotiating better pricing with vendors
- Restructuring Sales Prices
- Streamlining of costs
- Closing non-performing stores/divisions/branches

Red Flags to consider

FINANCIAL FACTORS

- Net liabilities or current liabilities
- Borrowings due
- Withdrawal of creditor support
- Negative cash flow
- Adverse ratios
- Operating losses
- Dividends in arrears
- Unable to pay creditors
- Credit to COD
- Unable to obtain financing
- Assessed losses

OPERATING FACTORS

- Intention to liquidate
- Loss of key management
- Loss of market, customer, supplier, etc.
- Labour difficulties
- **Supply shortage**
- **New competitor**

Red Flags to consider

OTHER FACTORS

- Non-compliance with legal requirements
- Pending litigation
- Changes in laws and regulations
- **Underinsured catastrophes**

Assessing future conditions

When assessing future conditions, both quantitative and qualitative information

Factors to weigh may include:

- Key industry financial metrics
- Operating results
- Future obligation and liquidity
- Covenant compliance
- Forecasted net cash flows from operations
- Capital expenditure commitments

Ratios to Consider

- Liquidity Ratio
 - Current ratios
 - Quick ratio
- Asset Management
 - Inventory Turnover
 - Days Sales Outstanding
 - Asset turnover (asset/sales)
- Debt Management
 - Debt : Equity
 - Debt : Asset
 - Times Interest Earned
- Profitability
 - Net Profit
 - Gross Profit
 - Return on Assets
 - Return on equity
 - Cash flow to Debt
- Market value ratios
 - Market to book value
- Cash flow analysis

Module 3: Companies Act Considerations



Sections to consider

- Section 4 Solvency and Liquidity
 - Section 22 Reckless Trading
 - Business Rescue – Financial Distress
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- Operating results
 - Future obligation and liquidity
 - Covenant compliance
 - Forecasted net cash flows from operations
 - Capital expenditure commitments

Section 4 Solvency and Liquidity

Section 4(1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering *all reasonably foreseeable financial circumstances* of the company at that time—

- (a) the assets of the company, as **fairly valued**, equal or exceed the liabilities of the company, as fairly valued; and
- (b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—
 - (i) 12 months after the date on which the test is considered; or
 - (ii) in the case of a distribution contemplated in paragraph (a) of the definition of “distribution” in section 1, 12 months following that distribution

Insolvency Tests

- Factual insolvency
 - Liabilities exceed its assets
- Commercial insolvency
 - Cannot pay debts as and when they fall due (liquidity)
 - Boschpoort Ondernemings (Pty) Ltd v Absa Bank Ltd (936/12) [2013] ZASCA 173 (28 November 2013)

Section 4 Solvency and Liquidity

Practically what does this mean??

“all reasonably foreseeable financial circumstances”

Distributions

Financial Assistance

Share buy backs

S22 Reckless Trading

(1) A company must not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

(2) If the Commission has reasonable grounds to believe that a company is

- engaging in conduct prohibited by subsection (1), or
- is unable to pay its debts as they become due and payable in the normal course of business,
- the Commission may issue a notice to the company to show cause why the company should be permitted to continue carrying on its business, or to trade, as the case may be.

(3) If a company to whom a notice has been issued in terms of subsection (2) fails within 20 business days to satisfy the Commission

- that it is not engaging in conduct prohibited by subsection (1), or
- that it is able to pay its debts as they become due and payable in the normal course of business,
- the Commission may issue a compliance notice to the company requiring it to cease carrying on its business or trading, as the case may be.

S22 Reckless Trading

Bellini v Paulsen and others
(17096/209) 2012 ZAWCHC 199 (28 Nov 2012)

- Contravention of the Act: personal liability
- When is a business person reckless?
- “... The defendant, with reckless disregard of his duties, allowed this situation to continue... ..well knowing that the company had no assets and no way of servicing the debt.”

