Sudit K. Parekh & Co. LLP
Chartered Accountants

Going Concern
Responsibilities of Management and Auditor’s Reporting

A fundamental decision management must make when preparing financial statements is whether to prepare them on a going concern basis. Under the going concern basis, financial statements are prepared assuming that the company will continue its operations for the foreseeable future.

When is going concern assumption appropriate?

An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or cease trading or has no realistic alternative but to do so. This could be due to factors such as the loss of key managerial personnel without replacement, the inability to obtain finances, adverse key financial ratios, or a combination of these or other factors.

When management is aware in making its assessment of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties.

When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

The auditor's role is to assess the management's basis for preparing financial statements and the necessary disclosure that provides relevant and reliable information. Auditors are guided by the principles of Standards on Auditing (SA) 570 or International Standards on Auditing (ISA) 570.

Disclosure requirements of Ind AS 1

Whether or not to prepare the financial statements on a going concern basis is a binary decision. However, the circumstances in which entities prepare the financial statements on a going concern basis will vary widely.

The circumstances could range from when an entity is profitable and has no liquidity concerns to when it is a 'close call' to prepare the financial statements on a going concern basis, even after considering any mitigating actions planned by the management. Therefore, disclosures are a key.

As per Ind AS 1, the following disclosures are required

- Disclosure of material uncertainties relating to an entity's ability to continue as a going concern.
- Disclosure relating to judgments that have the most significant effect on the amounts recognized in the financial statements.

Going concerns related information in financial statements and independent auditor's report

As a reader of the financial statements, information about going concern can be found at various places:

- In the notes to accounts, the basis for preparation of the financial statements section describes whether the financial statements are prepared on a going concern basis.
- For Ind AS-compliant companies, a section of the notes to accounts that describes the judgments may refer to the management judgment to conclude that there are no material uncertainties relating to going concern.
- An indicator but not the sole contributing factor could be negative cash flows from operating activities. This would indicate that the company has not been able to generate cash from its operations and there might be a threat to the going concern.

- Independent auditor's report might include a reference to the above disclosures by way of an 'Emphasis of matter paragraph' or 'Material uncertainties relating to going concern' as appropriate. Different scenarios where these might be appropriate are described below.

- Independent auditor's reporting on Companies (Auditor's Report) Order, 2020 (CARO 2020) would describe the auditor's opinion regarding material uncertainties surrounding the company's ability to pay the liabilities falling due in the next year.

In this article, we cover the spectrum of scenarios surrounding going concern. At one end, are the companies that can very easily assess that they are going concern, and at the other end, are the companies who have ceased to be a going concern. In between are scenarios often referred to as 'close call' situations. Below is the overview of the scenarios:

- **Scenario 1:** No significant doubts about going concern (For instance, profitable operations, accumulated profits, positive cash flows)

- **Scenario 2:** Significant doubts about going concern but mitigating actions judged sufficient to make going concern appropriate. The entity determines no material uncertainties (For instance, loss-making entities but with a revival plan already in place and the management has started executing a turnaround strategy that is showing positive signs)

- **Scenario 3:** Significant doubts about going concern. Material uncertainties about going concern remain after considering mitigating actions. (For instance, loss-making entities, a turnaround strategy yet to be executed)

- **Scenario 4:** Intends to liquidate or to cease trading, or no realistic alternative but to do so.

Each scenario along, with the impact on financial statements and auditor's report, are detailed below:

Scenario 1: No significant doubts about going concern

A Ltd. is an entity that has profitable operations and has no liquidity concerns, and for which there are no significant doubts about its ability to continue as a going concern.

Analysis of Scenario 1

For such a company, apart from the need to describe the basis of preparation, there are no specific disclosure requirements relating to going concern. It is also less likely that significant judgments were involved in concluding to prepare the financial statements on a going concern basis.

Deliverable

- **Preparation of the financial statements:** On a going concern basis.

- **Disclosure:** No specific disclosure, since going concern is a fundamental accounting assumption and does not require a specific disclosure if followed.
  OR
  An explicit disclosure stating that the going concern assumption is appropriate may be made.

- **Impact on the audit report:** No specific impact.

Scenario 2: Significant doubts about going concern but mitigating actions judged sufficient to make going concern appropriate entity determines no material uncertainties

B Ltd. is a loss-making entity, demand for its products has decreased rapidly and its funding facilities are due to expire in the next 12 months.

Management has started executing a turnaround strategy that shows sufficient evidence of success including identifying feasible alternative sources of financing. After considering the feasibility and effectiveness of the planned actions, management concludes that the material uncertainties are expected to be mitigated.

Analysis of Scenario 2

Management has concluded that it is appropriate to prepare financial statements on a going concern basis. Disclosures regarding material uncertainty will not be required. Although, the turnaround strategy has been showing sufficient evidence of success. However, it has yet to achieve all its goals. Hence, the management's conclusion that there are no material uncertainties would have involved a significant judgment. Therefore, according to Ind AS 1, the disclosure relating to these judgments would be required as per Ind AS 1.

Disclosures as per Ind AS 1, will also be required for the assumptions the management makes about the future and other major sources of estimation uncertainty at the end of the reporting period.

Deliverable

- **Preparation of the financial statements:** On a going concern basis.
- **Disclosure:** Disclosure relating to judgments made in concluding that no material uncertainty exists (Required as per Ind AS 1, no specific requirements under the AS)
- **Impact on the audit report:** No specific impact
- **Note for Listed Companies:** When the auditor concludes in accordance with SA 570 that no material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor may nevertheless determine that one or more matters relating to this conclusion arising from the auditor's work effort under SA 570 are Key Audit Matters (KAM). For example, this may include so-called 'close call' situations, as contemplated in paragraph 20 of SA 570.
- **Note for Ind AS Companies:** If, as required by Ind AS 1, the company has provided disclosures regarding significant judgments in the financial statements, the auditor may include an Emphasis of Matter paragraph in his report to draw the user's attention to such disclosures.

Scenario 3: Significant doubts about going concern. Material uncertainties about going concern remain after considering mitigating actions

C Ltd. is a loss-making entity. The demand for its products has decreased rapidly, and its funding facilities are due to expire in the next 12 months.

After considering all relevant information, including the feasibility and effectiveness of planned actions, management has concluded that preparing the financial statements on a going concern basis is appropriate.

Nonetheless, management concludes there are material uncertainties relating to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. This is because there are considerable uncertainties about management's ability to execute its turnaround strategy to address the reduced demand and to renew or replace funding.

Analysis of Scenario 3

Management has concluded that it is appropriate to prepare the financial statements on a going concern basis.

Disclosures regarding material uncertainty will be required in addition to disclosures described in Scenario 2.

Deliverable

- **Preparation of the financial statements:** On a going concern basis with disclosures relating to material uncertainty.
- **Disclosure:** Disclosures relating to material uncertainty in addition to disclosures described in Scenario 2.
- **Impact on the audit report:** The auditor's report is to include a separate paragraph, 'Material uncertainty related to Going Concern'. This paragraph will not amount to a modified opinion.
  However, if the financial statements do not provide adequate disclosures as required above, the auditor should modify his opinion on financial statements by issuing a qualified or adverse opinion as appropriate.

Scenario 4: Intends to liquidate or to cease trading or no realistic alternative but to do so

D Ltd. is a loss-making entity. Demand for its products has decreased rapidly, and its funding facilities are due to expire in the next 12 months.

After considering all relevant information, including the feasibility and effectiveness of planned actions, management has concluded that preparing the financial statements on a going concern basis is inappropriate.

Analysis of Scenario 4

AS and Ind AS explain that the going concern basis of preparation is no longer appropriate when management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

Therefore, the entity should prepare its financial statements on an alternate basis, for example, a liquidation basis.

Deliverable

- **Preparation of the financial statements:** This cannot be on a going concern basis but on an alternate basis, for example, a liquidation basis. Disclose the basis of preparation.
- **Disclosure:** The basis for preparation fact that the going concern assumption is not valid.
- **Impact on the audit report:** The emphasis of the matter paragraph is to draw the attention of users to the above disclosures. However, the auditor should issue an adverse opinion, if the auditor determines that
  - Another basis of accounting is not acceptable in the circumstances and has a pervasive effect or
    Financial statements are prepared on a going concern basis when it is not appropriate to do so.
- If disclosures for the basis of accounting are inadequate the auditor may issue a qualified or adverse opinion as appropriate.

Other takeaways

Startups and companies in the early stage of growth

These companies would generally have a threat looming in terms of accumulated losses or difficulties in obtaining finances. Management needs to make a detailed assessment of the company's ability to continue as a going concern. They can support these assessments with the help of cash flow forecasts, order books, and plans for obtaining finances. The auditor would perform procedures to determine whether the management's use of going concern is appropriate.

Impact of support from promoters/parent company and their financial soundness

In private companies with a negative net worth, auditors are very likely to question the appropriateness of the management's use of going concern assumption. In many cases, the management still makes a case for the company being a going concern based on the availability of financial support from the promoters or the parent company. In such cases, auditors generally ask the company to call for a support letter and they also assess the financial soundness of the promoter/parent company by perusing their financial statements and audit reports.

Representations and discussions with those charged with governance

A general representation from the management regarding its assessment of the entity's ability to continue as a going concern will be required in all cases.

In the non-standard cases, auditors would additionally request specific representations, such as regarding the estimates used in cash flow projections and plans to raise finances. These would additionally also involve discussion with those charged with governance.

External and internal factors COVID-19 scenario

The business environment is dynamic and brings challenges. A situation like COVID-19 caused a lot of disruptions that were not quite anticipated. During COVID-19, going concern assessment was tricky and almost every company described the impact the pandemic had and was likely to have on the business. Management should consider these factors while making going concern assessments. The emergence of a strong competitor and products becoming obsolete due to technology can all pose a risk to the going concern assumption and should be suitably incorporated in the assessment. The level of detailed assessment required for each company would vary. For profit-making companies with an order book, such an assessment could be an easier task, but not for other companies that do not have accumulated profits or are operating in a highly regulated or dynamic environment.

Auditors act as a second layer to the management assessment to ensure that readers of financial statements receive information that has been independently verified. However, having said that, since the future is not predictable, there are limitations to the management's assessments and the auditor's procedure.

Over a period though, reporting requirements have increased and judgment calls have been monitored and scrutinized in the interest of the readers of the financial statements.

Sudit K. Parekh & Co. LLP

Chartered Accountants

GET OUR INSIGHTS IN YOUR MAILBOX

Subscribe to our newsletter today for more insights, thought leadership publications, and success stories to help you better navigate complex business challenges.

communication@skparekh.com

Mumbai
Pune
Hyderabad
Gurugram
Bengaluru

www.suditkparekh.com

skpco.info@skparekh.com

Disclaimer

The contents of this presentation are intended for general marketing and informative purposes only and should not be construed to be complete. This presentation may contain information other than our services and credentials. Such information should neither be considered as an opinion or advice nor be relied upon as being comprehensive and accurate. We accept no liability or responsibility to any person for any loss or damage incurred by relying on such information. This presentation may contain proprietary, confidential or legally privileged information and any unauthorised reproduction, misuse or disclosure of its contents is strictly prohibited and will be unlawful.