Financial Distress

- It appears to be reasonably unlikely
- That the company will be able to pay all of its debts
- As they become due and payable
- Within the immediately ensuing 6 months
- OR
- Become factually insolvent in the impending 6 months

Directors Responsibilities

- S4 Solvency and Liquidity Test
- Maintain accounting records (S28)
- Financial Statements (S29 and S30)
- Declaration of personal interests (S75)
- Act with fiduciary care (S76)
- Consider business rescue if in financial distress S129(7)

Ratios to Consider

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Module 4: Financial Accounting Considerations



Sections to consider

- Section 4 Solvency and Liquidity
 - Section 22 Reckless Trading
 - Business Rescue – Financial Distress
-
- Operating results
 - Future obligation and liquidity
 - Covenant compliance
 - Forecasted net cash flows from operations
 - Capital expenditure commitments

Basis of Preparation

- Preparing on the going concern basis
- How do you prepare on liquidation basis?
 - Voluntary?
 - Forced?
- Liquidation basis
 - What values do you measure the assets and liabilities at?
 - Accounting policy notes?

Going Concern Note

- In the Directors Report

The annual financial statements have been prepared on the basis of accounting policies applicable to a going concern. The basis presumes that funds will be available to finance future operations and that the realisation of assets and settlement of liabilities, contingent obligations and commitments will occur in the ordinary course of business.

The directors believe that the company has adequate financial resources to continue in operation for the foreseeable future and accordingly the annual financial statements have been prepared on a going concern basis. The directors have satisfied themselves that the company is in a sound financial position and that it has access to sufficient borrowing facilities to meet its foreseeable cash requirements. The directors are not aware of any new material changes that may adversely impact the company. The directors are also not aware of any material non-compliance with statutory or regulatory requirements or of any pending changes to legislation which may affect the company.

Going Concern Note

- In the Financial Statements

The financial statements have been prepared on the basis of accounting policies applicable to a going concern. This basis presumes that funds will be available to finance future operations and that the realisation of assets and settlement of liabilities, contingent obligations and commitments will occur in the ordinary course of business.

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Accounting issues to pay attention too

- **Valuation assumptions and techniques**
- Financial instruments
- Impairments of monetary and non monetary assets
 - indicators
- Fair values
- Recoverability of financial assets
- Risk disclosures
- Property plant and equipment
- Subordination agreements
- Letters of comfort vs letters of support
- Related party transactions
- Deferred tax assets
- Provisions
- Intangibles (GW)
- Loan covenants
- Securities etc

Module 4: Assurance Implications of Going Concern



Exercise Professional Skepticism

- Being alert to:
 - Contradictions
 - Unreliable documentation
 - Fraud conditions
 - Additional procedures
- To reduce risk of:
 - Overlooking unusual circumstances
 - Over generalising
 - Inappropriate assumptions
- By:
 - Critical assessment
 - Avoiding overreliance on past experiences

Exercise Professional Judgement

- Competence from:
 - Training
 - Knowledge
 - Experience
- How evaluated:
 - To known facts and circumstances
 - Of audit and accounting principles
 - Competent application
 - Documentation

Going Concern

- Management's assessment – When performing risk assessment procedures:
 - Management assessed
 - Management did not assess
 - Request assessment
- Events and conditions identified
 - Evaluate management assessment
 - If events identified
 - At least 12 months
 - Period beyond assessment
- Going concern applicability
- Auditor response

Audit Report and KAMs

- Matters relating to going concern:
 - Including “close calls”
 - May be determined to be KAM and communicated in the auditor’s report in accordance with the new ISA 701
- When a material uncertainty related to going concern exists:
 - By nature it is a KAM
 - But is reported separately in the “Material Uncertainty Related to Going Concern” section of the auditor’s report

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ISA 570 (Revised) Going Concern

- Assessing material uncertainty regarding going concern
 - Fundamental concept of accounting
 - Challenge in current times
 - Management need to assess and comment on in AFS
- Auditors responsibility per ISA570 para 6
 - Obtain appropriate and sufficient evidence of management's use of going concern in prep of AFS
 - Conclude whether a material uncertainty exists
 - Absence of an assessment by the auditor should not be seen as a guarantee that the entity has no going concern challenges

Example of impact of Going Concern on Audit Report

- As part of an unqualified report

“Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company’s current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. Our opinion is not modified in respect of this matter.”

Reportable Irregularities and NOCLAR

- APA Section 45
- Companies Act Independent Review
- NOCLAR
- Effect on Accounting Officer

QUESTIONS?



THANK YOU!

